AU BLR
American University Business Law Review

Volume 8 • 2019 • Issue 2

* * *

The *American University Business Law Review* is published three times a year by students of the Washington College of Law, American University, 4300 Nebraska Avenue, NW, Suite CT11 Washington, D.C. 20016. Manuscripts should be sent to the Senior Articles Editor at the above listed address or electronically at blr-sae@wcl.american.edu.

The opinions expressed in articles herein are those of the signed authors and do not reflect the views of the Washington College of Law or the *American University Business Law Review*. All authors are requested and expected to disclose any economic or professional interests or affiliations that may have influenced positions taken or advocated in their articles, notes, comments, or other materials submitted. That such disclosures have been made is impliedly represented by each author.

Subscription rate per year is the following: $45.00 domestic, $50.00 foreign, $30.00 alumni, and $20.00 single issue. Periodicals postage is paid at Washington, D.C., and additional mailing offices. The Office of Publication is 4300 Nebraska Avenue, NW, Suite CT11, Washington, D.C. 20016. The Printing Office is Sheridan PA, 450 Fame Avenue, Hanover, Pennsylvania 17331. POSTMASTER: Send address changes to the *American University Business Law Review*, 4300 Nebraska Avenue, NW, Suite CT11, Washington, D.C. 20016.

Subscriptions are renewed automatically on expiration unless cancellation is requested. It is our policy that unless a claim is made for nonreceipt of the *American University Business Law Review* issues within six months of the mailing date, the *American University Business Law Review* cannot be held responsible for supplying those issues without charge.

Citations conform generally to *The Bluebook: A Uniform System of Citation* (20th ed. 2015).
To be cited as: 8 AM. U. BUS. L. REV.

American University Business Law Review
Print ISSN 2168-6890
Online ISSN 2168-6904

© Copyright 2019 American University Business Law Review

AMERICAN UNIVERSITY BUSINESS LAW REVIEW

VOLUME 8 • 2018-2019

LUCY KELLY
Editor-in-Chief

BIANCA PETCU
Managing Editor

ERICA HUGHES
Executive Editor

MARSHA RICHARD
Associate Managing Editor

STEPHANIE LEACOCK
Technical Editor

KIARRA STROCKO
Business & Marketing Editor

AMY D'AVELLA
Senior Articles Editor

MAXIMILIAN RAILEANU
Senior Note & Comment Editor

JOHN SPENCER SANDERS II
Symposium Editor

Articles Editors
ADRIENNE GREENBERG
BRIANNA SCHACTER

Note & Comment Editors
BRITTNEY HALL
STEPHEN KEEGAN
THEODORE SOTLAND
ROBERT TAPPARO
MAXWELL TERHAR

Senior Staff

GENEVIEVE BRESNAHAN
SARA DALSHEIM

ZAC JOHNSTON
MARIE CLAIRE O'LEARY

NAZ PAHLEVANI
MARIELENA REYES
CHRISTIAN ROJAS

Junior Staff

NASHRAH AHMED
AMADEA ANILE
SOFYA BAKRADZE
KAITLYN BELLO
MONICA CARRANZA
FAIZA CHAPPELL
KATHLEEN DUFFY
ELIZABETH FARLEY
MICHAEL FARMER
GEORGE GELINAS
SHANNON GOUGH
JENNA HERR
JONATHAN HUIE
MARIAM JAFFERY
JESSICA JOHNSON
CHRIS KATSANTONIS
ALLEN KOGAN
ROBERT LACKEY
ALEXIS LILLY
CARLOS MICAMES
AMI PATEL
HALIE PEACHER
DIVYA PRASAD
BETHANIE RAMSEY
SARAH RAVITZ
IAN ROBERTSON
JENNA RUSSELL
JAMIE SALAZER
HOLLY SANTAPAGA
JASMINE SANTOS
SYDNEY SHUFELT
LEON STERN
DANIEL TILLMAN
CAROLINE WHITLOCK


AU
BLR

AMERICAN UNIVERSITY
WASHINGTON COLLEGE OF LAW FACULTY

Administration

Camille A. Nelson, B.A., LL.B., LL.M., *Dean of the Washington College of Law*
Susan D. Carle, A.B., J.D., *Vice Dean of the Washington College of Law*
Brenda V. Smith, B.A., J.D., *Senior Associate Dean for Faculty and Academic Affairs*
Jayesh Rathod, A.B., J.D., *Associate Dean for Experiential Education*
*Billie Jo Kaufman, B.S., M.S., J.D., *Associate Dean for Library and Information Resources*
David B. Jaffe, B.A., J.D., *Associate Dean for Student Affairs*
Jonas Anderson, B.S., J.D., *Associate Dean for Scholarship*
William J. Snape III, B.A., J.D., *Assistant Dean for Adjunct Faculty Affairs*
Robert Campe, B.A., M.B.A., *Assistant Dean for Finance, Administration and Strategic Planning*
Hilary Lappin, B.A., M.A., *Registrar*
Akira Shiroma, B.A., J.D., *Assistant Dean for Admissions and Financial Aid*
Randall T. Sawyer, B.A, M.A., *Assistant Dean for External Relations*
Elizabeth Boals, B.S., J.D., *Assistant Dean for Part-Time and Online Education*

Full-Time Faculty

David E. Aaronson, B.A., M.A., Ph.D., The George Washington University; LLB, Harvard University; LL.M, Georgetown University. *B. J. Tennery Professor of Law and Director of the Stephen S. Weinstein Trial Advocacy Program*
Padideh Ala'i, B.A., University of Oregon; J.D., Harvard University. *Professor of Law, Faculty Director of the International Legal Studies Program, and Director of the Hubert Humphrey Fellowship Program*
Hilary Allen, B.A., University of Sydney, Australia; BL (LLB) University of Sydney, Australia. LL.M Georgetown University Law Center. *Associate Professor of Law*
Jonas Anderson, BS, University of Utah; J.D., Harvard University. *Professor of Law and Associate Dean of Scholarship*
*Kenneth Anderson, B.A., University of California-Los Angeles; J.D., Harvard University. *Professor of Law*
Jonathan B. Baker, A.B., J.D., Harvard University; M.A., Ph.D., Stanford University. *Research Professor of Law*
Susan D. Bennett, B.A., M.A., Yale University; J.D., Columbia University. *Professor of Law*
Barlow Burke Jr., A.B., Harvard University; LLB, MCP, University of Pennsylvania; LL.M, SJD, Yale University. *Professor of Law and John S. Myers and Alvina Reckman Myers Scholar*
Susan D. Carle, A.B., Bryn Mawr College; J.D., Yale University. *Professor of Law and Vice-Dean*
Michael W. Carroll, A.B., University of Chicago; J.D., Georgetown University. *Professor of Law and Director of the Program on Information Justice and Intellectual Property*
Janie Chuang, B.A., Yale University; J.D., Harvard University. *Professor of Law*
Mary Clark, A.B., Bryn Mawr College; J.D., Harvard University, LL.M, Georgetown University. *Professor of Law and Interim Provost*
Llezlie Green Coleman, A.B., Dartmouth College; J.D., Columbia University. *Associate Professor of Law*
John B. Corr, B.A., M.A., John Carroll University; Ph.D., Kent State University; J.D., Georgetown University. *Professor of Law*
Jennifer Daskal, B.A., Brown University; B.A., M.A., Cambridge University; J.D., Harvard University. *Associate Professor of Law*
Angela Jordan Davis, B.A., Howard University; J.D., Harvard University. *Professor of Law*
Robert D. Dinerstein, A.B., Cornell University; J.D., Yale University. *Professor of Law and Director of Clinical Programs*
N. Jeremi Duru, B.A., Brown University; MPP, J.D., Harvard University, *Professor of Law*
*Walter A. Effross, A.B., Princeton University; J.D., Harvard University. *Professor of Law*
Lia Epperson, B.A., Harvard University; J.D., Stanford University. *Professor of Law*
*Christine Haight Farley, B.A., State University of New York, Binghamton; J.D., State University of New York, Buffalo; LL.M, JSD, Columbia University. *Professor of Law*
Susan D. Franck, B.A., Macalester College; J.D., University of Minnesota; LL.M, University of London. *Professor of Law*
Amanda Frost, B.A., J.D., Harvard University. *Professor of Law*
Robert K. Goldman, B.A., University of Pennsylvania; J.D., University of Virginia. *Professor of Law and Louis C. James Scholar*
Claudio M. Grossman, Licenciado en Ciencias Juridicas y Sociales, Universidad de Chile, Santiago; Doctor of Science of Law, University of Amsterdam. *Professor of Law, Dean Emeritus, Raymond I. Geraldson Scholar for International and Humanitarian Law*
Lewis A. Grossman, B.A., Ph.D., Yale University; J.D., Harvard University. *Professor of Law*
Rebecca Hamilton, BEcon, University of Sydney, Australia; M.A., J.D., Harvard University. *Assistant Professor of Law*
Heather L. Hughes, B.A., University of Chicago; J.D., Harvard University. *Professor of Law and Director of the SJ.D. Program*
David Hunter, B.A., University of Michigan; J.D., Harvard University. *Professor of Law and Director of the Program on International and Comparative Environmental Law*
Cynthia E. Jones, B.A., University of Delaware; J.D., American University Washington College of Law. *Professor of Law*
*Billie Jo Kaufman, BS, MS, Indiana University; J.D., Nova Southeastern University. *Professor of Law and Associate Dean of Library and Information Resources*
Benjamin Leff, B.A., Oberlin College; AM, University of Chicago; J.D., Harvard University. *Professor of Law*
Amanda Cohen Leiter, BS, MS, Stanford University; MS, University of Washington; J.D., Harvard University. *Professor of Law*
James P. May, B.A., Carleton College; J.D., Harvard University. *Professor of Law*
Binny Miller, B.A., Carleton College; J.D., University of Chicago. *Professor of Law*
Camille Nelson, B.A., University of Toronto; LLB, University of Ottawa; LL.M, Columbia University School of Law. *Dean and Professor of Law*
Fernanda Nicola, B.A., University of Turin; Ph.D., Trento University; LL.M, Harvard University. *Professor of Law*
Mark C. Niles, B.A., Wesleyan University; J.D., Stanford University. *Professor of Law*
Diane F. Orentlicher, B.A., Yale University; J.D., Columbia University. *Professor of Law*
Teresa Godwin Phelps, B.A., M.A., Ph.D., University of Notre Dame; MSL, Yale University. *Professor of Law and Director of the Legal Rhetoric Program*
*Andrew D. Pike, B.A., Swarthmore College; J.D., University of Pennsylvania. *Professor of Law*

Nancy D. Polikoff, B.A., University of Pennsylvania; M.A., The George Washington University; J.D., Georgetown University. *Professor of Law*

Andrew F. Popper, B.A., Baldwin Wallace College; J.D., DePaul University; LL.M, The George Washington University. *Professor of Law and Bronfman Professor Law and Government*

Jamin B. Raskin , B.A., J.D., Harvard University. *Professor of Law*

Jayesh Rathod, A.B., Harvard University; J.D., Columbia University. *Professor of Law, Director of the Immigrant Justice Clinic and Associate Dean of Experiential Education*

Ira P. Robbins, A.B., University of Pennsylvania; J.D., Harvard University. *Professor of Law and Justice, Director of the J.D./M.S. Dual Degree Program in Law and Justice, and Barnard T. Welsh Scholar*

Jenny Roberts, B.A., Yale University; J.D., New York University. *Professor of Law*

Ezra Rosser, B.A., Yale University; J.D., Harvard University. *Professor of Law*

Herman Schwartz, A.B., J.D., Harvard University. *Professor of Law*

Ann Shalleck, A.B., Bryn Mawr College; J.D., Harvard University. *Professor of Law, Director of the Women and the Law Program, and Carrington Shields Scholar*

Anita Sinha, B.A., Barnard College, Columbia University; J.D., New York University. *Assistant Professor of Law, Director of the International Human Rights Law Clinic*

Brenda V. Smith, B.A., Spelman College; J.D., Georgetown University. *Professor of Law and Senior Associate Dean for Faculty and Academic Affairs*

*David Snyder, B.A., Yale University; J.D., Tulane University. *Professor of Law and Director of the Law and Business Program*

Robert L. Tsai, B.A., University of California, Los Angeles; J.D., Yale University. *Professor of Law*

Anthony E. Varona, A.B., J.D., Boston College; LL.M, Georgetown University. *Professor of Law*

Lindsay F. Wiley, A.B., J.D., Harvard University; MP..H, Johns Hopkins University. *Professor of Law*

Paul R. Williams, A.B., University of California-Davis; J.D., Stanford University. *Rebecca I. Grazier Professor of Law and International Relations and Director of the J.D./MBA Dual Degree Program*

Law Library Administration

Khelani Clay, B.A., Howard University; J.D., American University Washington College of Law; M.L.S., The Catholic University of America. *Assistant Law Librarian*

John Q. Heywood, B.S., Northern Arizona University; J.D., American University Washington College of Law. *Associate Law Librarian*

Billie Jo Kaufman, B.S., M.S., University of Indiana at Bloomington; J.D., Nova Southeastern University, Shepard Broad Law Center. *Professor of Law and Associate Dean for Library and Information Resources*

Sima Mirkin, B.Engr.Econ., Byelorussian Polytechnic Institute, Minsk, Belarus; M.L.S., University of Maryland. *Associate Law Librarian*

Shannon M. Roddy, B.A., University of North Carolina at Chapel Hill; J.D., American University Washington College of Law. *Assistant Law Librarian*

William T. Ryan, B.A., Boston University; J.D., American University Washington College of Law; M.L.S., University of Maryland. *Law Librarian*

Ripple L. Weistling, B.A., Brandeis University; M.A., King's College (London); J.D., Georgetown University Law Center; M.L.S., The Catholic University of America. *Assistant Law Librarian*

Wanhong Linda Wen, B.A., Hunan Normal University; M.S., University of South Carolina, *Associate Law Librarian*

Emeriti

Evelyn Abravanel, A.B., Case Western Reserve; J.D., Case Western Reserve. *Professor of Law Emerita*
Columbia Law School; LL.M., Harvard Law School. *Associate Professor of Law Emeritus*

Isaiah Baker, A.B., Yale University; M.A., DePaul University; M.B.A., Columbia University Graduate School of Business; J.D., Columbia Law School; LL.M., Harvard Law School. *Associate Professor of Law Emeritus*

Daniel Bradlow, B.A., University of Witwatersrand, South Africa; J.D., Northeastern University Law School; LL.M., Georgetown University Law Center; L.L.D., University of Pretoria. *Professor of Law Emeritus*

David F. Chavkin, B.S., Michigan State University; J.D., University of California at Berkeley School of Law. *Professor of Law Emeritus*

Elliott S. Milstein, B.A., University of Hartford; J.D., University of Connecticut; LL.M., Yale University. *Professor of Law Emeritus*

Egon Guttman, LL.B., LL.M., University of London. *Professor of Law and Levitt Memorial Trust Scholar Emeritus*

Peter A. Jaszi, A.B., J.D., Harvard University. *Professor of Law Emeritus*

Patrick E. Kehoe, B.C.S., Finance, Seattle University; M.L.S., Washington University; J.D., Washington University. *Law Librarian Emeritus*

Nicholas N. Kittrie, A.B., M.A., LL.B., University of Kansas; LL.M., S.J.D., Georgetown University Law Center. *University Professor*

Candace Kovacic-Fleischer, A.B., Wellesley College; J.D., Northeastern University College of Law. *Professor of Law Emeritus*

Susan J. Lewis, B.A., University of California at Los Angeles; J.D., Southwestern Law School; M.Libr., University of Washington. *Law Librarian Emeritus*

Robert Lubic, A.B., J.D., University of Pittsburgh; M.P.L., Georgetown University. *Professor of Law Emeritus*

Anthony Morella, A.B., Boston University; J.D., American University Washington College of Law. *Professor of Law Emeritus*

Mary Siegel, A.B., Vassar College; J.D., Yale University. *Professor of Law Emerita*

Michael E. Tigar, B.A., J.D., University of California at Berkeley. *Professor of Law Emeritus*

Robert G. Vaughn, B.A., J.D., University of Oklahoma; LL.M., Harvard Law School. *Professor of Law Emeritus and A. Allen King Scholar*

Richard J. Wilson, B.A., DePauw University; J.D., University of Illinois College of Law. *Professor of Law Emeritus*

Special Faculty Appointments

Nancy S. Abramowitz, A.B., Cornell University; J.D., Georgetown University Law Center. *Professor of Practice of Law*

Ana-Corina Alonso-Yoder, B.A., Georgetown University; J.D., American University Washington College of Law. *Professor of Practice of Law*

Adrian Alvarez, B.A., University of Texas at Austin; M.A., Princeton University; J.D., American University Washington College of Law. *Professor of Practice of Law*

Elizabeth Beske, A.B., Princeton University; J.D., Columbia Law School. *Legal Rhetoric Instructor*

Elizabeth Boals, B.S., Virginia Polytechnic Institute and State University; J.D., George Mason University School of Law. *Assistant Dean, Part-Time and Online Education, Practitioner in Residence, and Director Criminal Justice Practice and Policy Institute*

Hillary Brill, A.B., Harvard University; J.D. Georgetown University Law Center. *Practitioner-in-Residence, Glushko-Samuelson Intellectual Property Law Clinic*

Sherley Cruz, B.A., Boston University; J.D., Boston University. *Practitioner-in-Residence*

Paul Figley, B.A., Franklin & Marshall College; J.D., Southern Methodist University School of Law. *Associate Director of the Legal Rhetoric Program and Legal Rhetoric Instructor*

Sean Flynn, B.A., Pitzer College (Claremont); J.D., Harvard Law School. *Professorial Lecturer in Residence, Associate Director of the Program on Information Justice and Intellectual Property*

Jon Gould, A.B., University of Michigan; M.P.P., Harvard University; J.D., Harvard Law School; Ph.D., University of Chicago. *Affiliate Professor and Director of Washington Institute for Public and International Affairs Research*

Jean C. Han, A.B., Harvard College; J.D., Yale Law School; LL.M., Georgetown University Law Center. *Practitioner-in-Residence, Women & the Law Clinic*

Elizabeth A. Keith, B.A., University of North Carolina at Chapel Hill; J.D., George Mason University School of Law. *Legal Rhetoric Instructor*

Daniela Kraiem, B.A., University of California at Santa Barbara; J.D., University of California at Davis School of Law. *Associate Director of the Women and the Law Program and Practitioner-in-Residence*

Kathryn Ladewksi, B.A., Stanford University; J.D., University of Michigan. *Practitioner-in-Residence*

Fernando Laguarda, A.B., Harvard University; J.D., Georgetown University Law Center. *Professorial Lecturer and Director of the Program on Law and Government*

Jeffery S. Lubbers, A.B., Cornell University; J.D., University of Chicago Law School. *Professor of Practice in Administrative Law*

Claudia Martin, Law Degree, Universidad de Buenos Aires; LL.M., American University Washington College of Law. *Professorial Lecturer in Residence*

Juan Mendez, Law Degree, Stella Maris Catholic University; Certificate, American University Washington College of Law, *Professor of Human Rights Law In Residence*

Horacio Grigera Naón, J.D., LL.D., School of Law of the University of Buenos Aires; LL.M., S.J.D., Harvard Law School. *Distinguished Practitioner in Residence and Director of the Center on International Commercial Arbitration*

Victoria Phillips, B.A., Smith College; J.D., American University Washington College of Law. *Professor of Practice of Law and Director of the Glushko-Samuelson Intellectual Property Law Clinic*

Joseph Richard Pileri, B.A., University of California, Los Angeles; J.D., Harvard Law School. *Practitioner-in-Residence and Community and Economic Development Law Clinic*

Heather E. Ridenour, B.B.A., Texas Women's University; J.D., Texas Wesleyan School of Law. *Director of Legal Analysis Program, Legal Writing Instructor*

Diego Rodriguez-Pinzon, J.D., Universidad de los Andes; LL.M., American University Washington College of Law; S.J.D., George Washington University Law School. *Professorial Lecturer in Residence, Co-Director, Academy on Human Rights & Humanitarian Law*

Susana Sá Couto, B.A., Brown University; M.A.L.D, The Fletcher School of Law and Diplomacy; J.D., Northeastern University Law School. *Professorial Lecturer-in-Residence and Director of War Crimes Research Office*

Macarena Saez, J.D., University of Chile School of Law; LL.M., Yale Law School. *Fellow in ILSP and Director of the Center for Human Rights and Humanitarian Law*

Anne Schaufele, B.A., DePauw University; J.D., American University Washington College of Law. *Practitioner-in-Residence*

*Steven G. Shapiro, B.A., Georgetown University; J.D., Georgetown University Law Center. *Director of the Hospitality and Tourism Law Program*

William Snape III, B.A., University of California at Los Angeles; J.D., George Washington University Law School. *Director of Adjunct Faculty Development and Fellow in Environmental Law*

David H. Spratt, B.A., The College of William and Mary; J.D., American University Washington College of Law. *Legal Rhetoric Instructor*

Richard Ugelow, B.A., Hobart College; J.D., American University Washington College of Law; LL.M., Georgetown University Law Center. *Practitioner-in-Residence*

Rangeley Wallace, B.A., Emory University; J.D., American University Washington College of Law; LL.M., Georgetown University. *Practitioner-in-Residence*

Diane Weinroth, B.A., University of California at Berkeley; J.D., Columbia University Law School. *Supervising Attorney*

Stephen Wermiel, A.B., Tufts University; J.D., American University Washington College of Law. *Professor of Practice of Law*

** American University Business Law Review* Faculty Advisory Committee

* * *

AMERICAN UNIVERSITY BUSINESS LAW REVIEW
Volume 8 · 2019 · Issue 2

TABLE OF CONTENTS

* * *

UNRAVELLING CHINA'S GRADUAL APPROACH TO EQUITY CROWDFUNDING REGULATION

CHEN LI* AND YU QIANQIAN**

Crowdfunding is a phenomenon that has seen stunning growth since the early 2010s. With the advent of the Internet, it has become an increasingly commonplace method of fundraising, especially for startups and small and medium enterprises. Of the different types of crowdfunding, equity crowdfunding ("ECF") carries the unique traits of securities offering, and thus poses significant risks for investors and market regulators alike. Various jurisdictions have taken a stride to implement specific laws and regulations that specifically target such activities, while the rest have made modifications to the existing regimes in bid to accommodate ECF. As one of the largest economies and the most populous country in the world, the potential for ECF activities in China is enormous. Yet, it appears that ECF activities remain an ambiguous fit within the present Chinese legal regime. As such activities continue to tread with care in the grey areas of law, they risk falling foul of both the Chinese Securities Law and the Criminal Law. This Article thus seeks to give a brief overview of the current ECF practices in China, discuss their legal implications, and rationalize the current regulatory approach to ECF.

* CHEN Li is an Associate Professorial Fellow at Fudan University Law School. He received his J.D. and J.S.D. degrees from Washington University School of Law. The authors wish to thank Erica C. Hughes, Lucy Kelly, and their editorial colleagues at *AUBLR*.

** YU Qianqian was educated at the National University of Singapore, Fudan University, and Tsinghua University. She is admitted to the Singapore Bar.

I. INTRODUCTION

The concept of crowdfunding goes way back in history. A well-known instance of this is when Joseph Pulitzer published an advertisement in the New York World, seeking contributions of a dollar or less from the public to fund the installation of the pedestal for the Statue of Liberty in New York Harbor.[1] Today, with the advent of the Internet and related technologies, the modern idea of crowdfunding has taken shape and is now often known to comprise of three key components: "(1) attracting many investors; (2) who [each] provide small monetary investments; (3) through the convenience and connectivity of the internet."[2]

Equity Crowdfunding ("ECF") refers to the use of the crowdfunding methodology as a substitute for traditional forms of formal venture financing, such that individual small investors receive an equity stake in the business venture.[3] It is foremost different from charitable crowdfunding (gratuitous gifting) and rewards-based crowdfunding (funding in exchange of a non-financial token). It is also opposed to concepts such as crowdlending — i.e. debt crowdfunding, or an aggregated version of peer-to-peer lending — where the individual contributors (creditors) expect to have their contributions (loans) returned, often with interest. Hence, ECF is essentially a case where securities instruments are offered. It thus carries the usual risks of fraud, lack of transparency, and information asymmetry affecting the individual investor's capability to assess the quality of the projects. Moreover, given that such transactions are performed over an online platform that is often less formal or reputable, ECF carries higher risks and necessitates specific regulatory response.[4]

In light of China's Ministry of Commerce having recently published a

1. *Joseph Pulitzer*, NAT'L PARK SERV., https://www.nps.gov/stli/learn/history culture/joseph-pulitzer.htm (last updated Feb. 26, 2015) ("The [advertisement's] appeal was so popular that [within four months], the World collected over $100,000 in donations — most donations being about $1 or less. Roughly 125,000 people contributed to the completion of the pedestal thanks to Pulitzer's crusade.").

2. Alma Pekmezovic & Gordon Walker, *The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital*, 7 WM. & MARY BUS. L. REV. 347, 357–58 (2016); *see also* Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study,* 29 J. BUS. VENTURING 1, 2 (2014).

3. *See* James Chen, *Investment Crowdfunding*, INVESTOPEDIA, https://www.inves topedia.com/terms/i/investment-crowdfunding.asp (last updated Apr. 23, 2018); *Equity Crowdfunding*, SYNDICATE ROOM, https://www.syndicateroom.com/learn/glossary/equ ity-crowdfunding (last visited May 8, 2019).

4. Pekmezovic & Walker, *supra* note 2, at 361.

draft Foreign Investment Law that seeks to significantly liberalize market entry for foreign investment,[5] foreign investors' involvement in the Chinese market will only increase in the days to come. At present, ECF activities remain an ambiguous fit within the Chinese legal regime. The manner in which they are carried out today often risks falling foul to both Chinese securities law and criminal law. This Article thus aims to canvass the present regime and the prevalent practices adopted in China to help readers navigate the playing field insofar as ECF activities are concerned, for given the absence of foreseeable alterations to the regime in the near future, investors, both local and foreign alike, should necessarily stay apprised of the legal risks and implications, as well as the actual market practices.

II. POSSIBLE REGULATORY APPROACHES TOWARDS ECF

In the realm of ECF regulations around the world, jurisdictions have either imposed entirely new laws to specifically target the ECF industry or have merely adopted existing laws to regulate ECF.[6]

The United States ("U.S."), for instance, passed its Jumpstart Our Business Startups Act ("JOBS Act" or "JOBS") on April 5, 2012, with a stated goal of "improving access to the public capital markets for emerging growth companies."[7] Essentially, it was to ease the difficulty of finding funds for startups and small-medium enterprises ("SMEs") and to revitalize the lull in the post-2008 Financial Crisis finance industry.[8] Title III of the JOBS Act pertains to crowdfunding specifically, and the specific provisions thereunder make exemptions for qualifying issuers from federal securities law, namely the Securities Act of 1933. It further establishes a regulatory

5. *See China Consults Public Opinion on Draft Foreign Investment Law*, THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA (Dec. 27, 2018), http://www.npc.gov.cn/englishnpc/news/Legislation/2018-12/27/content_2068862.htm ("China's top legislature on Wednesday published the full text of a draft foreign investment law to consult public opinion . . . . Necessary mechanisms on the facilitation, protection and management of foreign investment are written into the draft law, such as the pre-establishment national treatment and negative list management, equal supportive policies and equal participation in government procurement.").

6. *See* Eleanor Kirby & Shane Worner, *Crowdfunding: An Infant Industry Growing Fast* 30 (IOSCO Res. Dep't, Staff Working Paper SWP3/2014), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD459.pdf (stating that three approaches are taken worldwide: an absolute ban, setting thresholds to be met by stakeholders before participation in ECF allowed, or to allow free market access to all).

7. Zachary Robock, Note, *The Risk of Money Laundering Through Crowdfunding: A Funding Portal's Guide to Compliance and Crime Fighting*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 113, 113 n.1 (2014).

8. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112–106, 26 Stat. 306 (2012).

framework for investors and intermediaries as well.[9] It further requires the Securities Exchange Commission ("SEC") to introduce rules and issue studies on capital formation, disclosure and registration requirements for participants of ECF activities. Accordingly, the SEC adopted Regulation Crowdfunding, which came into full force on May 16, 2016.

Unlike the U.S., jurisdictions such as the United Kingdom ("U.K.") and Singapore do not have express legislative enactments that target the ECF regime. In the U.K., ECF activities fall within the jurisdiction of the Financial Services and Markets Act 2000.[10] With the onslaught of ECF activities since the early 2010s, the Financial Conduct Authority conducted a two-month public consultation in 2013 and fine-tuned the existing securities framework to introduce regulations applicable to ECF activities.[11]

Similarly in Singapore, the legislature did not introduce any new laws. The main applicable law remains as the Securities and Futures Act ("SFA") 2001, though issuers participating in ECF could exploit the Small Offers Exemption under the SFA, under which they may be exempted from prospectus requirements.[12] As for the ECF platforms, these intermediaries may foremost be subject to the Financial Advisors Act ("FAA"), and licensing would be required before these intermediaries can lawfully commence operations.[13] From the perspective of the investors, accredited and institutional investors would also fall under the regulation of the FAA, but for retail investors, the Monetary Authority of Singapore has proposed for intermediaries to impose 'pre-qualifications' prior to granting them access to the ECF projects.[14] That said, these proposed 'pre-qualifications' require nothing more than that the retail investors sign a declaration that they acknowledge and accept the risks involved.[15]

---

9. Robock*, supra* note 7, at 114–15 (explaining that all three stakeholders — the issuer, investor and intermediary (platform) — fall within the purview of Title III of the JOBS Act).

10. Financial Services and Markets Act 2000, c. 8 (Gr. Brit.).

11. Pekmezovic & Walker, *supra* note 2, at 431–33.

12. Securities and Futures Act, Ch. 289 § 272A(1)(a)(i) (2002) (Sing.) (allowing offerors to make personal offers of securities up to SGD 5 million within any 12-month period, without a prospectus, subject to conditions).

13. Financial Advisors Act, Ch. 110 § 22(1) (2007).

14. *MAS Requires Intermediaries to Assess Investment Knowledge and Experience of Retail Customers*, MONETARY AUTHORITY OF SING., http://www.mas.gov.sg/news-and-publications/media-releases/2011/mas-requires-intermediaries-to-assess-investment-knowledge-and-experience-of-retail-customers.aspx (last modified Nov. 26, 2016).

15. *See Factsheet on MAS' Proposals for Securities-Based Crowdfunding*, MONETARY AUTHORITY OF SING., http://www.mas.gov.sg/~/media/resource/news_room/press_releases/2016/factsheet%20on%20mas%20proposals%20for%20securitiesbased

III. LEGAL REGIME IN CHINA

A. Securities Law

From the outset, since ECF is an exceptional instance in the offering equity, it bears noting that there are two general categorizations of securities offerings in China: public offering and private placement.[16] Article 10 of Securities Law, which was last revised in 2014, distinguishes these two categories as follows:

> The conditions set forth by laws or administrative regulations must be satisfied in the public issuance of securities, and such issuance must, pursuant to law, be submitted to the securities regulatory authority under the State Council or the departments authorized by the State Council for *examination and approval*. Without such examination and approval pursuant to law, no entities or individuals shall issue securities publicly.
>
> Any one of the following circumstances shall constitute a public issuance:
>
> (1) issuing securities to *non-specific persons*;
>
> (2) issuing securities to more than 200 specific persons in the aggregate; and
>
> (3) such other issuing activities as may be so prescribed by laws or administrative regulations.
>
> Where securities are issued in non-public manners, no advertising, public solicitation or any other covert ways in disguised form shall be employed.[17]

The crux of Article 10 of the Securities Law is that where an offering fulfills the circumstances under Article 10(2), it would be considered a public offering, which must then be subject to examination and approval; otherwise, when an offering is deemed a non-public issuance of shares, the issuer is subject to publicity restrictions as imposed under Article 10(3).[18] Notably, should ECF activities be found illegal in China, those involved would face severe sanctions, including criminal sanctions under Article 180 of the Criminal Law for offering securities without requisite approval.[19] Since December 2006, the State Council's Notice on Several Issues about Rigorously Cracking Down on Illegal Issuance of Stocks and Illegal

---

%20crowdfunding%20scf.pdf (last visited Apr. 19, 2018).

16. *See* Law of the People's Republic of China on Securities (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, rev'd Oct. 27, 2005, effective Jan. 1, 2006), art. 10, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China).

17. *See id.* (stipulating the requirements for a prospective issuer, which is specified as a company listed by shares, to comply with it if it wishes to make a public offering of shares) (emphasis added).

18. *Id.*

19. *Id.* art. 180.

Operation of Securities Business has mandated the strict forbiddance of issuing of stocks to the public without authorization or in any disguised form, and the illegal operation of securities business, and an "entity or individual that violates any of [these three prohibitions] shall be clamped down firmly, and the legal responsibilities shall be investigated according to law."[20]

The 2014 revision of the Securities Law makes no mention of ECF activities. Clearly, even though the size of the ECF market in China is evidently substantial given the sheer size of its population,[21] the government has taken a rather gradual and incremental regulatory approach in relation to the ECF industry in China. The earliest attempts at introducing some form of regulatory framework to the ECF industry was in the Securities Association of China's publication of its Consultation Draft on the Measures for Managing Private Equity Crowdfunding (Trial) on December 18, 2014.[22] The items considered in that Consultation Paper included the legal status of ECF, definition of ECF platforms, requirements for investors to participate, disclosure requirements by ECF platforms and issuers, prohibitions of ECF activities, many of which were largely repetitions of existing prohibitions under the Securities Law and Criminal Law.[23] Even though this document remains a draft document to date, official guidance has been introduced through the 2015 Guiding Opinions on Promoting the Sound Development of Internet Finance ("2015 Guiding Opinions"),[24] a normative regulatory document collectively issued by various governmental departments, paragraph 9 of which states:

> 9. Equity crowd financing. Equity crowd financing mainly means the

---

20. Circular of the General Office of the State Council Concerning Some Matter on Severely Cracking Down on Illegal Issuance of Stocks and Illegal Operation of Securities Business (promulgated by the Gen. Office of the State Council., Dec. 12, 2006, effective Dec. 12, 2006), Guo Ban Fa [2006] No. 99 (China).

21. Lin Lin, *Managing the Risks of Equity Crowdfunding: Lessons from China*, 17 J. CORP. L. STUD. 327, 328 (2017) (citing Shen Lingkun, *Qing Ke Observations: Publication of 2016 Equity Crowdfunding Report, Summary of 2015 Equity Crowdfunding Developments Spurred on by JD and Ali*, PE DAILY (Mar. 21, 2016)) ("2015 witnessed the establishment of 84 new platforms, with 1,175 projects successfully raising RMB 4.374 billion (about USD 660 million) from these platforms.").

22. 关于就《私募股权众筹融资管理办法（试行）(征求意见稿) [Administrative Measures for Private Equity Crowdfunding (Draft for Comments)] (promulgated by Sec. Ass'n of China, Dec. 18. 2014), http://www.sac.net.cn/tzgg/201412/t20141218_113326.html.

23. *See id.*

24. Para. 9, Guiding Opinions of the People's Bank of China, the Ministry of Industry and Information Technology, the Ministry of Public Security, et al, on Promoting the Sound Development of Internet Finance, (promulgated by the People's Bank of China et al., July 14, 2015, effective July 14, 2015) Yin Fa [2015] No. 221 (China).

> public small-sum equity financing activities carried out through the Internet. Equity crowd financing shall be carried out through the platforms of the equity crowd financing intermediary institutions (Internet websites or other similar electronic media). *Equity crowd financing intermediary institutions* may, under the premise of complying with the laws and regulations, innovate on and explore the business types, maximize the role of equity crowd financing as an organic integral part of the multi-level capital market so as to better serve the innovation and business startup enterprises. *Equity crowd financing parties* shall be micro and small enterprises and truthfully disclose the business model, business operation management, finance, capital use and other key information to investors through the equity crowd financing intermediary institutions, and shall not mislead or cheat investors. *Investors* shall fully understand the risks of equity crowd financing activities, have corresponding risk tolerance, and make small-sum investment. The equity crowd financing business shall be subject to the supervision by the China Securities Regulatory Commission.[25]

In addition to providing a definition, the 2015 Guiding Opinion also mandated the involvement of an intermediary in carrying out any ECF activity and further provided general guidelines as to the conduct of the ECF platform (intermediary), the financing parties as well as the investors.[26] Following the issuance of the 2015 Guiding Opinions, the China Securities Regulatory Commission ("CSRC"), which was tasked with supervising the ECF activities in China, soon issued its Notice on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet on August 3, 2015 ("2015 CSRC Notice").[27] This departmental regulatory document expressly sets out that these "financing activities are characterized as being 'open, small-sum and public' and concern the public interests and national financial security," which warranted its regulation "according to the law."[28] References were then made to the Company Law, Securities Law, and several related regulatory documents,[29] albeit none pertained exclusively to ECF activities. This 2015 CSRC Notice thus legitimized local offices of

25. *Id.* (emphasis added).

26. Guiding Opinions on Promoting the Healthy Development of Internet Finance (promulgated by State Admin. for Indus. & Commerce et al., July 18, 2015, effective July 18, 2015) Yin Fa [2015] No. 221 (China).

27. (promulgated by Gen. Off. of the China Sec. Reg. Comm'n, Aug. 3, 2015, effective Aug. 3, 2015) Zheng Jian Ban Fa [2015] No. 44 (China).

28. *Id*.

29. *Id.* These laws include the Interim Measures for the Supervision and Administration of Privately Offered Investment Funds, Order No. 105 of the CSRC with effect from August 21, 2014; and the Securities Investment Fund Law of the People's Republic of China (2015 Amendment), Order No. 23 of the President of the People's Republic of China with effect from April 24, 2015.

the CSRC to conduct inspection on equity financing platforms to determine "whether the financiers on platforms publicly propagandize, whether securities are issued to unspecific investors, whether the number of shareholders exceeds 200 cumulatively, and whether privately offered equity funds are offered in the name of equity crowdfunding."[30]

Following up on the 2015 CSRC Notice, the Implementation Plan for the Special Rectification of Risks in Equity Crowdfunding ("2016 Implementation Plan") was issued on April 14, 2016.[31] In particular, one of its main objectives was to conduct "centralized checking with full coverage," where "problematic institutions and individuals" shall be ordered to "make rectification in accordance with laws and regulations," failing which shall be "severely punished."[32] To that end, the 2016 Implementation Plan set out several "priority rectifications" to be made, including "internet equity financing platforms . . . that engage in equity financing business in the name of 'equity crowdfunding[,]' . . . platforms that raise private equity investment funds in the name of 'equity crowdfunding[,]' . . . platforms, real estate development enterprises, and real estate intermediaries that carry out illegal fund-raising activities in the name of 'equity crowdfunding.'"[33]

Rectifications were also aimed at the platforms that conduct false publicity and mislead investors by fabricating or exaggerating their strength, information on financing projects, returns, and other methods; money raisers on the platforms who publicly issue stocks directly or in disguise without approval; and securities companies, fund companies, futures companies, and other licensed financial institutions that cooperate with internet companies in carrying out business in violation of laws and regulations.[34]

All in all, these rectifications show that even though the CSRC did not introduce any positive regulations targeted at ECF activities per se, the clear notion of the 2016 Implementation Rules was to prevent the misuse of this new ECF label to cause undesirable disruptions to the existing economic activities and to negate any mischief caused by the illegal financial activities that might have escaped regulation by disguising as ECF platforms.[35] In other words, this was an attempt to prevent the existing regulatory regime

30. *Id.* para. III.

31. Notice of Issuing the Implementation Plan for the Special Rectification of Risks in Equity Crowdfunding, (promulgated by China Sec. Reg. Comm'n, Apr. 14, 2016, effective Apr. 14, 2016) Zheng Jian Fa [2016] No. 29. Notably, this 2016 Implementation Plan was supposed to have been completed by January 2017. *Id.* para. IV.

32. *Id.* para. (I)(1).

33. *Id.* para. (II)(1).

34. *Id.*

35. *See id.* (insinuating that while the CSRC does not explicitly provide regulations for ECF, it is implied within the text).

and economic equilibrium from being destabilized by the introduction of ECF platforms.

Another objective of the 2016 Implementation Plan was to further improve the "laws, regulations, and rules . . . and the long-term regulatory mechanism" for the sound development of internet equity financing.[36] In line with this motivation, news released in mid-2016 disclosed that the CSRC was looking to include ECF regulations in the amendments to the Securities Law,[37] although to date, neither amendments to the Securities Law nor positive laws or regulations targeted at ECF activities have been introduced, leaving them subject to the existing regulatory framework. Besides national laws and departmental regulations, there are various provinces in China that have enacted local regulatory policies to supervise ECF activities conducted within their locality.[38] Besides the municipalities of Beijing, Shanghai and Tianjin, the other early adopters of ECF regulations include the provinces of Guangdong, Shandong, Jinan, Anhui, Shanxi, and Hunan.[39]

B. Criminal Law

ECF is also susceptible to criminal sanctions in China, under what is generally known as "illegal fundraising."[40] This term does not correspond with any specific offenses in the Criminal Law of China. Instead, the Supreme People's Court ("SPC") issued its Judicial Interpretation on Several Issues on the Specific Application of Law in the Handling of Criminal Cases about Illegal Fundraising in 2010 ("2010 SPC Judicial Interpretation"), which suggests that the ambit of "illegal fundraising" could cover the following six different types of crimes in the Criminal Law[41]:

Figure 1

36. *Id.* para. (I)(1).

37. *See* 证监会:积极推动出台私募基金监管条例 [*CSRC: Actively Promote the Introduction of Private Equity Fund Supervision Regulations*], CHINA SEC. NEWS: CHINA SEC. NETWORK (BEIJING) (Apr. 28, 2016, 12:33 PM), http://money.163.com/16/0428/08/BLNNNT6K00251LDV.html.

38. *See* FINANCING FROM MASSES CROWDFUNDING IN CHINA 121–30 (Jiazhuo G. Wang et al. eds., 2018) (listing "local regulatory policies of the crowdfunding industry").

39. *See id.* (showing an extensive list of the local regulatory policies in place from 2015 to September 2016 and stating that policies relating to ECF activities were introduced in these municipalities and provinces by the end of 2015).

40. Interpretation of the Supreme People's Court on Certain Issues Relating to Specific Application of Law with Respect to the Trial of Illegal Fund Raising Criminal Cases (promulgated by Sup. People's Ct., Dec. 13, 2010, effective Jan. 4, 2011) Fa Shi [2010] No. 18 (China).

41. *Id.* at *1–4, 7–8, 11–12.

	Type of Offence	**Category of Offence**	**Criminal Law**
(1)	Illegal Procurement of Public Savings (or Procurement in Disguised Form)	Section 4, Criminal Law — Crimes of Undermining the Order of Financial Administration	Article 176[42]
(2)	Illegal Fundraising by means of Fraud	Section 5, Criminal Law — Financial Fraud Crimes	Article 192[43]
(3)	Illegal Offering of Securities without Approval[44]	Section 4, Criminal Law — Crimes of Undermining the Order of Financial Administration	Article 179[45]
(4)	Illegal Offering of Securities by means of Fraud[46]	Section 3, Criminal Law — Crimes of Disrupting the Order of Administration of Companies and Enterprises	Article 160[47]
(5)	Illegal Business Operation	Section 8, Criminal Law — Crimes of Disrupting Market Order	Article 225[48]

42. Criminal Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., July 1, 1979, rev'd Mar. 14, 1997, effective Mar. 14, 1997) art. 176, 1997 P.R.C. LAWS 83, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384075.htm (China).

43. *Id.* art. 192, 1997 P.R.C. LAWS 83.

44. *See also* Law of the People's Republic of China on Securities (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, rev'd Oct. 27, 2005, effective Jan. 1, 2006) art. 188, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China) (regulating public issuance of securities).

45. Criminal Law of the People's Republic of China, art. 179, 1997 P.R.C. LAWS 83.

46. *See also id.* arts. 5, 69, 189 (regulating the public issuance of securities and illegal acts surrounding such action).

47. Criminal Law of the People's Republic of China, art. 160, 1997 P.R.C. LAWS 83.

48. *Id.* art. 225.

(6)	False Advertisement and Publicity	Section 8, Criminal Law — Crimes of Disrupting Market Order	Article 222[49]

Items three and four are the two offences directly related to illegal offering of securities and are therefore directly relevant to the very nature of ECF activities, whereas items five and six are the operational offences that ECF platforms could face, should there be lapses in their business processes. Due to the nature of these violations, the six offences listed above can be categorized into three types of illegality: those arising from the lack of approval from the relevant authorities (Items 3 and 5); those arising from the use of fraudulent or deceitful means (Items 2, 4, and 6); and the offence of Illegal Procurement of Public Savings or Procurement in Disguised Forms (Item 1).

The offence of Illegal Procurement of Public Savings or Procurement in Disguised Forms ("Illegal Procurement") is a unique criminal offence in China that merits specific mention.[50] Its roots are found in the establishment of the central bank, i.e. the People's Bank of China ("PBC"), where under Article 31 of the 1995 Law of the People's Bank of China, the PBC was given the authority to "examine and approve the establishment, modification and termination of banking institutions, as well as the scope of their business operations."[51] Any private "commercial banks or any other banking institutions" formed without the approval of the PBC were thus illegal.[52] This was first criminalized under Article 174 of the 1997 Criminal Law.[53] Some even take the opinion that this offence constitutes the seventh crime that falls under the umbrella of "illegal fundraising,"[54] albeit not at all being

49. *Id.* art. 222.

50. Based on the literature consulted for this Article, there does not appear to be any equivalent criminal offences constituted by the absorption of public funds in other jurisdictions; instead, usually these fell under the broad categories of swindling, cheating, or even corruption or embezzlement, but never as a crime on its own.

51. Laws of the People's Republic of China on the People's Bank of China (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 18, 1995, effective Mar. 18, 1995) art. 31, 1995 P.R.C. LAWS 4, http://www.asianlii.org/cn/legis/cen/laws/pboc154/ (China).

52. Criminal Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., July 1, 1979, rev'd Mar. 14, 1997, effective Mar. 14, 1997) art. 174, 1997 P.R.C. Laws 83, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384075.htm (China) (ordering that the PBC is the only entity with the power to create and provide the advantages of a commercial bank).

53. *See id.*

54. *See* LU QINZHONG, THE CRIMINAL LAW THEORY & PRACTICE OF ILLEGAL FUND-RAISING CRIMES 6 (Shanghai Renmin Press 2014).

referenced in the 2010 SPC Judicial Interpretation. In the same vein, any "illegal taking of deposits from the general public or . . . in disguised form thus disrupting financial order" was therefore criminalized as well, under Article 176 of the 1997 Criminal Law.[55] Today, the case law on Illegal Procurement largely pertains to criminals who procured public 'savings' with the intent to retain such illegally acquired funds,[56] as opposed to retaining the 'savings' due to a promise of return of principal with interests.

With the advent of ECF, it comes as no surprise that this fundraising vehicle could be used as a tool to conduct Illegal Procurement; analyzing actions for illegality thus boils down to a matter of characterization as to whether the monies were invested in exchange for equity with dividends or loaned in exchange for repayment with interests.[57] Pursuant to the 2010 SPC Judicial Interpretation, it was further qualified that Illegal Procurement pertained explicitly to illegal absorption from the "general public, i.e. unspecific persons" and does *not* apply to anyone who "absorbs funds from his relatives, friends or specific person within an entity without publicity in the society."[58] In other words, the exception to this offence is rather wide, which inevitably greatly limits the scope of this provision's reach. Indeed, at the enforcement level, there have been reports that forty-three ECF platforms were shut down in the first four months of 2016 due to illegal fundraising, misrepresentation, internal conflict, and lack of funding,[59] but none were prosecuted for the illegal procurement of public savings. As such, it can be said that this unique crime is hardly the main cause of worry for ECF platforms in China. Because of its relative novelty, the greatest source of doubt cast upon ECF is still in its potential for fraud.[60]

IV. PREVALENT ECF PRACTICES IN CHINA

It is not difficult to see that the purported prohibitions under the present

55. Criminal Law of the People's Republic of China, art. 174, 1997 P.R.C. Laws 83.

56. Fang Binwei, *Jizi Qipian yu Feifa Xishou Gongzhou Cunkuan Zui De Qufen*, 29 RENMIN SIFA ANLI 30 (2016).

57. *See, e.g.*, Yang Jiao, 股权众筹4个月倒闭43家平台 生存环境仍艰难 [Equity Crowdfunding in Trouble, 43 Platforms Closed in 4 Months], YICAO GLOBAL (June 14, 2016), http://finance.sina.com.cn/money/lczx/2016-06-14/details-ifxszkzy5230708.shtml (describing the unclear legal status of equity crowdfunding).

58. Interpretation of the Supreme People's Court on Certain Issues Relating to Specific Application of Law with Respect to the Trial of Illegal Fund Raising Criminal Cases (promulgated by Sup. People's Ct., Dec. 13, 2010, effective Jan. 4, 2011) art. 1, Fa Shi [2010] No. 18 (China).

59. Yang Jiao, *supra* note 57.

60. *See* Zhong Wei & Wang Yi-chun, *The Chinese Style Crowdfunding: Legal Regulation and Investors Protection*, 17(2) J. SW. UNIV. POL. SCI. & L. 23 (2015).

ECF regulatory regime result in a very awkward and superficial, if not artificial, regulatory exercise. Under the 2015 Guiding Opinion, ECF was defined as mainly referring to "*the public small-sum equity financing activities*" which shall be "*carried out through the platforms of the equity crowd financing intermediary institutions (Internet websites or other similar electronic media)*."[61] It mentions "small-sum equity" injections, but no concrete numbers are found in the text of the laws to quantify or benchmark this qualifier. Also, ECF shall not constitute "public issuances" under the Securities Law by issuing to unspecified persons or to an aggregate of more than 200 specific persons, unless they underwent requisite examination and obtained approval.[62] Hence, entities that wish to raise funds from a large pool of individual contributors from the general mass are by default precluded from using this mechanism;[63] instead, they may turn to conduct project- or rewards-based crowdfunding. Moreover, if equity is privately offered, public solicitation, advertising, or the like in disguised forms, such as "in the name of equity crowdfunding," should not be present.[64] In any case, once a fundraising activity finds itself within the four corners of this ECF category, the sourcing entity would be free from the CSRC's strict scrutiny in its equity issuance[65] and be at liberty to look for investors from the "public," albeit a limited pool therefrom.

---

61. Para. 9, Guiding Opinions of the People's Bank of China, the Ministry of Industry and Information Technology, the Ministry of Public Security, et al, on Promoting the Sound Development of Internet Finance, (promulgated by the People's Bank of China et al., July 14, 2015, effective July 18, 2015) Yin Fa [2015] No. 221 (China) (emphasis added).

62. Para. III, Notice of the General Office of the China Securities Regulatory Commission on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet (promulgated by Gen. Off. of the China Sec. Reg. Comm'n, Aug. 3, 2015, effective Aug. 3, 2015) Zheng Jian Ban Fa [2015] No. 44 (China); Law of the People's Republic of China on Securities (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, rev'd Oct. 27, 2005, effective Jan. 1, 2006), art. 10, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China).

63. *See* Law of the People's Republic of China on Securities, art. 10, 2006 P.R.C. LAWS 43. On this note, the limitation on number of unspecified investors would already have been curtailed by the type of underlying vehicle seeking to raise funds through ECF. Companies Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27. 2005, rev'd Jan. 1, 2006, effective Jan. 1, 2006) art. 24, 2006 P.R.C. Laws 42, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384124.htm (China) (limiting the maximum number of shareholders to 50 for Limited Liability Companies); *id.* arts. 78–79 (limiting the maximum number of shareholders to 200 for privately-held Joint Stock Companies, also known as companies limited by shares).

64. Para. II, Zheng Jian Ban Fa [2015] No. 44; *id*.

65. Lin, *supra* note 21, at 335, 351–52 (stating CSRC's involvement is in the approval of ECF platforms, a temporary measure that was put in place by the CSRC).

In spite of these regulatory red tapes and uncertainties, the Chinese market has nevertheless embraced this commercial financing vehicle.[66] Various creative ways have been adopted by ECF participants to survive and perhaps even prosper amidst the murky regulatory environment. The general trend today is that ECF platforms invite experienced investors who are high risk-takers to join the venture instead of targeting the general public. Amongst the 'elite circle,' some ECF projects adopt a 'lead investor, plus follower investors' method, where the bulk of the required capital is first contributed by an angel investor, who is usually more experienced and reputable within the investment circle, and who will then take the lead and pull in smaller investors.[67] Query whether the lead investor's bulk investment would contravene the "small-sum equity" restriction in the 2015 Guiding Opinion. Sometimes, the lead angel investor would also form a limited partnership and draw in individual 'partner' investors before the entire enterprise takes on the final project together.[68] In this manner, the funding process would be cloaked as a private placement in a private enterprise, although these 'partner' investors were in fact largely gathered from the public through ECF platforms.[69] In such cases, the 'lead investor' takes on the important role of instituting trust to his fellow investors, whose ultimate decision to invest would often couch not upon their own individual confidence in the underlying project, but more upon their reliance on the lead investor's assessment of the project's viability.[70] However, because of the trust placed upon the lead investor, it magnifies the risks of fraud in an instance of collusion between the issuer and the lead investor.[71]

Another oft-used method is to have a membership arrangement, such that unspecified members of the public undergo detailed identity registration to become a named (specific) investor.[72] Any such issuance to less than 200 of

66. *See id.* at 328 (explaining that startups and SMEs in China have long faced great difficulty in obtaining financing from traditional avenues, and ECF thus presents itself as a practical solution this difficulty).

67. *See, e.g.*, Grant Thorton, *Raising Cornerstone Investment: Kicking Off Your Crowdfunding Campaign*, CROWDCUBE (Nov. 19, 2018), https://www.crowdcube.com/explore/entrepreneur-articles/raising-cornerstone-investment-kicking-off-your-crowdfunding-campaign ("A cornerstone [or, lead] investor is any investor that commits a significant portion of your funding round — usually 25-50% of the amount you are seeking. Securing cornerstone investment is becoming more and more instrumental in the success of crowdfunding campaigns as it demonstrates validity.").

68. Lin, *supra* note 21, at 339–40.

69. Wei & Yi-chun, *supra* note 60, at 21.

70. *See* Lin, *supra* note 21, at 339–40.

71. *See id.* at 340 (discussing the issues with the lead-investor model).

72. There could be legal issues pertaining to privacy and data protection arising from such activities, but these matters are beyond the ambit of this Article.

these 'club members' would thus allow the issuer to avoid falling under the definition of 'public issuance.'[73] However, the effectiveness of such 'alteration' of character of investors from non-specific to specific has not been tested in the Chinese courts. Even if these methodologies successfully enable such ECF activities to take on the characterisation of a private placement, care must be placed by the platforms to ensure their publicity of the ECF events does not fall foul of Article 10(3) of the Securities Law.[74] To that end, some ECF platforms not only take on a membership model, but also arrange physical meetings within their exclusive club to publicize and promote their ECF opportunities offline.[75] Such arrangements are sometimes termed as 'speed dating,' where large scale platforms such as AngelCrunch run roadshows for their potential investors.[76]

More importantly, the manners in which the current practices are adopted are arguably in direct contravention of the 2015 CSRC Notice. These practices are precisely the kinds of mischief that the 2016 Implementation Plan sought to "rectify." The manifest prevalence of such "ECF" activities nevertheless evidences a gaping gray area that continues to exist between black-letter law and law in action.

V. REGULATORY CHALLENGES

The architecture of ECF regulation should rest on the twin pillars of investor protection considerations and the ease of access for fund-seeking entities. Given that the concept of ECF boils down to the solicitation of funds from the public masses through the Internet, the modern arrangement of ECF presents a challenge to the traditional notion of regulation based on the public offering and private placement divide.[77] Since the main advantage of ECF lies in the relative ease and speed in which funds are supposed to be procured for SMEs, by reason of ECF's low barriers to entry and lack of complicated procedures, requiring compliance with any such formal public

73. Law of the People's Republic of China on Securities (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, rev'd Oct. 27, 2005, effective Jan. 1, 2006), art. 10, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China).

74. *See id.*

75. Ya Xian Sun, *Gu Quan Zhong Chou Ji Qi Yun Zuo Ping Tai De Fa lv Xing Zhi Fen Xi*, JING JI ZHONG HENG 128 (2018).

76. Lin, *supra* note 21, at 334 ("Most of the Chinese [ECF] platforms are VC firm-like investment service providers that provide fundraising, investment and exit services for the fundraisers and investors. They generally assume the role of selecting projects, determining valuation, publishing the project, facilitating negotiation between fundraiser and investors through providing road show service and offline 'matchmaker' meetings.").

77. Wei & Yi-chun, *supra* note 60, at 20.

offering requirements of the Securities Law defeats the purpose of ECF entirely. On the other hand, ECF's method of soliciting funds from the masses through the Internet is another ingredient that does not sit well with the traditional notion of offline private placement activities. In effect, it is a hybrid vehicle that meets halfway between a public offering and a private placement.

The division between the law's treatment of public offering and private placement arises from the underlying differentiation of the public retail investors and the private individual actors. The U.S. Supreme Court reasoned this distinction on the basis that the former is in need of protection of the Securities Act, whilst a private group does not because they "are able to fend for themselves."[78] Hence, if this public-private distinction is blurred and the so-called 'private' individual investors of an ECF project are not afforded sufficient protection, the resulting agency and information asymmetry problems would undoubtedly be extreme. Investor protection is thus the key consideration in preventing the ECF industry from becoming a 'market for lemons' where only low-quality ventures would turn to ECF, while high-quality ventures would continue to rely upon the more matured methods of financing, such as through venture capital or private equity.[79] To that end, investor protection is the key thrust taken by a majority of the regulatory approaches across the world. For instance, in the U.S., there are even limits imposed on the amount of investment that the retail investor is allowed to partake in.[80] However, it must be recognized that a risk is a risk regardless of its quantum, and ECF by its very nature is an avenue for the masses to engage in a high-risk investment, even if each individual investment were minute in terms of absolute quantum.

Moreover, the notion of investor protection in public offering is often based upon the accurate and complete disclosure of information, incentivized by sanctions for non-compliance. There are foremost inherent limitations as to a disclosure-based regime for the protection of investors, for it presumes that investors have the capacity to process the disclosed information to make informed decisions.[81] When put in the context of an economically and

78. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) ("Since exempt transactions are those as to which 'there is no practical need for . . . (the bill's) application,' the applicability of [Section 4(a)(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

79. Pekmezovic & Walker, *supra* note 2, at 451.

80. *See* 15 U.S.C. § 77d(a)(6)(B) (2018) (limiting the amount an investor can invest in crowdfunding based on their income and net worth).

81. Troy A. Paredes, *Blinded by the Light: Information Overload and Its*

socially diverse country like China, this premise founded upon full and frank disclosure becomes extremely shaky. In addition, such an extensive exercise necessarily leads to high costs in procuring funds, which goes against the second pillar of ECF regulation, which is to reduce the costs for SMEs to acquire funds. As such, under the ECF regime, the balance of the considerations of investor protection and access to funds naturally hinges upon the ECF platforms as intermediaries to not only bridge the information asymmetry, but also to perform a gatekeeping role. Various jurisdictions have thus imposed upon ECF platforms regulatory measures of registration as well as substantive positive obligations of conducting due diligence and procuring mandatory insurance.[82]

Faced with the institutional deficiencies in the Chinese ECF regulatory regime, academics have long called for more proactive public intervention to fill the legislative gap and to strengthen investor-protection.[83] The general view is that guidance can be gleaned from other jurisdiction's approach to provide a small offer exemption, set minimum requirements for "qualifying" investors, and impose positive obligations upon ECF intermediaries.[84] In addition to positive regulatory intervention targeting ECF activities, there are also supplementary (or alternative) options that could assist in containing investment risks between ECF stakeholders, including the strengthening of corporate governance of the issuers and intermediaries,[85] or for individual stakeholders, the redistribution of risks among themselves through contractual design.[86] That said, the feasibility and effectiveness of these various mechanisms in managing the fledging ECF industry in the diverse Chinese market are similarly uncertain.

VI. CONCLUDING OBSERVATIONS

Whilst ECF is still in its developmental stages in China, the growth of the

Consequences for Securities Regulation, 81 WASH. U. L. Q. 417, 418 (2003) ("In short, if the users do not process information effectively, it is not clear what good mandating disclosure does."); Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption,* 4 HARV. BUS. L. REV. 281, 321–22 (2014).

82. PENG BING, TOUZIXING ZHONGCHOU DE FALV LUOJI 244–48 (Peking Univ. Press 2017).

83. *See* Pekmezovic & Walker*, supra* note 2, at 398; Gan Qiang & Li Weinan, *Woguo Touzixing Zhongchou Falvzhidu de Chubu Jiangou*, HULIANWANG YU MINJIAN RONGZI FALVWENTI YANJIU 42–57, 50 (Law Press, China 2014).

84. *See* Lin, *supra* note 21, at 31 (arguing there ought to be positive due diligence duties on the intermediaries, requiring that they facilitate the information transfer as between issuers and investors, such that the latter can be assured of receiving timely, adequate and truthful information about the underlying investments).

85. Pekmezovic & Walker*, supra* note 2.

86. Lin, *supra* note 21, at 340.

industry — especially with the technological advances that have improved not only the market's connectivity, but also the fluidity of cashflow — has ventured far ahead of the existing legal regime, and it is high time that the law picks up speed to catch up with such advancements. Under the current Chinese legal regime, however, ECF remains dubious, with its legitimacy and the permitted ambits of activities being left largely to the determination of local authorities. However, the fact that the Chinese ECF industry is well active and thriving indicates that this degree of legal uncertainty and unpredictability is still acceptable to fund-sourcing SMEs, platforms, and investors alike. Yet, the commonplace reduction of the scale of fundraising and cautious publicity of ECF activities, while contributing to cloaking ECF activities with the appearance of legitimacy, does go against the spirit of crowdfunding to make use of the strength of the masses to offer financial support for a worthwhile endeavor. This deficient legal regime as to ECF regulation has even been argued to be a cause that hindered the Chinese ECF industry from realizing its full potential for growth.[87]

If positive intervention were indeed the best recourse, it goes without saying that a combination of measures should be adopted, and sufficient flexibility must be given to allow the regulators to make necessary adjustments to suit their regulatory and administrative needs. The crux lies in the ability of the regulators to balance the spirit of crowdfunding (in allowing the masses to unite behind a common objective to provide funding with a low barrier or threshold for investment) and the need to protect the population from fraud or undesirable distortion of the financial market. In this regard, while it makes theoretical sense for a government to introduce a detailed set of regulations to ensure that all stakeholders' interests are protected, this postulation may be less defensible in light of how the consistent application of detailed rules is known to be a massive challenge for China, given the diverse judiciary standards across its vast territory.

Hence, it is understandable why regulators have taken a wait-and-see approach and have not introduced any ECF-specific legislation, but have, for the time being, left regulating as necessary largely to local authorities. This lack of regulation essentially means that the government is not dictating the rules for the market but is instead giving sufficient room to the stakeholders to forge forward in their trial-and-error attempts to arrive at the most efficient way of structuring an ECF project. Moreover, at the present stage, ECF is largely used by startups and SMEs for their seed and pre-A investments,

87. Qiang & Weinan, *supra* note 83 (asserting that the growth and development of the ECF industry in China have in fact been impeded by the skimpy legal regulatory framework, including the restrictions placed upon the eligibility of the issuer, the nature of the ECF platform and the number of investors).

which means that the scale of economic risks for ECF projects ought to be reasonably contained, and that there ought not to be any disproportionately substantial losses for an individual or community from ECF projects alone. If so, then it might not be a bad idea to allow market forces to let ECF practices mature and take shape first, before regulators take a reactive stance to impose positive rules. After all, economically unsustainable activities would eventually be driven out by competition, even without any positive regulatory intervention.

* * *

WORLDWIDE FRAND LICENSING STANDARD

GARRY A. GABISON*

Worldwide licenses linked to the standard-setting process are being challenged on antitrust and jurisdictional grounds. While, so far, most courts have batted away these challenges, some courts have not recognized their validity. If worldwide licenses were to not be enforced globally, then the patent exhaustion doctrine could further eat into the patent holders' returns. Raising cost of enforcement linked to local licenses and lower returns linked to patent exhaustion would disincentivize standard-setting participants. These worldwide licenses are essential to the standard system and must be protected as such: the standard-setting organizations, antitrust authorities, and courts have a part to play to ensure the standards survive these attacks.

* JD-PhD, Lecturer of Law, Economics & Regulations, Queen Mary University of London, Centre for Commercial Law Studies. The first draft of this paper was written while visiting the Georgia Institute of Technology School of Public Policy. I would like to thank Nikolaus Thumm for our conversations and the seminar participants at the Technische Universität München for our lively discussion.

I. INTRODUCTION

Over the last ten years, the number of standards, standard-associated patents, and patent litigation has steadily increased in the United States ("U.S.").[1] Recently, these litigations have challenged various aspects of licenses associated with standards.[2]

Standard Setting Organizations ("SSOs")[3] have often set broad licensing terms.[4] SSOs created patent declaration to avoid patent ambush.[5] Patent holders declare in letters of assurance to SSOs which of their patents qualify as essential,[6] which can be defined as patents without a workaround.[7]

---

1. *See, e.g.*, Justus Baron & Tim Pohlmann, *Mapping Standards to Patents Using Declarations of Standard-Essential Patents*, J. ECON. & MGMT. STRATEGY (forthcoming) (manuscript figs.1 & 6) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3119145## (illustrating the increase in the number of standard essential patents, associated patents and associated lawsuits over the last two decades); TIM POHLMANN & KNUT BLIND, IPLYTICS GMBH, LANDSCAPING STUDY ON STANDARD ESSENTIAL PATENTS (SEPS), 23–24 fig.14 (2016), https://ec.europa.eu/docsroom/documents/20741/attachments/1/translations/en/renditions/native (describing the number of standard essential patent associated lawsuits in the U.S.).

2. *See, e.g.*, Garry A. Gabison, *A Two-Dimensional Approach to Non-Discriminatory Terms in FRAND Licensing Agreements*, 24 B.U.J. SCI. & TECH. L. 100, 102–04 (2018) (discussing the case law challenging the discriminatory aspect of standards).

3. Andrew Updegrove, *The Essential Guide to Standards Chapter 6*, CONSORTIUMINFO.ORG (2007), https://www.consortiuminfo.org/essentialguide/forming2.php (indicating that some standards develop through a cooperative enterprise in SSOs also referred to in the literature as Standard Developing Organizations ("SDOs")).

4. *See, e.g.*, Michael A. Cusumano et al., *Strategic Maneuvering and Mass-Market Dynamics: The Triumph of VHS over Beta*, 66 BUS. HIST. REV. 51, 65–66, 75–76 (1992) (describing how VHS won the market and came out as the de facto standard for the videocassette standard following an intense competitive process with Betamax, with a focus on the SSO set standards created through cooperation from various entities). Companies can create a de facto standard by winning the market. Standards discussed in this paper, however, focus on the SSO set standards created through cooperation from various entities.

5. *See, e.g.*, Rambus Inc. v. FTC, 522 F.3d 456, 461, 466–67 (D.C. Cir. 2008) (discussing Rambus' tactics of not disclosing that it held standard essential patents — tactics later branded as "patent ambush" — and holding that such tactics did not amount to an attempt to monopolize because Rambus's deceptive conduct aimed at increasing prices and not monopolizing).

6. *See infra* note 11.

7. ETSI RULES OF PROCEDURE § 15.6 (EUR. TELECOMM. STANDARDS INST. 2018), http://www.etsi.org/images/files/IPR/etsi-ipr-policy.pdf ("'ESSENTIAL' as applied to IPR means that it is not possible on technical (but not commercial) grounds, taking into account normal technical practice and the state of the art generally available at the time

Inventors declare essential patents covering the same or similarly technical content from different jurisdictions. These patents form a patent family covered by the same declaration.[8] As such, these families can lead to similar litigations in different jurisdictions.

Besides declarations, SSOs also require that standard participants commit to licensing their standard essential patents ("SEPs") on Fair, Reasonable, and Non-Discriminatory ("FRAND") terms.[9] SSOs created FRAND licenses in an attempt to circumvent patent hold-up and royalty stacking, while encouraging widespread adoption of their standards.[10] FRAND terms attempt to decrease the bargaining inequality post-standard adoption.[11] Part of the FRAND commitment is that SEP holders offer worldwide licenses.[12]

However, not all SEP implementers are willing participants. Some commit holdout, which is also known as reverse holdup. Holdout occurs when a standard implementer uses FRAND commitment against the patent holder to negotiate a small license fee.[13] Part of this bargaining strategy

---

of standardization, to make, sell, lease, otherwise dispose of, repair, use or operate EQUIPMENT or METHODS which comply with a STANDARD without infringing that IPR. For the avoidance of doubt in exceptional cases where a STANDARD can only be implemented by technical solutions, all of which are infringements of IPRs, all such IPRs shall be considered ESSENTIAL.").

8. ORG. FOR ECON. COOPERATION & DEV., OECD PATENT STATISTICS MANUAL 71 (2009), http://dx.doi.org/10.1787/9789264056442-en.

9. Gabison, *supra* note 2, at 102–04 (discussing the meaning of FRAND terms).

10. *See, e.g.*, Ericsson, Inc. v. D-Link Sys., Inc., 773 F.3d 1201, 1209 (Fed. Cir. 2014) ("To help alleviate these potential concerns [of patent hold-up and royalty stacking], SDOs often seek assurances from patent owners before publishing the standard. IEEE, for example, asks SEP owners to pledge that they will grant licenses to an unrestricted number of applicants on 'reasonable, and nondiscriminatory' ('RAND') terms.").

11. *See, e.g.*, Apple, Inc. v. Motorola, Inc., 869 F. Supp. 2d 901, 913 (N.D. Ill. 2012) ("[O]nce a patent becomes essential to a standard, the patentee's bargaining power surges because a prospective licensee has no alternative to licensing the patent; he is at the patentee's mercy. The purpose of the FRAND requirements . . . is to confine the patentee's royalty demand to the value conferred by the patent itself as distinct from the additional value — the hold-up value — conferred by the patent's being designated as standard-essential.").

12. *See, e.g.*, *Letter of Assurance for Essential Patent Claims*, IEEE STANDARDS ASS'N, https://development.standards.ieee.org/myproject/public//mytools/mob/loa.pdf (last visited Mar. 10, 2019) (illustrating a letter of assurance template where the signatory promises to "make available a license for Essential Patent Claims under Reasonable Rate to an unrestricted number of Applicants on a *worldwide basis* with other reasonable terms and conditions that are demonstrably free of unfair discrimination" or can declare that it refuses to grant FRAND licenses) (emphasis added)).

13. *See, e.g.*, Anne Layne-Farrar, *Moving Past the SEP RAND Obsession: Some Thoughts on the Economic Implications of Unilateral Commitments and the Complexities of Patent Licensing*, 21 GEO. MASON L. REV. 1093, 1098 (2014).

relies on leveraging litigation costs against the patent holder — who promised to license his product regardless — to lower the patent holder's negotiation threat value.

Some SEP implementers have attempted to use the same technique by attacking the validity of FRAND worldwide licensing promise. These attacks have occurred all over the globe. For example, in the U.S., in *InterDigital Communications, Inc. v. ZTE Corp.*,[14] InterDigital owned SEP related to different wireless standards.[15] InterDigital made multiple license offers for "a worldwide license, while ZTE wanted the license to be limited to sales in the United States."[16] Similarly, InterDigital made a similar claim against Nokia, but Nokia made a U.S.-only counter-offer.[17] In Germany, this issue arose in *Pioneer v Acer*.[18] Pioneer held patents linked to the DVD standards and sued Acer alleging infringement of its SEPs.[19] Pioneer and Acer attempted to negotiate a license: Pioneer offered a worldwide license, while Acer counter-offered with a license limited to Germany.[20]

SSOs create standards to increase interoperability, which thereby increases the value of standards to society.[21] Interoperability comes in many flavors: interoperability between manufacturers, between equipment and service providers, and between countries.[22] With current global supply chains, worldwide licenses contribute to all three.

Worldwide licenses offer multiple efficiencies. First, worldwide licenses increase negotiation efficiency because they avoid another holdout

14. No. 1: 13-cv-00009-RGA, 2014 WL 2206218, at *2 (D. Del. May 28, 2014).

15. *Id.*

16. *Id.*

17. *Id.*

18. Landgericht Mannheim [LG] [Mannheim Regional Court] Jan. 8, 2016, 7 O 96/14 (¶ 2) (Ger.), *aff'd*, Oberlandesgericht [OLG] [Higher Regional Court] May 5, 2017, 6 U 55/16 (Ger.); Pioneer v. Acer, 4iPCouncil, https://caselaw.4ipcouncil.com/german-court-decisions/lg-mannheim-1/pioneer-v-acer-lg-mannheim (last visited Mar. 10, 2019).

19. 7 O 96/14 (¶¶ 9, 17).

20. 6 U 55/16 (¶¶ 6–8).

21. U.S. DEP'T OF JUSTICE & U.S. PATENT & TRADEMARK OFFICE, POLICYSTATEMENT ON REMEDIES FOR STANDARDS-ESSENTIAL PATENTS SUBJECT TO VOLUNTARY F/RAND COMMITMENTS 2–3 (2013) https://www.justice.gov/atr/page/file/1118381/download ("Voluntary consensus standards serve the public interest in a variety of ways, from helping protect public health and safety to promoting efficient resource allocation and production by facilitating interoperability among complementary products. Interoperability standards have paved the way for moving many important innovations into the marketplace, including the complex communications networks and sophisticated mobile computing devices that are hallmarks of the modern age.").

22. *See id.* at 3–4.

opportunity.[23] Licensors and licensees negotiate over many terms. Having one fewer term to negotiate makes negotiation less costly. FRAND aims to grant patent implementers more bargaining power than they have post-standard adoption to avoid hold-up. Excluding negotiations over territory leaves fewer opportunity for licensees to hold-out on a given term.[24] SEP holders and willing licensees need only negotiate one license for a whole patent family instead of multiple licenses for each jurisdiction where the willing licensees plan to operate.[25] This paper argues that only worldwide licenses should be considered FRAND.

Second, besides negotiation, worldwide licenses ease the contract enforcement, accounting, and monitoring costs.[26] With worldwide negotiation, licensees need only discuss how many units were sold worldwide.[27] This information is usually available for large, publicly traded multinationals.[28] Licensees need not itemize by country because doing so can be difficult or time consuming, and can inadvertently disclose sensitive information about production. Furthermore, licensors need not monitor the movement of licensed/unlicensed good across jurisdictions.

Having multiple national licenses decreases efficiency. FRAND terms

---

23. *See* Apple Inc. v. Motorola, Inc., 757 F.3d 1286, 1334 (Fed. Cir. 2014).

24. *See id.* at 1333 (Rader, C.J., dissenting-in-part) ("Market analysts will no doubt observe that a 'hold out' (i.e., an unwilling licensee of an SEP seeking to avoid a license based on the value that the technological advance contributed to the prior art) is equally as likely and disruptive as a 'hold up' (i.e., an SEP owner demanding unjustified royalties based solely on value contributed by the standardization).").

25. *Contra id.* at 1323 (stating that Motorola had many different licenses).

26. *See* Anne Layne-Farrar & Koren W. Wong-Ervin, *Methodologies for Calculating FRAND Damages: an Economic and Comparative Analysis of the Case Law from China, the European Union, India, and the United States*, 8 JINDAL GLOBAL L. REV. 127, 151 (2017) (noting that licensing on the grounds that . . . a patentee "not only has a 'legitimate interest to settle all acts of use' by a single license agreement rather than on a patent-by-patent basis around the world but would 'incur high costs,' 'including transaction and monitoring costs.'").

27. The parties often negotiate licenses royalty as a function of the pricing of the embodying product. During these negotiations, they also devise what is the embodying product. Licenses can take many forms. *See* Commonwealth Sci. & Indus. Research Org. v. Cisco Systems, Inc., 809 F.3d 1295, 1301–02 (Fed. Cir. 2015) (stating in the facts that the parties negotiated different royalty rate starting with a royalty rate of the value of the final product and a flat rate); *id*. at 1302 (discusses that the general rule is to base damages as a function of the price of the smallest saleable patent-practicing unit but "if a party can prove that the patented invention drives demand for the accused end product, it can rely on the end product's entire market value as the royalty base"). Courts usually use the smallest saleable patent-practicing unit, but in some cases, they opt to use entire market value rule.

28. *See* Jorge L. Contreras, *Global Rate-Setting: A Solution for Standards-Essential Patents?*, 94 WASH. L. REV. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3253954.

attempt to guarantee a sufficiently high return for standard creators to incentivize their participation and a sufficiently low price for standard implementers to incentivize their participations.[29] Forcing patent holders to negotiate jurisdiction-specific licenses increases transactions costs. This increase would either decrease the returns to the patent holders[30] or the patent holders would need to pass on the added cost to licensees. In *Unwired Planet v. Huawei Technologies*,[31] Justice Birrs found that an SEP holder must be compensated for the inconvenience of having to negotiate a state-by-state license.[32] He suggested that the United Kingdom ("UK") licensing rate be doubled for the inconvenience of having to renegotiate other licensing agreements abroad.[33]

Finally, worldwide licenses provide efficiencies for downstream suppliers and customers. In some jurisdictions, like the U.S., end users can be sued for patent infringement.[34] With worldwide licenses, parts and products can move across jurisdictions. Downstream customers can ship and sell their equipment worldwide without having to worry about infringing on any patents and facing a suit. "[N]ot only is international movement foreseeable, it is intended because as it is the point of [a standard compliant product]."[35]

This article discusses worldwide licenses as an industry standard and the attacks on the industry standard. First, section two discusses the threats to worldwide FRAND licensing agreements: antitrust and personal jurisdiction. So far, courts in the European Union ("EU") and U.S. have affirmed that only worldwide licenses were FRAND licenses. They have rebuffed antitrust challenges by failing to find an anticompetitive effect and jurisdictional challenges by asserting that patents could still be challenged abroad. Second, section three discusses the global movement of patented goods. The patent exhaustion doctrine has traditional dealt with the movement of goods to the U.S. However, this doctrine may be inadequate

29. FREDRIK ERIXON & MATTHIAS BAUER, EUROPEAN CTR. FOR INT'L POLITICAL ECON., STANDARD ESSENTIAL PATENTS AND THE QUEST FOR FASTER DIFFUSION OF TECHNOLOGY 2–3 (2017), https://ecipe.org/wp-content/uploads/2017/10/Standard-Essential-Patents-and-the-Quest-for-Faster-Diffusion-of-Technology.pdf.

30. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2017] EWHC (Pat) 711, [92] (Eng.) (stating that decreasing returns can raise problems: if the standard creators were not sufficiently remunerated, then they might decide not to participate in the standard setting process).

31. *Id.*

32. *Id.*

33. *Id.* [602].

34. *See* Gaia Bernstein, *The End User's Predicament: User Standing in Patent Litigation*, 96 B.U. L. REV. 1929, 1973 (2016) (discussing end-user litigations).

35. *Unwired Planet Int'l, Ltd.* [2017] EWHC (Pat) 711, [617].

to deal with FRAND licenses where terms were set by a foreign court. Finally, section four suggests how some of these concerns can easily be addressed by SSOs, Antitrust authorities, and the Supreme Court.

II. THE THREATS TO FRAND WORLDWIDE LICENSES

Worldwide licenses offer efficiencies that help both licensors and licensees save on negotiation, monitoring, and enforcement. However, technology implementers have a lot to gain in requesting local licenses instead of global licenses. They can leverage the cost of litigation against licensor because a patent holder "cannot practically sue separately around the world."[36] To leverage these litigation costs, SEP implementers have raised two arguments against worldwide licenses: an antitrust argument and a personal jurisdiction argument. This section investigates these two arguments.

A. Bundling & Antitrust

Standards have a complicated relationship with antitrust. For the most part, SSO participants are either competitors or vertical collaborators.[37] Competitors can cooperate on technical aspects of standard,[38] but they cannot discuss most licensing aspects (e.g. pricing) without violating antitrust laws.[39] To preempt antitrust liability, SSOs consult with the Justice Department to ensure they are not violating antitrust laws when implementing new policies.[40] The efficiency gains (e.g., interoperability and

36. *Id.* [561].

37. ELI GREENBAUM, FORGETTING FRAND: THE WIPO MODEL SUBMISSION AGREEMENTS 87 (2015), https://www.wipo.int/export/sites/www/amc/en/docs/frand_2015.pdf.

38. *See, e.g.*, Ruben Schellingerhout, *Standard-Setting From a Competition Law Perspective*, COMPETITION POL'Y NEWSL., (European Commission) 2011, at 3 (2011), http://ec.europa.eu/competition/publications/cpn/2011_1_1_en.pdf (discussing the development of standards and their implementations).

39. *See, e.g.*, United States v. Trenton Potteries Co., 273 U.S. 392, 396 (1927) (holding that price fixing between competitors is per se illegal).

40. SSOs often seek an assurance from the antitrust authority that they will not face antitrust liability when they change their policies. *See, e.g.*, Letter from Renata B. Hesse, Acting Assistant Attorney General, U.S. Dep't of Justice, Antitrust Div., to Michael A. Lindsay, DORSEY & WHITNEY LLP (Feb. 2, 2015), http://www.justice.gov/file/338591/download (addressing the Institute of Electrical and Electronics Engineers ("IEEE") after it sought the approval of the Department of Justice ("DOJ") when the IEEE tried to implement a new policy where participants could not use injunctive relief while enforcing their patent); *see also* Letter from Thomas O. Barnett, Assistant Attorney General, U.S. Dep't of Justice, Antitrust Div., to Michael A. Lindsay, DORSEY & WHITNEY LLP (Apr. 30, 2007), http://www.justice.gov/atr/public/busreview/222978.pdf (discussing and authorizing the implementation of a new policy that gives the option to

network effects[41]) from coordinating are weighed against the associated negatives (e.g., decreased competition).

Worldwide licenses have elicited a similar balancing act. The UK High Court of Justice faced this issue in *Unwired Planet v. Huawei Technologies*.[42] Unwired held a portfolio of 225 SEPs that covered three standards and forty-two jurisdictions.[43] Unwired insisted on a worldwide license, whereas Huawei wanted a UK-only license.[44] Justice Birss argued that "[licensor and licensee acting reasonably and on a willing basis] would regard country by country licensing as madness. A worldwide license would be far more efficient."[45]

Faced with this efficiency argument, Huawei challenged worldwide licenses by making an antitrust argument. It argued that the worldwide license was a form of an unlawful bundling/tying arrangement.[46] Justice Birss applied the tying rule developed in *Microsoft Corp*.[47] The rule states that to find an unlawful tying arrangement, the plaintiff must show that (1) the defendant has market power in tying good; (2) the tying and tied goods are separate products; (3) the tying and tied goods are sold separately; and that (4) the tying arrangement restricts competition.[48] The High Court assumed dominance in the tying good, finding that the patents were separate products and that Unwired chose to sell them together; however, the Court did not find sufficient evidence that a worldwide license foreclosed competition.[49]

IEEE members to publicly commit and disclose their most restrictive licensing terms but the DOJ also warns IEEE that it will investigate if this policy is used to price fix); Letter from Thomas O. Barnett, Assistant Attorney General, U.S. Dep't of Justice, Antitrust Div., to Robert A. Skitol, DRINKER, BIDDLE & REATH LLP (Oct. 30, 2006), http://www.justice.gov/atr/public/busreview/219380.pdf (discussing and approving the implementation of a new policy requiring VMEbus International Trade Association members, an SSO, to disclose their most restrictive licensing terms but warning that such policy will be investigated if used for collusive purposes).

41. Jorge L. Contreras, *A Market Reliance Theory or FRAND Commitments and Other Patent Pledges*, 2 UTAH L. REV. 479, 480 (2015) (discussing the benefits associated with standards).

42. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2017] EWHC (Pat) 711 [2] (Eng.).

43. *Id.* at Annex1.

44. *Id.* [524].

45. *Id.* [543]–[44].

46. *Id*. [545].

47. Microsoft Corp v. Comm'n of European Cmtys. [2007] E.C.R. 3619 ¶¶ 15–16.

48. *Id.*

49. *Id.* ¶¶ 545–550.

On appeal,[50] the Court of Appeal affirmed the High Court's decision that "only a global license would be FRAND."[51] Looking at the efficiency issue, the Court of Appeal wrote that, about efficient negotiation and enforcement support,[52] "a global license between a SEP owner and an implementer may be FRAND. Indeed, on the face of it, it is very hard to see how a contrary view could be justified."[53]

The U.S. perspective mirrors this argument. In 2017, the U.S. Department of Justice ("DOJ") and the Federal Trade Commission ("FTC") published their latest Antitrust Guidelines for the Licensing of Intellectual Property (hereinafter "Antitrust Guidelines").[54] The Antitrust Guidelines consider a wide range of licensing-related antitrust issues, including bundling intellectual property.[55] The Antitrust Guidelines state that:

> Package licensing — the licensing of multiple items of intellectual property in a single license or in a group of related licenses — may be a form of tying arrangement if the licensing of one intellectual property right is conditioned upon the acceptance of a license of another, separate intellectual property right.[56]

According to this definition, licensing patent families together into a worldwide license could qualify as a tying arrangement.[57]

The Antitrust Authorities would then need to assess whether the tying arrangement is unlawful based on three criteria: "(1) the seller has market power in the tying product, (2) the arrangement has an adverse effect on competition in the relevant market for the tying product or the tied product, and (3) efficiency justifications for the arrangement do not outweigh the anticompetitive effects."[58]

First, "[t]he Agencies will not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner."[59] Standards can grant the patent holder market power if a critical mass adopts those standards. But, even in the standard-setting context, a generalization cannot

---

50. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2018] EWCA Civ. 2344 (Eng.).

51. *Id*. [129].

52. *Id*. [55]–[56].

53. *Id*. [56].

54. U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY (2017), https://www.justice.gov/atr/IPguidelines/download.

55. *Id.* at 26.

56. *Id.* at 29.

57. *See also infra* Section IV.B.

58. *Id.* at 28–29 (citing United States v. Microsoft Corp., 253 F.3d 34, 95-96 (D.C. Cir. 2001)).

59. *Id.* at 29.

be made about market power because some standards have substitutes. For example, Code Division Multiple Access ("CDMA") and Global System for Mobiles ("GSM") are multiple access technologies developed in the late 1980s and early 1990s.[60] GSM was developed by the European Telecommunications Standards Institute ("ETSI"), an SSO, whereas CDMA was developed by Qualcomm as a proprietary standard and later adopted as a standard by the Telecommunications Industry Association, an SSO.[61] They were substitutes in the early mobile phone market network.[62]

Second, at worst, worldwide licenses have no effect on competition. At best, they increase competition. Worldwide licenses increase competition because products embodying standards can move across borders without the manufacturers having to obtain new licenses.[63] A manufacturer would face one less barrier to export its products and thus would be incentivized to export more of its products — thereby competing with local manufacturers.

Third, worldwide licenses have substantial efficiency consideration. They exploit economies of scope because they bundle similar patents necessary in different jurisdictions.[64] A licensee who only wants a local license would not be negatively affected: if the licensee does not sell products in a country where it does not want a license, then the extra coverage has no impact.[65] If the licensee changes its mind and decides to export to a country where it does not want a license, then it avoids an additional negotiation or litigation.[66]

The DOJ and FTC would not likely challenge global licenses. While the U.S. courts need not follow the same Guidelines, the Guidelines are based on U.S. case precedents and hint that these worldwide licenses would not be invalidated on antitrust grounds.[67] In *U.S. Philips Corp. v. International*

60. Sascha Segan, *CDMA vs. GSM: What's the Difference?*, PC MAG UK (Nov. 19 2018, 5:05 PM), https://uk.pcmag.com/news-analysis/11593/cdma-vs-gsm-whats-the-difference.

61. *Id.*

62. *Id*.

63. *See* Saint Lawrence Commc'ns LLC v. Motorola Mobility LLC, No. 2:15-CV-351-JRG, 2018 WL 915125, at *9 (E.D. Tex. Feb. 15, 2018) (holding that the plaintiff's pursuit of worldwide licenses achieves many procompetitive efficiencies, and is not patent misuse).

64. *Id.* ("For example, seeking a worldwide license helps both parties avoid the extraordinary transaction costs of litigating or licensing a global patent portfolio on a country-by-country or patent-by-patent basis.").

65. *Cf.* Texas Instruments, Inc. v. Hyundai Elecs. Indus., Co., 49 F. Supp. 2d 893, 901 (E.D. Tex. 1999) (holding that worldwide licenses were necessary in defendant's market because it was a worldwide market, and thus did not have the luxury of selling in one country).

66. *Id.* at 914 (stating that worldwide licenses help large companies avoid country-by-country litigation).

67. *See* U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, *supra* note 54, at 1 ("By

Trade Commission,[68] Philips bundled essential and nonessential patents in a licensing package.[69] The U.S. International Trade Commission ("ITC") ruled that the patent bundle was unenforceable because it was a patent misuse likened to an unlawful tying arrangement.[70] The Federal Circuit recognized that package licenses ensure access and have cost-saving virtues.[71] The Federal Circuit stepped away from a per se rule and pointed out that the ITC analysis failed to address a number of issues from cost savings to temporal technological changes.[72] The Federal Circuit did not discuss the worldwide license aspect of the case; nonetheless, it stated that:

> If a patentholder has a package of patents, all of which are necessary to enable a licensee to practice particular technology, it is well established that the patentee may lawfully insist on licensing the patents as a package and may refuse to license them individually, since the group of patents could not reasonably be viewed as distinct products.[73]

This statement provides support to the lawfulness of global licenses because patents in one family may not be distinct products, as they protect the performance of a similar function. Therefore, if the antitrust tying argument against worldwide license was made, it seems unlikely that a U.S. court would rule in favor of said argument.

B. Jurisdictional Reach

SEP implementers have used personal jurisdiction (or the lack thereof) to attack worldwide licenses and limit the court's reach to national licenses.[74] This section discusses whether courts should impose jurisdictional limits on FRAND licenses.

This argument was raised in a number of cases across the globe. In the United Kingdom ("UK"), Huawei made this civil procedure argument to the High Court.[75] Huawei argued that a UK court does not have jurisdiction to enforce a license in other countries.[76] Justice Birss had agreed with

---

stating their general policy, the Agencies hope to assist those who need to predict whether the Agencies will challenge a practice as anticompetitive.").

68. U.S. Philips Corp. v. Int'l Trade Comm'n, 424 F.3d 1179, 1193–97 (Fed. Cir. 2005).

69. *Id.* at 1182.

70. *Id.* at 1183.

71. *Id.* at 1193.

72. *Id.* at 1193–97.

73. *Id.* at 1196.

74. Microsoft Corp. v. Motorola, Inc., 795 F.3d 1024, 1031 (9th Cir. 2015).

75. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2017] EWHC (Pat) 711, [711] (Eng.).

76. *Id.* [553]–[54].

Huawei's approach in the past.[77] Faced with the question anew, he concluded that even if Huawei agrees to a worldwide license, it can still challenge the patent validity where it wants.[78]

The Court of Appeal agreed with his reasoning.[79] The Court looked at the treatment from different jurisdictions, including the European Commission, Germany, the U.S., China, and Japan.[80] The Court rejected that "the [worldwide licensing] approach adopted by [Justice] Birss in these proceedings loses sight of the territorial nature of patent proceedings and does not accord with the approach taken in other jurisdictions."[81] The Court of Appeal also rejected that this approach would render foreign suits moot or "usurped the right of foreign courts"[82] because global licensing does not foreclose the ability to challenge a patent validity in a different jurisdiction.[83] The Court of Appeal rejected Huawei's argument that global licenses would undermine negotiations or public policy or competition law.[84]

In the U.S., the Ninth Circuit was faced with a cross-jurisdiction injunction between U.S. and German patent holders in *Microsoft Corp. v. Motorola, Inc.*[85] Motorola owned SEPs related to a video-coding standard and to a Wi-Fi standard.[86] Motorola encumbered its SEP with RAND commitments.[87] After unsuccessful licensing negotiations, Microsoft sued Motorola for a breach of its duty of good faith and fair dealing during the negotiation based on a third party beneficiary theory.[88] In turn, Motorola sued Microsoft in other fora, including Germany, over the video-coding standard.[89] In the U.S. suit, Microsoft sought to stop Motorola's German injunction.[90] Microsoft succeeded in obtaining the injunction to block Motorola's injunction in a

77. *Id.* [558].

78. *Id.* [567].

79. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2018] EWCA Civ. 2344 (Eng.).

80. *Id.* [59]–[73].

81. *Id.* [74].

82. *Id.* [81].

83. *Id.* [88].

84. *Id.* [95]–[99].

85. Microsoft Corp. v. Motorola, Inc., 795 F.3d 1024, 1024 (9th Cir. 2015).

86. *See id.* at 1031–32 (stating the two SEPs at issue are a video-coding patent and a Wi-Fi patent).

87. *Id.* at 1031 (showing that reasonable, and nondiscriminatory (RAND) and fair, reasonable, and nondiscriminatory (FRAND) have been used interchangeably); Apple, Inc. v. Motorola, Inc., 869 F. Supp. 2d 901, 911–12 (N.D. Ill. 2012); Anne Layne-Farrar, *supra* note 13, at 1098 (stating that "Fair" was added in an attempt to address issues of *holdout*).

88. *Microsoft Corp.*, 795 F.3d. at 1032.

89. *Id.*

90. *Id.* at 1033.

U.S. District Court.[91] Microsoft was also awarded damages linked to the cost of defending the German case and the relocation of its distribution center.[92]

In *Microsoft Corp. v. Motorola, Inc.*, Judge Robart evaluated whether to grant the anti-suit injunction.[93] He first considered the "[e]ffect of the U.S. Action on the German Action."[94] He found that the case involved the same parties and because the original license offer was on a worldwide basis — including the European Patents involved in the German suit — the U.S. action would be dispositive of the German litigation.[95] Second, he considered whether the injunction would "[f]rustrate a Policy of the Forum Issuing the Injunction" and found that having two suits would raise the issue of inconsistent judgment and "the timing of the filing of the German Action raises concerns of forum shopping and duplicative and vexatious litigation."[96] Lastly, he considered "[w]hether the impact on comity would be tolerable" and found that the impact would not be intolerable because of the later timing of the German suit and because the German action involved the same private U.S. corporations, the U.S. court had a strong interest in the claims.[97]

The Ninth Circuit affirmed.[98] In SEP licensing agreements, SEP holders bundle their family into a single worldwide license as general practice.[99] The Ninth Circuit recognized this practice and that the two parties were negotiating a worldwide licensing agreement.[100] The Ninth Circuit viewed the German litigation as a sign of bad faith dealing.[101] The U.S. court was willing to meddle with the German court's decision to grant an injunction because of the worldwide nature of the licensing negotiation.[102]

Judge Berzon of the Ninth Circuit found that a federal district court could enjoin proceeding with an action in a foreign court.[103] He echoed and

91. *Id.* at 1055.
92. *Id.* at 1033.
93. Microsoft Corp. v. Motorola, Inc., 871 F. Supp. 2d 1089, 1100 (W.D. Wash. 2012).
94. *Id.* at 1098–1100.
95. *Id.*
96. *Id.* at 1100.
97. *Id.* at 1101–02.
98. Microsoft Corp. v. Motorola, Inc., 795 F.3d 1024, 1057 (9th Cir. 2015).
99. *Id.* at 1030–31.
100. *Id.* at 1032 n.4.
101. *Id.* at 1055.
102. *Id.*
103. Microsoft Corp. v. Motorola, Inc., 696 F.3d 872, 875 (9th Cir. 2012).

affirmed Judge Robart's findings.[104] Particularly, he found that the FRAND issue is a contractual issue (instead of a patent issue) and the original promise was of a worldwide license, which encompassed both the U.S. and EU patents.[105] Much like in the UK *Huawei* case, the Ninth Circuit signaled that worldwide licenses were part of the FRAND commitment.

Much like in the UK *Huawei* case, Ninth Circuit recognized that the parties could still litigate the validity or infringement finding in a foreign court.[106] "[The Ninth Circuit] cannot say that the district court's limited antisuit injunction to protect its ability to reach that final resolution enacts any intolerable incursion into Germany's sovereignty."[107]

This willingness to intervene across jurisdictions has become more pervasive in the SEP context because of the worldwide aspect of the FRAND contractual promises. But this willingness has limits. *Apple Inc. v. Qualcomm Inc.*[108] involved a similar request for an anti-suit injunction. Qualcomm held a number of SEPs linked to wireless standards, and Apple had implemented these standards in its phones.[109] Apple filed a suit against Qualcomm for breach of contract claims, patent claims, and antitrust claims.[110] Qualcomm filed contract-based counterclaims.[111] Subsequently, Apple filed a suit in the U.K., Japan, China, and Taiwan.[112] Qualcomm moved to have the foreign suits enjoined.[113]

The District Court differentiated the *Apple v. Qualcomm* case from the *Microsoft v. Motorola* case on multiple bases.[114] First, the court found that the parties were differently situated: in *Motorola* the SEP holder was the one suing abroad, whereas in *Qualcomm* the SEP implementer was the one suing abroad.[115] Second, the court found that the Apple suits were not about the

104. *Id.* at 889.

105. *Id.* at 883–85.

106. *Id.* at 883.

107. *Id.* at 889.

108. Order Denying Anti-Suit Injunction at 2, Apple Inc. v. Qualcomm Inc., No. 3:17-cv-00108-GPC-MDD (ECF No. 92-1) (S.D. Cal. Sept. 7, 2017).

109. *Id.* at 2–3.

110. *Id.* at 5–6.

111. *Id.* at 5.

112. *Id.* at 8–10.

113. *Id.* at 10.

114. *See id.* at 17–20.

115. *See id.* at 18–20 ("The *Microsoft* court concluded that the U.S. and foreign actions were functionally the same because Motorola's contractual commitment to the standard-setting organization effectively mooted any right Motorola had to bring an action for infringement in a foreign court. The same cannot be said of Apple's U.S. and foreign actions. Apple has made no binding commitment that limits where it can bring a lawsuit, under what laws, or how it can enforce its third-party beneficiary rights under

licensing agreement but about Qualcomm's business methods: Apple suits were based on anti-competitive claims and patent exhaustion.[116] Therefore, the resolution of the U.S. suit would not resolve the other suits.[117]

The court found that the facts of the case did not warrant an anti-suit injunction. The court found that the cases filed by Apple in other jurisdictions were not vexatious or oppressive and inconsistent and they did not justify granting an injunction because Apple did not ask the court for a worldwide relief.[118] Finally, the court found that other countries had their own interest enforcing their antitrust laws.[119] In fact, China, Japan, and Korea had already penalized Qualcomm for its anticompetitive business methods.[120] As such, these and other countries like the EU had their own interest in enforcing their own antitrust laws.[121] As such, the District Court rejected the request for injunction.[122] The *Qualcomm* case shows the multifaceted issues intertwined with FRAND cases (i.e., antitrust, contract, and intellectual property).

China has a different approach to FRAND licensing. In *Huawei v. InterDigital*,[123] the Guangdong High People's Court did not seem willing to enforce worldwide licenses and instead enforced only a Chinese license.[124] In the case, Huawei claimed that InterDigital violated antimonopoly laws and its FRAND commitment by charging Huawei higher licensing fees than Apple and Samsung.[125] China did not recognize the negotiations that took

---

ETSI. As a baseline matter, therefore, Apple is free to exercise its rights in the United Kingdom, China, Taiwan, and Japan under those countries' law.").

116. *See id.* at 20–21 (favoring Apple's argument that "even the global FRAND issue will not dispose of the foreign actions because Apple's foreign suits have challenged the validity and exhaustion of Qualcomm's foreign patents, under foreign patent law, and have additionally challenged Qualcomm's licensing practices under foreign competition and anti-trust laws.").

117. *Id.* at 22 ("Qualcomm has failed to demonstrate that . . . an adjudication on the merits here would dispose of the claims abroad.").

118. *Id.* at 23–26.

119. *Id.* at 30–34.

120. *Id.*

121. *Id.*

122. *Id.* at 2.

123. Yue Gao Fa Min San Zhong Zi No. 305 (粤高法民三终字第305号) [Huawei Tech. Co., Ltd. v. InterDigital Corp.], http://en.anjielaw.com/downloadRepository/084d342a-0bc7-4592-a796-52e9b9f140ce.pdf (Guangdong Province High People's Ct. 2013) (China); *see also* D. Daniel Sokol & Wentong Zheng, *FRAND (and Industrial Policy) in China*, *in* CAMBRIDGE HANDBOOK OF TECHNICAL STANDARDIZATION LAW: ANTITRUST AND PATENTS 315–17 (Jorge L. Contreras ed., 2017).

124. *See* Sokol & Zheng, *supra* note 123, at 315–17.

125. *See id.* (stating that the Guangdong Province High People's Court of China affirmed the lower court decision).

place abroad.[126] In that respect, China took a more limited approach and distinguished itself from the rest of the world about FRAND worldwide licenses.

While most courts have enforced worldwide licenses, this approach is not universal. The next section discusses in more details the third efficiency of having worldwide licenses: the unencumbered movement of patented goods.

III. GLOBAL SUPPLY CHAINS AND MOVEMENT OF PATENTED GOODS

Willful negotiations of worldwide licenses create a number of efficiencies. First, participants need only negotiate once. Second, patented goods can move easily through the stream of commerce. This last efficiency can also be garnered thanks to the patent exhaustion doctrine. This section discusses in more details why worldwide licenses may not be as necessary to reach some of its efficiencies.

A. The Patent Exhaustion Doctrine

Even before the introduction of global supply chains and standards, courts worried about the free movement of patent implementing goods. To deal with that issue, the U.S. Supreme Court created the patent exhaustion doctrine.[127]

In *Bloomer v. McQuewan*,[128] Woodworth owned a patent and assigned its right to Wilson, who then licensed the right to Bloomer to make and sell machines embodying the patented invention in Pittsburg.[129] McQuewan licensed the right to make and use machines embodying the same patents.[130] In the meantime, Congress extended the length of patents, and Bloomer sued McQuewan for infringement by claiming that the original agreement ended with the original patent length.[131] The Court ruled that "[t]he inventor might

126. In the meantime, Huawei and InterDigital were also tangled in arbitration in France and litigations in the U.S. InterDigital Commc'n, Inc. v. Huawei Inv. & Holding Co., 166 F. Supp. 3d 463, 467–68, 470–74 (S.D.N.Y. 2016) (discussing the arbitration between InterDigital and Huawei in France).

127. This doctrine has a long history. Chief Justice Roberts traces its origin as far as back as 1628 England. Impression Products v. Lexmark International, 137 S. Ct. 1523, 1532 (2017) (stating that Lord Coke wrote that "if an owner restricts the resale or use of an item after selling it, that restriction 'is voide, because . . . it is against Trade and Traffique, and bargaining and contracting betweene man and man.'"); *see also* Quanta Computer, Inc. v. LG Electronics, Inc., 553 U.S. 617, 625 (2008) (quoting Bloomer v. McQuewan, 68 U.S. 539, 549 (1864)) (tracing the U.S. Supreme Court first mention as far back as 1853 in *Bloomer v. McQuewan*).

128. Bloomer v. McQuewan, 55 U.S. 539, 549–550 (1853).

129. *Id.* at 548.

130. *Id.*

131. *Id.* at 549.

lawfully sell [a machine] to him . . . . And when the machine passes to the hands of the purchaser, it is no longer within the limits of the monopoly. It passes outside of it, and is no longer under the protection of the act of Congress."[132] This ruling created the patent exhaustion doctrine. In this ruling, the Supreme Court attempted to balance the interest of the inventors and machine purchasers.[133] While the issue has evolved over the years, the Supreme Court reaffirmed its commitment to the patent exhaustion doctrine continuously.[134] The Supreme Court saw that the patent holders cannot not use patent law to extend their rights over patent good purchasers beyond their contractual agreements.[135] The next two subsections discuss how the U.S. Supreme Court has addressed the patent exhaustion doctrine in the context of (1) global movement of goods and (2) modern functional patents.

1. Patent exhaustion limits national and international ability to stop arbitrage

Since *Bloomer v. McQuewan*, the Supreme Court has also ruled on patent exhaustion cases linked to import-export between national and international jurisdictions.

First, the Supreme Court addressed the national movement of goods between national territorial divisions devised by the patent holders. Much like other rights, the Supreme Court consistently found that patent rights did not grant its holder rights to decrease the movement of patented goods lawfully purchased, once put in the stream of commerce.

---

132. *Id.*

133. *Id.* at 552–54.

134. *See* Bos. Store of Chi. v. Am. Graphophone Co., 246 U.S. 8, 20-22 (1918) (holding that a patent holder could not use its patent right to enforce a resale price maintenance); Wade v. Metcalf, 129 U.S. 202, 205 (1889) (holding that if an inventor and its partners made a machine, then, after the partnership dissolved, the non-inventor partner could continue using the patented machine without infringing because the patent right were exhausted); Birdsell v. Shaliol, 112 U.S. 485, 489 (1884) (holding infringement damages did not exhaust the patent rights); *see also* Dr. Miles Med. Co. v. John D. Park & Sons, Co., 220 U.S. 373, 408 (1911) (making resale price maintenance per se illegal); Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 907 (2007) (reversing *Dr. Miles Med. Co. v. John D. Park & Sons, Co.*).

135. *But see* Bowman v. Monsanto Co., 569 U.S. 278, 280-288 (2013) (holding a patent on a genetically modified soybean seed was not exhausted by the first purchase of the seed and the planting of the seed was literal reproduction or copying); *id.* (departing from its patent exhaustion doctrine). The Supreme Court asserted that the patent exhaustion limitation raised in this case was limited to the fact at hand and should not be read to apply to all self-replicating technology. *Id.* at 289. Besides its application to seeds or reproducing genetically modified organisms, the implications of *Bowman v. Monsanto* remain unknown.

In *Adams v. Burke*,[136] the Supreme Court repeated this principle when faced with a patent holder attempting to enforce a territorial restriction. In this case, a licensee sold a patented coffin lid, but the coffin was used outside the licensee's territory.[137] The licensee from the territory where the coffin was imported sued the coffin purchaser.[138] The Court found that once purchased, the purchaser could move the good beyond the licensee's territory without infringing on the patent.[139]

Justice Bradley dissented and pointed out that the patent exhaustion doctrine granted the licensee more power than negotiated: since its purchasers could take the good outside its territory, a licensee could target consumers outside its territory.[140]

The Supreme Court re-addressed the issue of patent exhaustion and territorial restriction in *Hobbie v. Jennison*.[141] In this case, a patent holder had licensed his patent for pipes to multiple entities.[142] In doing so, the patent holder divided the territory and gave an exclusive right to each licensee within a geographical region.[143] One licensee ended up selling the patented pipes to someone building a house outside the licensee's territory.[144] The licensee from the territory where the house was located sued the licensee seller of the pipes.[145] The plaintiff attempted to distinguish his case from *Adams v. Burke* by affirming that the licensee in *Burke* did not know where the coffin would be used, whereas the licensee in *Hobbie* knew where the pipes would be installed.[146] The Supreme Court disagreed and found that neither the sellers nor the users/purchasers are liable under a territorial restriction agreement.[147] Again, the Court pointed to contracts being the best avenue to resolve these problems.[148]

Second, the Supreme Court addressed the international movement of goods. The Supreme Court addressed patent exhaustion in the international context in two cases. In both cases, the Court repeated the same principle:

136. 84 U.S. 453 (1873).
137. *Id.* at 456–57.
138. *Id.* at 454.
139. *Id.* at 456–57.
140. *Id.* at 457–59.
141. 149 U.S. 355, 356 (1893).
142. *Id.* at 360–61.
143. *Id.*
144. *Id.*
145. *Id.* at 356.
146. *Id.*
147. *Id.* at 363–64.
148. *Id.*

patents did not grant its right holders the ability to decrease the movement of patented goods lawfully placed in the stream of commerce.

In *Boesch v. Gräff*,[149] the plaintiff held three German patents and one U.S. patent for an invention, a lamp burner.[150] The defendant bought the patented invention in Germany and imported the lamps to the U.S.[151] The German manufacturer had made the lamps without a license and instead had benefited from a court ruling that allowed him to continue making lamps because it had been using the invention prior to the plaintiff applying for the patents.[152] The Supreme Court ruled that while the German manufacturer was able to legally make the lamps under German law, it was not able to make them in the U.S. under U.S. law.[153] Therefore, even though the lamp was legally made, it could not be legally sold in the U.S.[154]

After *Boesch v. Gräff*, it took over 125 years to re-address this issue. *Impression Products, Inc. v. Lexmark International, Inc.*[155] involved a patent holder, Lexmark, who held foreign and U.S. patents.[156] The patents covered printing cartridges. Impression Products bought used cartridges from consumers both in the U.S. and abroad, it refiled the ink in the cartridges, and resold them to consumers in the U.S.[157] Lexmark sued for patent infringement for the refurbishment of U.S.- and foreign-bought cartridges.[158]

The Court made a two-part ruling. First, the Supreme Court ruled that Lexmark exhausted its patent rights by the time Impression Products purchased the U.S. cartridges.[159] Lexmark had a contractual agreement with some consumers who received a discount in exchange for their promise not to sell.[160] However, Lexmark did not have a contract with Impression Products and similarly situated refurbishers.[161] Lexmark could not use patent law to enforce a no-resale clause.[162] Once again, the Court pointed out the

149. 133 U.S. 697 (1890).
150. *Id.* at 698.
151. *Id.* at 699, 702.
152. *Id.* at 701–02.
153. *Id.* at 703.
154. *Id.*
155. 137 S. Ct. 1523 (2017).
156. *Id.* at 1529.
157. *Id.* at 1529–30.
158. *Id.* at 1530.
159. *Id.* at 1533.
160. *Id.* at 1530.
161. *Id.* (noting Lexmark's contractual agreements were exclusively with the initial customers, not with remanufacturers like Impression Products).
162. *Id.* at 1533.

issue of using patent law to enforce incomplete contracts.[163]

Second, the Supreme Court ruled that Lexmark also exhausted its patent rights by selling the product abroad.[164] The Supreme Court distinguishes *Impression Products v. Lexmark* from *Boesch v. Gräff* through the decision to sell: Gräff held a patent in the U.S. and abroad, but it did not want to sell abroad, whereas Lexmark held a patent in both jurisdictions and wanted to sell in both jurisdictions.[165] The Supreme Court supported its argument by comparing the patent exhaustion doctrine to the copyright first sale doctrine.[166] The Court stated that while a patent rewards its holder by providing the right to exclude others, it does not guarantee that "the patentee receives a premium for selling in the United States."[167] The (smaller) premiums the patentee receives in other jurisdictions already exhausted its right.[168]

Justice Ginsburg disagreed with the majority.[169] She argued that: "[p]atent law is territorial. When an inventor receives a U.S. patent, that patent provides no protection abroad . . . . Accordingly, the foreign sale should not diminish the protections of U.S. law in the United States."[170] In other words, she recognizes that patent holders may be offered less protection in other countries. This weaker protection diminishes the inventor's ability to profit from its invention. This difference in protection incentivizes the patent holders to avoid a smaller royalty jurisdiction to enforce worldwide licenses.

Justice Ginsburg reprised the argument she made in *Kirtsaeng v. John Wiley & Sons, Inc.*[171] when discussing the copyright first sale doctrine, and she re-enforced her argument by noting that, while copyright has been internationally harmonized, patent rights have not.[172] In *Kirtsaeng*, she observed that other territories have different exhaustion doctrines — including the EU — "under which the sale of a copy anywhere within the

163. *Id.* at 1537 ("More is at stake when it comes to patents than simply the dealings between parties, which can be addressed through contract law.").

164. *Id.* (holding patent exhaustion applies to foreign sales).

165. *Id.* at 1537.

166. *Id.* at 1536.

167. *Impression Products*, 137 S. Ct. at 1531, 1538.

168. *Id.* at 1537 (noting that exhaustion is triggered when a patent owner makes a foreign or domestic sale for any amount because it chose to give up the right to exclude the purchaser for a fee).

169. *Id.* at 1538 (concurring with the majority regarding domestic exhaustion but dissenting based upon international exhaustion).

170. *See id.* at 1538–39 (discussing how U.S. patents do not extend to other countries, so when the patents are sold abroad the U.S. laws should still protect the patent).

171. 568 U.S. 519 (2013).

172. *Impression Products*, 137 S. Ct. at 1538.

European Economic Area exhausts the copyright," but not sales outside the region.[173]

Thanks to this broad patent exhaustion doctrine, goods can already move more easily between foreign countries and the U.S., thereby negating the necessity for U.S.-negotiated worldwide licenses: SEP implementers need only obtain a license in one of the jurisdictions before the goods reach U.S. shores.[174] The next subsection discussion method patents, a type of patent often involved in modern standards.

2. Patent exhaustion limits the rent seeking ability associated with method patents

Besides contracts, patent holders might resort to other ways to extend their patent rights and control how the patented goods are sold.

First, a patentee might create a product that required the purchaser to carry out the last patented step to get a fully functional invention. As such, the patentee would claim that the incomplete invention did not amount to a (first) sale. Instead, the recipient of the incomplete invention would be a licensee under an implicit contract, not a purchaser who could dispose of it at will.

In *United States v. Univis Lens Co.*,[175] Univis Lens held a number of patents and licensed their uses to wholesalers and retailers.[176] Univis Lens collected royalties, commanded how lenses were finished, and imposed a resale price maintenance on all supply chain participants through licensing agreements.[177] The government challenged Univis Lens' licensing practices on antitrust grounds: the government asserted that the patent did not address how the lenses were finished and as such, it could not control the sale of lenses once made.[178]

The Supreme Court ruled that patent rights cannot be extended through incomplete processes: when an inventor lawfully sells an unfinished invention that embodies the essential patented features and that requires the purchaser to complete the last step in conformity with a patent, it transfers ownership, allows a license to practice the final stage of the patent procedure, and exhausts its patent.[179] The inventor can no longer "control the price at

173. *Kirtsaeng*, 568 U.S. at 575.

174. *Impression Products*, 136 S. Ct. at 1538–39 (2017).

175. 316 U.S. 241 (1942).

176. *Id.* at 244–45 (discussing how the corporation issued three classes of licenses to wholesalers, finishing retailers and prescription retailers).

177. *Id.* at 245–46.

178. *Id.* at 248.

179. *Id.* at 250–52.

which it may be sold either in its unfinished or finished form."[180]

This issue of incomplete product would resurface some seventy years later in the form of method patents.[181] However, with method patents, this issue took a different meaning: more than one product are often necessary to practice the patented invention.[182]

In *Quanta Computer, Inc. v. LG Electronics, Inc.*,[183] the U.S. Supreme Court faced such method patents. In this case, LG Electronics (LGE) held and licensed its patents to Intel Corp.[184] Intel made microchips that practiced the patent they licensed from LGE.[185] But to practice the patents (i.e. storing and retrieving data), a computer called

on multiple elements and microchips.[186] Some of these elements were not Intel-made and had not been licensed to practice LGE's patents.[187] Quanta Computer made computers with Intel and non-Intel components.[188] LGE sued Quanta for infringement because the non-licensed components were practicing LGE's patents.[189]

The Supreme Court ruled that method claims were exhausted by the sale of the microchips.[190] Once more, the Court noted that LGE might have a breach of contract claim against Intel but not a patent infringement claim against Quanta.[191]

---

180. *Id.* at 251.

181. *See Business Method Patents*, IP WATCHDOG, http://www.ipwatchdog.com /patent/business-method-patents/ (last visited Mar. 7, 2019) (discussing the history of method patents and their current requirements under U.S. federal law).

182. *See business-method patent*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining a business-method patent, or "method patent," as "[a] U.S. patent that describes and claims a series of process steps that, as a whole, constitutes a method of doing business," which necessarily requires that there be more than one product to practice the patented invention).

183. 553 U.S. 617, 625 (2008).

184. *Id.* at 621–23.

185. *Id.* at 623.

186. *See id.* 623–24 (stating that Quanta created and manufactured products that practiced LGE patents by using Intel products with other, non-Intel "memory and buses").

187. *See id.* at 624.

188. *See id.* at 624–25.

189. *See id.*

190. *Id.* at 638 ("The authorized sale of an article that substantially embodies a patent exhausts the patent holder's rights and prevents the patent holder from invoking patent law to control postsale use of the article.").

191. *See id.* n.7 ("We note that the authorized nature of the sale to Quanta does not necessarily limit LGE's other contract rights. LGE's complaint does not include a breach-of-contract claim, and we express no opinion on whether contract damages might be available even though exhaustion operates to eliminate patent damages.").

The Supreme Court's ruling in *Quanta Computer, Inc.* affects the enforcement of standards and FRAND cases discussed in this paper. Most patents associated with standard settings in the Information and Communication Technology industry are method patents.[192] As such, the patent holders have to restructure their licensing agreements to account for patent exhaustion.

This interpretation of the patent exhaustion doctrine is not universal. In China, patent exhaustion doctrine does not apply to patented methods.[193] For example, in *Iwncomm v. Sony*,[194] the Beijing IP Court ruled that method patents were not exhausted by the sale of an article that substantially embodies the patent.[195] As such, patent holders must also adapt to different jurisdictions.

As discussed, the U.S. Supreme Court has, in a number of cases, noted that patent holders can more effectively create restrictions through contracts rather than through its patent rights.[196] The Supreme Court used the patent exhaustion doctrine to limit the rights granted to patentees and avoid issues related to incomplete contracts.[197]

In *Quanta Computer, Inc.*, the policy argument that the Court presented mirrors the policy argument to support worldwide licenses — principally with respect to the free movement of patented products.[198] As the Supreme Court suggested, contracts, rather than patent law, should be used to resolve the issue of appropriate return on innovation because voluntary negotiations from worldwide licenses are better equipped to deal with the issue of the global movement of goods than a patchwork of different patent exhaustion

192. *See* Kate Gaudry & Tom Franklin, *Post-Alice Exam Stats in Software Art Units: A Bleaker Road*, LAW360 (Oct. 03, 2014, 9:39 AM), https://www.kilpatricktownsend.com/~/media/Files/articles/2014/Post-Alice%20Exam%20Stats%20In%20Software%20Art%20Units%20A%20Bleajer%20Road.ashx ("business-method . . . patent applications, includ[e] many software applications focused, for example, on medical software, business crypto, anti-counterfeiting, fraud detection and electronic voting.").

193. *See* Yangjin Li, *No Exhaustion Doctrine for "method-of-use" Patents* – Iwncomm v. Sony *Decision in China*, TRUST IN IP (July 25, 2017), https://trustinip.com/no-exhaustion-doctrine-for-method-of-use-patents-iwncomm-v-sony-decision-in-china/.

194. Xi'an Xi Dian Jie Tong Radio Network Co. v. Sony Mobile Communication (China) Co., Ltd [IWNComm v. Sony], (Jing Zhi Min Chu Zi No. 1194 (Beijing Intellectual Property Ct. 2015) (China).

195. *Id.*; *see* Thomas Cotter, *Translation of Abridged Version of* IWNCOMM v. Sony Judgment, COMP. PAT. REMEDIES (Apr. 8, 2017), http://comparativepatentremedies.blogspot.com/2017/04/translation-of-abridged-version-of.html (translation of *IWNComm v. Sony*).

196. *See Quanta Computer, Inc.*, 553 U.S. 637 n.7; *supra* Section III.A.

197. *See Quanta Computer, Inc.*, 553 U.S. 637 n.7.

198. *See id.* at 636–37.

doctrines. [199]

The patent exhaustion doctrine offers mixed incentives to patent holders and implementers to negotiate worldwide FRAND licenses. On the one hand, SEP holders could refuse to negotiate a worldwide license and wait for the products to reach U.S. shores to ensure they avoid patent exhaustion and get that premium. On other hand, SEP holders could want to negotiate a worldwide license because they fear that an implementer enjoin their suit in the U.S. and attempt to take the suit in a lower premium jurisdiction. These issues are discussed in more details in the next section.

B. Global Movement of SEP Implementing Goods

Supply chains are global. A product might be designed in the U.S., manufactured in Korea, assembled in China, and sold in Europe. Without worldwide licenses, any step along this supply chain could be exposed to infringement claims. Two types of movement can be problematic: (1) the movement from unlicensed to licensed jurisdictions, and (2) the movement between licensed jurisdictions.

First, the movement from an unlicensed to a licensed jurisdiction creates a number of problems. Namely, the patent holder has not received any benefit abroad[200] and can raise infringement claims or block the importation of the patented good. Additionally, infringement suits will eat into the patent holder's profits and blocking product imports can be difficult.[201] Both options require patent holders to spend more resources monitoring imports, and some imports may go undetected.

These issues arose in *Unwired Planet v. Huawei Technologies*.[202] Unwired Planet ("Unwired") raised the problems SEP licensor would face without worldwide licenses in the context of global trade and the movement of people.[203] Huawei Technologies ("Huawei") manufactures its phones in Venezuela, where Unwired does not have any patents,[204] where the IP regime has been called "inefficient and ineffective," and where there have not been any patents granted since 2007.[205] If Unwired were to agree to a UK license

199. *See id.* (recommending that the parties look to the structure of the Licensing Agreement to determine the rights of each party).

200. *Impression Prod.*, 137 S. Ct. at 1538–39.

201. *See, e.g.*, Beverly Hills Fan Co. v. Royal Sovereign Corp., 21 F.3d 1558, 1571 (Fed. Cir. 1994) ("Economic loss occurs to the patent holder at the place where the infringing sale is made because the patent owner loses business there.").

202. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2017] EWHC (Pat) 711, [711] (Eng.).

203. *See id.* [1]–[4] (providing case background information).

204. *Id.* [539].

205. *See* Investment Climate Statements 2018 Venezuela, U.S. Dep't of State (July

only, unlicensed products may find their way into the UK.[206] To account for these unlicensed imports and roaming consumers, Justice Birrs imposed a four percent increase on the UK licensing fee.[207]

While Justice Birrs' licensing fee increase may help avoid additional litigation, it creates other problems. Justice Birrs implicitly estimates that Unwired lost four percent of licensing fees because Huawei phones were used in the UK but purchased in a jurisdiction where Huawei does not have a license.[208] Justice Birrs provides no statistical support to this estimate.[209] Such uplift could under- or over-estimate the circulation of foreign unlicensed goods.[210] Therefore, without a *fair* compensation, patent holders could be under-incentivized to participate in the standard-setting process.[211]

Moreover, this uplift means that licensed users subsidized unlicensed users. This subsidy means that unlicensed users would pay a lower price for equipment than licensed users. The discrepancy between pricing abroad and at home makes arbitrage even more attractive. More arbitrage worsens the problem and decreases the SEP holders' revenues, which puts even more pressure on the standard setting-process.

Second, the movements from unlicensed to licensed jurisdictions may not be the standard-setting process's main concern. SEP holders may worry more about the movements from a licensed jurisdiction with court mandated low FRAND rate to the U.S.

The patent exhaustion doctrine offers some protection to U.S. importers. If, at any point along the supply chain, a supplier paid a licensing fee, then the importers should be protected from patent litigation under the patent

---

19, 2018), https://www.state.gov/e/eb/rls/othr/ics/2018/wha/281787.htm ("Venezuela's Intellectual Property Rights (IPR) regime remains inefficient and ineffective. . . . Venezuela ranked as one of the top 20 economies worldwide for unlicensed software and an estimated 87 percent of the software used in Venezuela in 2014 was unlicensed . . . .[The Autonomous Intellectual Property Service (SAPI)] has issued no new patents since 2007.").

206. *Unwired Planet Int'l, Ltd.* [2017] EWHC (Pat) 711, [615]–[17].

207. *See id.* [619] (showing that the patent exhaustion doctrine does not afford such protection in the other jurisdictions); *see also* Impression Prod., Inc. v. Lexmark Int'l, Inc., 137 S. Ct. 1523, 1538–39 (2017) (Ginsburg, J., dissenting) (arguing that patents were territorial and U.S. patents do not grant protect abroad and foreign patents do not grant protection in the U.S. and that the patent exhaustion doctrine should follow the same principle).

208. *Unwired Planet Int'l, Ltd.* [2017] EWHC (Pat) 711, [619].

209. *See id.* [619] ("Absent any other figures, the parties would agree a simple percentage uplift on the total handset royalty to take it into account[;] I think a fair, reasonable uplift is [four percent].").

210. *See id.* [620]–[21] (showing the different margin of error that Huawei suggested).

211. *See id.* [622] ("The other issue is about the licensor's access to the licensee's information in the event an audit identifies an underpayment.").

exhaustion principles (under *Boesch v. Gräff* and *Lexmark*). In such situation, the U.S. SEP holders may already have received some benefits from the patent family.[212] In *Lexmark*, the Supreme Court has stated patent rights do not guarantee a U.S.-level premium.[213] Therefore, a holder of such SEP family could be stuck with low court mandated royalty rate because of the patent exhaustion doctrine.

China has a different approach to FRAND terms.[214] Electronics are heavily produced in China, and, for the last decade, electronic standards have been at the center of numerous U.S. FRAND licensing disputes.[215] First, China focuses on national licenses terms in *Huawei v. InterDigital*.[216] Second, China has imposed low FRAND rates.[217] For a while, Chinese authority hoped that standards could be implemented royalty-free or for "'significantly lower' than the normal amount."[218] While this policy is not written in official documents, it seems to have been implemented in *Huawei v. InterDigital*.[219] The Shenzhen Intermediate People's Court set the FRAND rate that Huawei had to pay equal to InterDigital's lowest contracted rate.[220] If Huawei's equipment made in China was imported to the U.S., a U.S. court following the *Lexmark* precedent could consider that InterDigital

212. *See Impression Prod.*, 137 S. Ct. at 1538–39 (differentiating between imports where the patent holders received some benefit from patent protection abroad and imports where the patent holders did not).

213. *Id.* at 1538.

214. Sokol & Zheng, *supra* note 123, at 315.

215. *See* RAMAN CHITKARA & JIANBIN GAO, CHINA'S IMPACT ON THE SEMICONDUCTOR INDUSTRY: 2016 UPDATE 5 (2017), https://www.pwc.com/gx/en/technology/chinas-impact-on-semiconductor-industry/assets/china-impact-of-the-semiconductor-industry-2016-update.pdf (explaining that China has about a third of worldwide production of electronics); *see, e.g.*, Ericsson, Inc. v. D-Link Systems, Inc., 773 F.3d 1201, 1208 (Fed. Cir. 2014) (discussing Wi-Fi standards); Apple, Inc. v. Motorola, Inc., 757 F.3d 1286 (Fed. Cir. 2014) (discussing wireless standards); Microsoft Corp. v. Motorola, Inc., 795 F.3d 1024, 1042–45 (discussing Wi-Fi and video standards); Commonwealth Scientific and Industrial Research Organisation v. Cisco Systems, Inc., 809 F.3d 1295, 1297–99 (Fed. Cir. 2015) (discussing Wi-Fi standards).

216. *Id.* at 315–17.

217. *Id.*

218. *Id*. at 312.

219. Huawei Jishu Youxian Gongsi Su Jiaohu Suzi Tongxin Youxian Gongsi [Huawei Tech. Co. v. InterDigital Communications, Inc.] 2013 Yue Gao Fa Min San Zhong Zi No. 305 & 306 (Guangdong High People's Ct. 2013) http://www.mlex.com/China/Attachments/2014-04-18_AXRC879FW8P38IO7/guangdonghpc_IDChuawei_SEP_18042014.pdf; ANJIE LAW FIRM, http://en.anjielaw.com/downloadRepository/084d342a-0bc7-4592-a796-52e9b9f140ce.pdf (last visited Feb. 5, 2019) (translating Huawei Tech. Co. v. InterDigital Communications, Inc.) [hereinafter Huawei Translation].

220. Huawei Translation, *supra* note 219, at 5–6.

exhausted its rights.[221]

Those low court mandated royalties could disincentivize SEP holders to participate in the standard-setting process. Because of the patent exhaustion doctrine, China could become the most important jurisdiction when it comes setting FRAND licensing terms and royalty rates[222] — and SSOs everywhere.

IV. CONTRACTS AND POLICIES RE-ENFORCEMENT

The patent exhaustion doctrine has attempted to rein in patent holders' efforts to increase their power over purchasers of patented goods. In the same vein, FRAND attempts to rein in patent holders' market power post standard adoption through an ex-ante contractual commitment.

A. FRAND Commitments

Many scholars have debated about the meaning of FRAND commitments.[223] All of the court cases described above view FRAND commitments as contracts where the standard implementer is a third-party beneficiary.[224] The SSOs dictated the terms of these contracts. Most SSOs already required that the letters of assurance include the "worldwide"

221. *Id.*

222. D. Daniel Sokol & Wentong Zheng, *FRAND in China*, 22 TEX. INTELL. PROP. L.J. 71, 73 ("Because of the size of China's economy, developments on FRAND in China potentially have global impact on FRAND rates and even the business models of innovative firms. The operation of market forces will result in globalization of the lowest rate set by a court or agency for a particular patent or patent portfolio in a major jurisdiction. China is such a jurisdiction. Consequently, if China is more influential, it will be because China will be inclined to set rates lower than other jurisdictions. In essence, what happens in China on FRAND now impacts decision-making in the boardrooms of Silicon Valley.").

223. *See e.g.*, J. Gregory Sidak, *The Meaning of FRAND, Part II: Injunctions*, 11 J. COMPETITION L. & ECON. 201, 206–07 (2015); Damien Geradin, *The Meaning of "Fair and Reasonable" in the Context of Third-Party Determination of FRAND Terms*, 21 GEO. MASON L. REV. 919, 921–22 (2014); J. Gregory Sidak, *The Meaning of FRAND, Part I: Royalties*, 9 J. COMPETITION L. & ECON. 931, 951 (2013); Roger G. Brooks & Damien Geradin, *Interpreting and Enforcing the Voluntary FRAND Commitment*, 9 INT'L. J. IT STANDARDS AND STANDARDIZATION RES. 1, 6 (2011); Damien Geradin & Miguel Rato, *Can Standard-Setting Lead to Exploitative Abuse? A Dissonant View on Patent Hold-Up, Royalty Hold-Up, Royalty Stacking and the Meaning of FRAND*, 3 EUR. COMPETITION J. 101, 114 (2007).

224. *See e.g.*, Microsoft Corp. v. Motorola, Inc., 696 F.3d 872, 884 (9th Cir. 2012); Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2017] EWHC (Pat) 711 [572] (Eng.); Landgericht [LG] Jan. 8, 2016, 7 O 96/14 (¶ 2) (Ger.); *see also* Oberlandesgericht [OLG] May 5, 2017, 6 U 55/16 (Ger.).

language.[225] For example, in *Microsoft Corp. v. Motorola*,[226] the letters of assurance promise that the patent holder may grant non-exclusive licenses on "a *worldwide basis* without compensation or under reasonable rates, with reasonable terms and conditions that are demonstrably free of any unfair discrimination."[227]

In courts, SEP implementers have tested the limit of so-called "worldwide" terms.[228] Courts should not allow SEP implementers to pick and choose which part of the FRAND commitment they want enforced. If a standard implementer wants FRAND terms based on a third-party beneficiary theory, then the implementer would have to also agree on the other terms included in the letter of assurance such as *worldwide basis*. In *Unwired*, Justice Birss concluded that "[a local] portfolio license is not

225. *See* Microsoft Corp. v. Motorola, Inc., 854 F. Supp. 2d 993, 996 (W.D. Wash. 2012) (stating that letters of assurance are required to include either a disclaimer restraining the patent holder from enforcing the "Essential Patent Claims," or "a statement that a license for a compliant implementation of the standard will be made available to an unrestricted number of applicants on a worldwide basis").

226. *Id.*

227. *Id.*; *see* Microsoft Corp. v. Motorola, Inc., No. C10-1823JLR, at *4 (W.D. Wash. Nov. 30, 2012) (order granting motion to dismiss Motorola's claim for injunctive relief) (citing the IEEE letter of assurance; however, the typical ITU letter also provide for worldwide language); *id.* at 5–6. ("The Patent Holder will grant a license to an unrestricted number of applicants on a worldwide, non-discriminatory basis and on reasonable terms and conditions to use the patented material necessary in order to manufacture, use, and/or sell implementations of the above ITU-T Recommendation | ISOC/IEC International Standard.").

228. *See Microsoft Corp.*, 854 F. Supp. 2d at 995–96 (remarking the offer made by Motorola for the Wi-Fi standard includes the worldwide language whereas the offered for the video standard does not); *id.* at 998 (noting that the letter for the license offer for the Wi-Fi standard states: "This letter is to confirm Motorola's offer to grant Microsoft a *worldwide* non-exclusive license.") (emphasis added); *id.* (comparing that letter with the offer letter for the video standard which states: "Motorola offers to license the patents on a non-discriminatory basis on reasonable terms and conditions ('RAND'), including a reasonable royalty, of 2.25 [percent] per unit for each H.264 compliant product . . . ."); Mannheim Landesgericht [LG] [Regional Courts] May 2, 2012, RECHTSORECHUNG DER OBERLANDESGERICHTE IN STRAFSACHEN [OLGSt] 1 (8) (Ger.), http s://www.scribd.com/document/94523005/Translation-of-Mannheim-2O240-Ruling-Motorola-v-Microsoft (last visited Mar. 10, 2018) (translating Motorola' suit against Microsoft in Germany only based on the video standard); [OLGSt] 1 (11) (Ger.) (discussing the uncertainty of whether Motorola offered a worldwide license for its video portfolio by paraphrasing: "the Plaintiff's parent company submitted to the Defendant's parent company an offer, effective for 20 days, described as 'RAND' . . . to enter into an agreement for a worldwide, nonexclusive license for the portfolio."); *Microsoft Corp.*, 854 F. Supp. 2d at 998 (quoting the offer without the worldwide language and explaining that a sophisticated licensor like Motorola would likely make license offers with different breath consciously); *cf.* Microsoft Corp. v. Motorola, Inc., 795 F.3d 1024, 1056–57 (9th Cir. 2015) (confirming that Motorola breached its duty of good faith and fair dealing but the different language was not questioned).

FRAND."[229] He further noted that "the FRAND license between Unwired Planet and Huawei is a worldwide license."[230] SSOs need to echo clearly that sentiment in their policy documents: the term should be revised to be WFRAND — worldwide, fair, reasonable, and non-discriminatory.

In fact, FRAND commitments create obligations for both SEP holders and implementers.[231] Part of these obligations include a requirement that the SEP implementers communicate in good faith with the SEP holders, according to recognized industry standard.[232] Part of this recognized industry standard includes worldwide licenses. In *Pioneer v Acer*, the Mannheim Regional Court — the lower court — considered that a Germany-only license would not qualify as a FRAND offer because it failed to follow customary business practices.[233] The court reasoned that an honest and royalty-willing negotiator will not respond to a license offer by the patent proprietor for a worldwide portfolio license with a counteroffer limited to Germany.[234]

As such, worldwide licenses should be part of anyone's attempt to obtain a license under a FRAND license. While courts have enforced this standard, courts are not the correct venue to deal with these terms.

SSOs have an interest in promoting worldwide licenses because worldwide licenses encourage widespread adoption and create more network externalities. SSOs should make a better effort to promote this industry standard. They can ensure that all parties are educated about the benefits. They should ensure that implementers know that if they reject the worldwide aspect of the licensing commitment, they reject all aspect of the commitment including the reasonable licensing terms. SSOs should also petition with courts (through amicus briefs) to encourage courts to view the worldwide aspect of the license as part of the FRAND package.

B. Bundling & Patent Families

Antitrust authority could carve out an antitrust safety zone for bundled patents that are part of the same patent family. The DOJ and the FTC

229. *Unwired Planet Int'l, Ltd.* [2017] EWHC (Pat) 711, [807 (11)].

230. *Id.*

231. *See, e.g.*, Landgericht Düsseldorf [LG] [Düsseldorf Regional Court] Nov. 20, 2014 RECHTSORECHUNG DER OBERLANDESGERICHTE IN STRAFSACHEN [OLGSt] 1 (103(1)) (Ger.), http://curia.europa.eu/juris/liste.jsf?num=C-170/13 (discussing the obligations of SEP holders and implementers during FRAND negotiations).

232. Pedro Henrique D. Batista & Gustavo Cesar Mazutti, Comment, *Huawei Technologies (C-170/13): Standard Essential Patents and Competition Law–How Far Does the CJEU Decision Go?* 47 IIC-INT'L R. INTELL. PROP. & COMPETITION L. 244, 246 (2016).

233. OLGSt 330 (¶¶ 131–33) (Ger.).

234. *Id.* (¶¶ 132–33) (author translation).

published their guidelines on a regular basis.[235] The DOJ and the FTC created an Antitrust Safety Zone in their Antitrust Guidelines "to provide some degree of certainty and thus to encourage such activity [as licensing]."[236] They should create an explicit Safety Zone for tying patents that belong to the same patent family.

This Safety Zone would fall within their published Guidelines. The criterion put forth in the Guidelines is: "[a]bsent extraordinary circumstances, the Agencies will not challenge a restraint in an intellectual property licensing arrangement if (1) the restraint is not facially anticompetitive and (2) the licensor and its licensees collectively account for no more than twenty percent of each relevant market significantly affected by the restraint."[237]

In the FRAND context, bundling patents that belong to the same family is not facially anticompetitive. The tying question may be moot in the patent family context. Justice Birss in *Unwired Planet v. Huawei Technologies* ruled that patents in the same family are different products because patents in a family may cover slightly different technologies.[238] But these differences are a question of fact. Moreover, even if slightly different, they could be considered the same patent because they enable similar processes.[239]

Even if they were different products, these patents do not facially impede competition. Faced with a slightly different question, the Federal Circuit court established that bundling essential and non-essential patents was not a per se violation of antitrust laws.[240] The Federal Circuit found that package patent licensing provided efficiencies and "reject[ed] the Commission's conclusion that [SEP holder's bundling] conduct showed a 'lack of any redeeming virtue' and should be 'conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.'"[241]

In fact, in no case discussed above did the SEP implementers show that tying these different patents was anticompetitive or had anticompetitive

235. *See* U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, *supra* note 54 (providing 2017 guidelines).

236. *Id.* at 24.

237. *Id.*

238. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2017] EWHC (Pat) 711 [546] (Eng.).

239. *Id.* [546] ("A patent in one state is clearly separate from a member of the same patent family in another state . . . . However the way in which FRAND royalty rates are determined in practice treats these two distinct patents as a single thing.").

240. U.S. Philips Corp. v. ITC, 424 F.3d 1179, 1193–97 (2005).

241. *Id.* at 1193 (internal citation omitted).

effects.[242] SEP holders do not gain a competitive advantage over their competitors because (in theory) they have no competitors for their patents because the patent is essential (i.e., without a work around).

Furthermore, FRAND commitments can be interpreted as a guarantee that any willing licensee has access to the patent on similar terms.[243] As such, the worldwide license — even if it ties patents — would not have anticompetitive effects at the patented product level.

Alternatively, SSOs can work with the DOJ to signal that these worldwide licenses are not an antitrust violation. Any SSO can write a request for a business review letter, and the DOJ could clarify that such licenses do not violate the antitrust laws.[244] Such a signal could encourage courts to adopt the same view and would avoid guess-work about the movement of goods and individuals to impose an appropriate uplift.

C. Worldwide License & Patent Exhaustion

In *Birdsell v. Shaliol*,[245] the Supreme Court held that if an infringer paid damages for infringement and resold the machine, the patent holder could sue the purchaser of the machine because its patent rights had not been exhausted.[246] The infringement damages did not exhaust the patent.[247]

However, court-imposed FRAND terms are not always damages. For example, in some FRAND cases, the SEP holders commit to grant a license;[248] but in some cases, the (foreign) courts set what they consider

242. *See id.* at 1193–97; Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2017] EWHC (Pat) 711 (Eng.), [787], [791] (rejecting that the SEP holder's bundling or tying of SEPs and non-SEPs was unlawful).

243. *See generally* Gabison, *supra* note 2, at 114–23 (analyzing contextual and court interpretations of FRAND commitments as guarantees of licensee access to patents on similar terms).

244. *See supra* notes 38–40 and accompanying text (discussing how SSOs have consulted with the DOJ to ensure their policies did not violate antitrust laws); *see also Business Review Letters and Request Letters*, U.S. DEP'T OF JUSTICE, https://www.justice.gov/atr/business-review-letters-and-request-letters (last visited Feb. 5, 2019); *id.* (showing that the DOJ's record goes as far back as 1991 and no letter since 1991 refers to these worldwide licenses); *Antitrust Enforcement and Intellectual Property Rights: Promoting Innovation and Competition*, DEP'T OF JUSTICE & FED. TRADE COMM'N 103–14 (Apr. 2007), www.usdoj.gov/atr/public/hearings/ip/222655.pdf (showing that the DOJ and FTC have in the past held hearings about the antitrust implications of intellectual property rights); *id.* at 103 (referring to tying and bundling intellectual property rights similarly to the guidelines but does not refer to worldwide licenses).

245. 112 U.S. 485 (1884).

246. *Id.* at 488–89.

247. *Id.* at 488.

248. *See* Gabison, *supra* note 2, at 102, 105, 118.

FRAND royalty rates.[249]

The U.S. Supreme Court has not been faced with needing to set FRAND royalty rates. When faced with the situation, the Court may need to clarify the patent exhaustion doctrine as applied to this context. Based on precedent, the Court should rule that any benefits drawn abroad or at home (under *Lexmark*) exhaust the patent rights of the holder if the benefits were extracted voluntarily (under *Boesch* and *Birdsell*). The reasoning is that, during voluntary negotiation, the SEP holder can control better what the uplifts must be to avoid arbitrage, which may not be a concern for courts setting FRAND royalty rates.

Therefore, the Court would avoid having to decide whether a court-mandated rate that is adjudged to be fair and reasonable in China would be fair and reasonable in the U.S. The Court would avoid having to determine whether the SEP holders may be better off having a lower worldwide rate rather than forgoing the Chinese market entirely to avoid having a low rate in other jurisdictions under patent exhaustion.

V. CONCLUSION

Worldwide licenses play an important role within the FRAND standard and the standard setting process. However, the attacks on this aspect of FRAND licenses should come as no surprise. SEP implementers have a lot to learn. By requesting national licenses, implementers increase the litigation and monitoring costs of SEP holders, which they can leverage into lower royalty rates. This form of rent-seeking should be construed as a holdout.

Forum-shopping remains an issue with worldwide licenses. SEP holders and implementers may seek the most favorable terms to their cause among the mosaic of FRAND term interpretations and attempt to impose these terms through worldwide licenses. But avoiding forum shopping does not warrant losing the efficiencies associated with worldwide licenses.[250] The efficiencies these licenses offer should be protected — even from long-standing doctrines like the patent exhaustion doctrine.

---

249. *See, e.g.*, Layne-Farrar & Wong-Ervin, *supra* note 26 (discussing how different judges have estimated FRAND royalty rates and damages, distinguishing the two).

250. Unwired Planet Int'l, Ltd. v. Huawei Tech. Co. [2018] EWCA Civ. 2344 (Eng.), [100]–[04] (considering the argument that avoiding forum shopping does not warrant losing the efficiencies associated with worldwide licenses, and finding that "a court in one country will decide, as between the parties, whether a global or multi-territorial license is FRAND but that is inevitable and we see nothing unfair about it, and it most certainly does not deprive a licensee from challenging the validity and essentiality of the SEPs in any jurisdiction where it may choose to do so.").

ACCESS TO JUSTICE AND THE DENIAL OF STAY IN A PENDING BANKRUPTCY APPEAL: REVIEWABILITY BY THE COURTS OF APPEALS

ROBERT J. LANDRY, III*

When a party in a bankruptcy case seeks to appeal an adverse final judgment from a bankruptcy court, the ability to stay the effect of that judgement is of utmost importance. As with other appeals, the bankruptcy appellate process is long; and often, particularly in bankruptcy proceedings involving distributions of money and property, the appeal may be moot before a ruling by an appellate court because the judgement has been carried out. This risk of mootness impacts the ability to have an appellate court provide relief if it finds the appeal to have merit. This raises access to justice concerns generally, but the concern is exacerbated because the ability to obtain a stay pending appeal in a bankruptcy case varies among the circuits and from case to case within a circuit. This article details the current state of the law and the access to justice concerns that arise in this context. The author offers a rules-based solution to ensure that appellant has the same procedural ability to seek a stay pending appeal regardless of the location in which the particular circuit an appeal arises.

*Professor of Finance, School of Business and Industry, Jacksonville State University, Jacksonville, AL.

I. INTRODUCTION

Obtaining a stay pending appeal is of utmost importance to most parties adversely impacted by a trial court order that wish to challenge the trial court order on the merits through the appellate process. Without a stay of the order on appeal, the concern is that if the appeal is successful on the merits, an appellant will be left without any meaningful relief from the appellate court. The worry is that the appeal may be moot by the time the appellate court reaches the merits of the appeal. Mootness arises if a court cannot grant effective relief.[1] The appeal will essentially be for naught.

This concern of mootness and the significance of obtaining a stay are particularly important in bankruptcy appeals.[2] Fortunately, the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules") expressly provide that a party may seek a stay of a bankruptcy court order pending appeal from the bankruptcy court.[3] If that order is denied,[4] a stay of the bankruptcy court order can be sought from the district court or, if applicable, the bankruptcy appellate panel ("BAP").[5] If the appellant obtains a stay pending appeal from

1. *See* Mills v. Green, 159 U.S. 651, 653 (1895); *see also* Charles Tabb, *Lender Preference Clauses and the Destruction of Appealability and Finality: Resolving a Chapter 11 Dilemma*, 50 OHIO ST. L.J. 109, 126 (1989) (recognizing that mootness arises when it is "*impossible* for the appellate court to give meaningful, effective relief because of changed circumstances.").

2. *See* Nordhoff Invs., Inc. v. Zenith Elecs. Corp., 258 F.3d 180, 192 (3d Cir. 2001) (Alito, J., concurring) (explaining that, in the context of an order confirming a plan of reorganization, equitable mootness may prevent an appellate review of the bankruptcy court order confirming the plan); *see also* Eleanor H. Gilbane, *Investing in an Appeal: The Dilemma Facing an Appellant of Confirmation Orders*, 32 AM. BANKR. INST. J. 38, 38 (2013) (discussing the potential of equitable mootness in the context of the confirmation of a Chapter 11 plan).

3. FED. R. BANKR. P. 8007(a)(1)(A).

4. *Id.* 8007(a)(1) (stating a stay pending appeal initially should be sought in the bankruptcy court); *see id.* 8007(b)(2) (providing that a motion may be made in the district court or BAP if a showing is made of the impracticality of seeking relief from bankruptcy court or that the motion is pending in bankruptcy court); *id.* (concluding that in rare cases a denial of a stay by the bankruptcy court may not have occurred).

5. *Id.* 8007(b)(1) (providing for motion in district court or BAP).

the bankruptcy court, district court, or BAP, the mootness concerns are alleviated while the stay is in effect.[6]

The focus of this article is on a scenario that arises when a stay pending appeal is denied by the bankruptcy court, the district court, or BAP, and the underlying appeal of the bankruptcy court order on the merits is pending in the district court[7] or BAP.[8] Under these facts, the appellant's mootness concern and ability to obtain meaningful relief if the appellant is successful on the merits of the appeal are not alleviated. The difficulty for the appellant exists because a court of appeals' appellate jurisdiction to review a district court or BAP denial of the stay is suspect, as the denial of a stay may not be an appealable final order,[9] or an appealable injunction,[10] or warrant the issuance of a writ of mandamus,[11] and is not authorized by the Bankruptcy Rules[12] or the Federal Rules of Appellate Procedure.[13]

There appears to be only one scholarly article, published thirty years ago, that has meaningfully addressed this specific issue — the appellate jurisdiction of the courts of appeals in this context — in detail.[14] Although

---

6. *See also*, *infra* notes 95–98 and accompanying text. *See generally* FED. R. BANKR. P. 8025 (explaining that if the appellant has an adverse ruling from the district court or BAP, and the appellant appeals that order to the court of appeals, a stay will need to be sought to alleviate mootness concerns on the leg of the appeal).

7. 28 U.S.C. § 158(a) (2018) (granting jurisdiction over bankruptcy appeals to district court).

8. *Id.* § 158(b) (granting jurisdiction over bankruptcy appeals to BAP, if applicable); *see id.* § 158(d)(2) (detailing that in a direct appeal the appellant will have the opportunity to seek a stay from the bankruptcy court and the court of appeals); *see also* FED. R. BANKR. P. § 8007(a)–(b) (providing authority to seek stay from bankruptcy court and from the court of appeals in a direct appeal). This article does not address a direct appeal from the bankruptcy court to the court of appeals.

9. *See* discussion *infra* Section II.A.1 (discussing the ability to appeal under 28 U.S.C. § 158(d)(1).

10. *See infra* notes 53–79 and accompanying text (describing the circuit split with respect to review as an interlocutory order).

11. *See* discussion *infra* Section II.D (discussing the scope of reviewability under the Bankruptcy Rules).

12. *See* discussion *infra* Sections II.D.2–3 (differentiating the powers granted to appellate courts under the Bankruptcy Rules).

13. *See infra* notes 102–03 and accompanying text (noting the jurisdictional limitations of authorizing review under the Federal Rules of Appellate Procedure).

14. *See* James M. Grippando, *Circuit Court Review of Orders on Stays Pending Bankruptcy Appeals to U.S. District Courts or Appellate Panels*, 62 AM. BANKR. L.J. 353, (1988) (noting the issue has gained more attention in recent years in practitioner oriented journals); *see, e.g.*, Gilbane, *supra* note 2, at 38 (recognizing the "dilemma" facing appellants in bankruptcy appeals in the denial of stay context with confirmation orders); Brian Wells, *Appeal-Proof: Court of Appeals Jurisdiction Over Order Concerning Stays Pending Appeal*, WEIL BANKR. BLOG (Sept. 27, 2012) [hereinafter *Appeal-Proof*], https://business-finance-restructuring.weil.com/jurisdiction/appeal-

Grippando's article provided a solid baseline and clear guidance on how to analyze this issue, it is still unsettled, and divergent courts of appeals' case law on this issue has developed and continues to arise.[15] The different approaches employed the courts of appeals and disparate ability of parties to review the denial of a stay or request a stay from the courts of appeals raise access to justice concerns.[16]

This Article is organized as follows: Part I examines potential bases of appellant jurisdiction for a court of appeals to review the denial order of stay pending appeal by a district court or BAP to consider a motion to stay the bankruptcy court order is set forth. Part II offers a critique of the divergent approaches and the underlying legal issues in the stay analysis employed by the courts of appeals and the resulting issue of access to justice they raise. Part III suggests a detailed reform that will ensure uniformity in terms of access to justice in seeking a stay from the courts of appeals when a stay is denied by the district court or BAP. Finally, Part IV provides conclusions and suggestions.

II. JURISDICTIONAL ARGUMENTS TO REVIEW DENIAL OF STAY

A. Review as a Final Decision

1. Not a Final Decision under 28 U.S.C. § 158(d)(1)

Under 28 U.S.C. § 158(d)(1),[17] in a bankruptcy appeal to the district court[18] or BAP,[19] "[t]he courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders, and decrees entered under subsections (a) [by district courts] and (b) [by BAPs] of this section."[20] The

---

proof-court-of-appeals-jurisdiction-over-orders-concerning-stays-pending-appeal/; Brian Wells, *Court Refuses to Apply "Divestiture Doctrine" in Denying Creditors' Committee Stay Pending Appeal*, WEIL BANKR. BLOG (May 23, 2018), https://business-finance-restructuring.weil.com/jurisdiction/court-refuses-to-apply-divestiture-doctrine-in-denying-creditors-committee-stay-pending-appeal/.

15. *See infra* p. 29.

16. *See infra* notes 151–52 and accompanying text. *See generally* Portia Pedro, *Stays*, 106 CALIF. L. REV. 869 (2018) (providing a detailed analysis of problems with the current state of the law pertaining to obtaining a stay pending appeal in the non-bankruptcy context, recognizing the procedural problems and hurdles with obtaining review of a denial of stay and the significant impact that has on parties and the legal system); *id.* (implying that the issues raised, and concern for a meaningful opportunity to appeal on the merits, highlight the broader problem of how a lack of review of a denial of stay can constitute an access to justice issue).

17. 28 U.S.C. § 158(d)(1) (2018).

18. *See id.* § 158(a) (detailing jurisdiction of district court in bankruptcy appeals).

19. *See id.* § 158(b) (detailing jurisdiction of BAP in bankruptcy appeals).

20. *Id.* § 158(d)(1); *see In re* Gugliuzza, 852 F.3d 884, 889–91 (9th Cir. 2017) ("28

only basis for a court of appeals to have jurisdiction under § 158(d)(1) is if both the bankruptcy court and district court or BAP have entered final decisions.[21] For a judgment or order to be final, it must be "one which ends the litigation on the merits and leaves nothing for the court to do but execute judgment."[22]

A deny of a stay by a district court or BAP does not end the litigation on the merits. Such an order is typically entered very early in a pending appeal, and, although issues in the underlying appeal are considered in the context of a stay analysis,[23] an order of a stay pending appeal does not resolve the merits of the appeal.[24] It simply determines whether the stay is warranted at that juncture in the case.[25] The denial of a stay is simply an interlocutory order.[26] Therefore, as expressly found by the Fifth, Sixth, Seventh, Ninth, and Tenth Circuits, a denial of a stay by the district court or BAP is not an appealable final decision, judgment, order, or decree.[27]

U.S.C. § 158(d) gives us jurisdiction specific to bankruptcy decisions of district courts and decisions of three-judge bankruptcy appellate panels (or BAPs)."); *see also In re* The Celotex Corporation, 700 F.3d 1262, 1265 (11th Cir. 2012) (internal quotations omitted) (quoting *In re* F.D.R. Hickory House, Inc., 60 F.3d 724, 725 (11th Cir. 1995)) (stating that the court of appeals " . . . has jurisdiction over only final judgments and orders entered by a district court . . . sitting in review of a bankruptcy court, *see* § 158(d).").

21. *See In re* Forty-Eight Insulations, Inc., 115 F.3d 1294, 1299 (7th Cir. 1997) (noting that the court appeals has jurisdiction "under § 158(d) only if both the bankruptcy and district court orders [are] final").

22. *See In re The Celotex Corporation*, 700 F.3d at 1265 (citations omitted).

23. *See* Hilton v. Braunskill, 481 U.S. 770, 776 (1987) (considering four factors in determining whether to issue a stay pending appeal: "(1) whether the stay applicant has made a strong showing that he is likely to succeed on the merits; (2) whether the applicant will be irreparably injured absent a stay; (3) whether issuance of the stay will substantially injure the other parties interested in the proceeding; and (4) where the public interest lies."); *see also* Nken v. Holder, 556 U.S. 418, 434 (2009) (applying these four factors) (stating that of these factors, the first two factors — including the success on the merits — "are the most critical").

24. *See id.* at 776 (stating that stays are granted pending appeal, not post-appeal).

25. *See id.*

26. *See In re* Gugliuzza, 852 F.3d 884, 890 n.5 (9th Cir. 2017).

27. *See* Walker v. Fed. Nat'l Mortg. Ass'n, No. 91-3883, 948 F.2d 1291, at *1291 (6th Cir. Nov. 22, 1991) (appearing in an unpublished opinion table); *In re* Atencio, 913 F.2d 814, 816 (10th Cir. 1990); *In re* Barrier, 776 F.2d 1298, 1299 (5th Cir. 1985); *In re* Teleport Oil Co., 759 F.2d 1376, 1377 (9th Cir. 1985); ''s*ee also* Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253–54 (1992) (stating that the holding of these courts — the denial of a stay by a district court or bankruptcy appellate panel is not a final order under 28 U.S.C. § 158(d) — was not abrogated by the Supreme Court ruling); *see, e.g.*, *In re* Sinha, No. 13-60100, 605 Fed. Appx. 664, at *664 (9th Cir. May 22, 2015) (noticing that the earlier Ninth Circuit case of *Teleport Oil* was abrogated on grounds other than the holding that a denial of a stay is not a final order and dismissing the appeal of the denial of stay by the bankruptcy appellant panel because said order was not a final order and the court of appeals did not have jurisdiction over the appeal).

It is well settled that denying a stay pending appeal in a bankruptcy proceeding by a district court or bankruptcy appellant panel is not a final order.[28] The Fifth, Sixth, Ninth, and Tenth Circuits have all expressly found that a district court denial of a stay pending appeal in a bankruptcy appeal is not a final order under 28 U.S.C. § 158(d)(1).[29] Importantly, the decisions of the Fifth, Sixth, Ninth, and Tenth Circuits were abrogated to the extent said decisions held that 28 U.S.C. § 158(d)(1) was the exclusive basis of appellate jurisdiction for courts of appeals in bankruptcy appeals. The Supreme Court found that 28 U.S.C. § 158(d), which grants courts of appeals jurisdiction over district court final orders when the district court sits as an appellate court in bankruptcy cases, did not limit interlocutory review of district court orders under 28 U.S.C. § 1292, provided the requirements of that statute are satisfied.[30] The Seventh Circuit has also expressly held that "stay denials at the bankruptcy and district court levels were not final order for purposes of § 158(a) or (d) . . . ."[31]

2. Final Decision under Pragmatic Analysis

When addressing this issue, the Third Circuit has found that a district court order denying a stay pending appeal is not technically a final judgment, which is consistent with other circuit courts. The Third Circuit considers "finality" under § 158(d)(1) on a pragmatic basis.[32] Under this approach, whether a particular order denying a stay pending appeal is an appealable order under § 158(d)(1) turns on the facts of the underlying bankruptcy case on appeal, and not the denial of stay order itself. The Third Circuit applied this pragmatic analysis and in so doing dismissed appeals of district court denials of a stay for lack of jurisdiction in some, but not all, cases.[33]

---

28. *See, e.g.*, *In re* Dalton, 733 F.2d 710, 714 (10th Cir. 1984).

29. *See Walker*, 948 F.2d at *1291; *In re Atencio*, 913 F.2d at 816; *In re Barrier*, 776 F.2d at 1299; *In re Teleport Oil Co.*, 759 F.2d at 1377.

30. *See* Conn. Nat'l Bank, 503 U.S. at 253–54.

31. *See also In re* Forty-Eight Insulations, Inc., 115 F.3d at 1299–1300 (considering whether jurisdiction exists over the interlocutory stay denial order under § 1292); *infra* notes 55–57 and accompanying text (analyzing the Seventh Circuit analysis of this issue).

32. *See In re* Revel AC, Inc., 802 F.3d 558, 566–67 (3d Cir. 2015).

33. *Compare* Black Horse Capital Master Fund Ltd. v. JP Morgan Chase Bank, N.A., No. 12-1263, at *4–5 (3d Cir. Feb. 10, 2012) (dismissing appeal of denial of stay order by district court for lack of jurisdiction in that it was not a final order under § 158(d) and the court went on and rejected the argument that the denial of a stay was an injunction and appealable under § 1292(a)(1)), *with In re Revel AC, Inc.*, 802 F.3d at 566–67 (exercising jurisdiction over an appeal of the district court denial of a stay in the context of a sale under 11 U.S.C. § 363(m) because once the sale closed there would be no recourse for the parties challenging the sale as the terms of the sale were not subject to any modification on appeal).

3. Collateral Order Doctrine Exception to Finality

Although the denial of a stay is not a final decision unless a court applies a pragmatic approach based on the facts of a specific case, there is an argument that it may be reviewable by a court of appeals under the collateral order doctrine, an exception to the final judgement rule employed by the courts of appeals in other procedural contexts.[34] This approach is similar to the pragmatic approach to finality applied by the Third Circuit.[35] Under the collateral order doctrine, the court of appeals exercises discretion to review a district court order, and arguably a BAP order,[36] that is not final.[37] The collateral order exception permits appeals of otherwise non-final orders which:

> (1) finally determine claims collateral to and separable from the substance of other claims in the action; (2) cannot be reviewed along with the eventual final judgment because by then effective review will be precluded and rights conferred will be lost, and (3) are too important to be denied review because they present a serious and unsettled question of law.[38]

The difficulty with applying the collateral order exception doctrine to a denial of stay order by the district court or a BAP is that a showing on all three factors, which is required,[39] is quite doubtful. A showing on one or two factors is possible, but all three seem to be a nearly insurmountable burden in the stay denial context. This is particularly true because the collateral order exception is a narrow exception limited to those cases that are "too important to be denied review and too independent of the cause itself to require that appellate consideration be deferred until the whole case is adjudicated."[40]

---

34. *See, e.g.*, *In re* King Memorial Hospital, Inc., 767 F.2d 1508, 1510 (11th Cir. 1985) (recognizing the exception to the final judgment rule).

35. *See supra* notes 25–26 and accompanying text.

36. 28 U.S.C. § 158(d) (2018). Courts of appeals have jurisdiction over final orders of a BAP under 28 U.S.C. § 158(d). Presumably the collateral order doctrine would apply and provide a jurisdictional basis for a court of appeals to have jurisdiction over a non-final judgment of the BAP if the requirements of the doctrine were satisfied. *See id.*

37. McElmurry v. U.S. Bank Nat'l Ass'n, 495 F.3d 1136, 1140 (9th Cir. 2007) ("Under the collateral order exception, an appellate court 'may exercise its § 1291 jurisdiction to review a district court order that is not a final decision.'").

38. *In re King Memorial Hospital, Inc.*, 767 F.2d at 1510; *see also* Coopers & Lybrand v. Livesay, 437 U.S. 463, 468–69 (1978) (footnote omitted) (detailing the three factors required to satisfy the collateral order doctrine).

39. Stringfellow v. Concerned Neighbors in Action, 480 U.S. 370, 375 (1987) (noting that a party must show all three elements of the collateral source doctrine to establish jurisdiction).

40. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 546 (1949).

First, a denial of stay order does not "finally determine claims collateral to and separable from the substance of other claims."[41] The only determination of the denial of stay order is that the burden of proof has not been met by the appellant or applicant to warrant the issuance of the stay.[42] The underlying claims on the merits of the appeal are not resolved, although they are considered as part of the analysis of whether a stay is warranted.[43] Even though the underlying claims are considered, there is no final determination of the merits of the underlying claims.[44]

Second, the denial of the stay does not preclude a review of the underlying claims as the underlying claims will be considered in the appeal on the merits. There is an argument that certain rights may be lost, particularly if the issue becomes moot by the time it reaches the appellate court. However, the mootness argument is really part of the four-factor stay test the district court or bankruptcy appellate panel considered in its denial of the stay, i.e. the irreparable harm factor if a stay is not issued. With a bankruptcy court and the district court or BAP already likely finding no irreparable harm — i.e. mootness in underlying appeal in denial of a stay — it is therefore unlikely in most cases that a court of appeals finding of that an effective review will be precluded and rights conferred lost.[45] In this context, the denial of stay would be unreviewable, but the underlying rights would not be unreviewable as the appeal is still pending.[46] It will be hard to show that the "right at stay" will be destroyed, particularly when two other courts will have engaged in a similar analysis in the context of an irreparable harm analysis.[47]

Lastly, the legal analysis and framework to consider a stay in the federal

---

41. *In re King Memorial Hospital, Inc.*, 767 F.2d at 1510.

42. *See* Nken v. Holder, 556 U.S. 418, 433–34 (2009) (holding that the burden is on the appellant or applicant to show that the issuance of a stay is warranted because "[t]he party requesting a stay bears the burden of showing that the circumstances justify an exercise of that discretion.").

43. *See id.* at 434 (stating that one important factor a court considers in a stay request is "whether the stay applicant has made a strong showing that he is likely to succeed on the merits," which will involve an analysis of the underlying merits of the appeal, but not a final resolution of the merits).

44. *See id.* at 432 ("The whole idea is to hold the matter under review in abeyance because the appellate court lacks sufficient time to decide the merits [of the underlying case].").

45. Midland Asphalt Corp. v. United States, 489 U.S. 794, 799 (1989) (quoting United States v. MacDonald, 435 U.S. 850, 860 (1978)) (holding that an order is effectively unreviewable when "'the legal and practical value of [the right at stake will] be destroyed if . . . not vindicated before trial.'").

46. *See id.* at 800 ("[W]e have found denials of only three types of motions to be immediately appealable.").

47. *See id.*

courts is well-settled.[48] The underlying legal issues in the appeal may present serious or unsettled questions of law, but those are not conclusively resolved or decided by a denial of stay order. The denial of the stay, provided the district court or bankruptcy appellate panel employed the four-factor analysis as required by the Supreme Court, will likely not raise any serious or unsettled questions of law.

4. The Forgay-Conrad Doctrine Exception to Finality

Another narrow exception permitting an appeal of a non-final order is the Forgay-Conrad Doctrine that arose in an 1848 Supreme Court case[49] involving an order in a bankruptcy case requiring the defendants to immediately turnover land and slaves.[50] The defendants appealed the order, which the plaintiffs sought to dismiss on the grounds that the order was not a final order.[51] The Supreme Court disagreed and considered it final because with "the immediate transfer of property . . . the losing party will be subjected to undue hardship and irreparable injury if appellate review must wait until the final outcome of the litigation."[52] A party seeking to invoke this doctrine will need to show that the order at issue directs immediate delivery of property and the losing party is subject to irreparable injury without an immediate appeal.[53]

The Forgay-Conrad Doctrine would arguably be applicable in the appeal of a denial of a stay by the district court or the BAP,[54] provided the underlying bankruptcy court order required the disposition of property that fits into the category of an irreparable injury.[55] Whether the Forgay-Conrad Doctrine will warrant review of a denial of stay by the district court or BAP

48. *See also* Pedro, *supra* note 16, at 892–96. *But see supra* note 23 (stating that although the four factors of the analysis are generally consistent, it has been recognized that the application of these factors by the federal courts is quite inconsistent).

49. Grippando, *supra* note 14, at 367–68 (noting the origin of the doctrine and its potential application to an appeal of a denial of stay to the court of appeals).

50. Forgay v. Conrad, 47 U.S. 201, 201–02 (1848); *see also* Hon. Joan N. Feeney, Mary P. Sharon & James M. Wilton, Address at the Northeast 23rd Annual Bankruptcy Conference: Appealing Propositions: (Most) Everything You Need to Know About Bankruptcy Appeals, (July 14, 2016) (transcript available on Westlaw at 071416 ABI-CLE 227) (analyzing the case and application of the Forgay-Conrad Doctrine in the bankruptcy generally).

51. Feeney et al., *supra* note 50 (citing Forgay v. Conrad, 47 U.S. 201, 203 (1848)).

52. *See id.* (citing Forgay v. Conrad, 47 U.S. 201, 203–04 (1848)).

53. *See* Vylene Enters. v. Naugles, Inc., 968 F.2d 887, 895 (9th Cir. 1992).

54. *See* Grippando, *supra* note 14, at 367 (presuming a court of appeals would have jurisdiction over a non-final order of a BAP if the Forgay-Conrad rule requirements were met as with the collateral order doctrine).

55. *See id.*

will depend on how a particular circuit interprets the doctrine — narrowly or broadly.[56] The narrow or broad application, coupled with the underlying facts and impact of the underlying bankruptcy court order, determines whether the Forgay-Conrad Doctrine can be employed to invoke a court of appeals jurisdiction over the denial of a stay order by a district court or BAP.[57]

B. Review as an Interlocutory Order

Beyond the argument to review the denial of a stay — an interlocutory order — under the common law exceptions to finality outlined above,[58] appellate review is possible under § 1292(a)(1).[59] The Supreme Court held that courts of appeals have appellate jurisdiction in bankruptcy appeals under both §§ 158(d) and 1292.[60] Therefore, even if jurisdiction over the denial of stay is not available as a final decision under § 158(d), it may be available under § 1292 to review a district court order. This basis of jurisdiction is not available to review denial of a stay order by a BAP as § 1292(a)(1) does not provide jurisdiction over interlocutory BAP orders.[61]

Although this basis for appellate jurisdiction from district court orders by the court of appeals is certainly available generally in bankruptcy appeals, it is uncertain in the context of a denial of stay. Under § 1292(a)(1) the court of appeals has jurisdiction over "[i]nterlocutory orders of the District Courts . . . granting, continuing, modifying, refusing or dissolving injunctions . . . ."[62] For a court of appeals to have jurisdiction to consider the denial of a stay order, it must fit within the parameters of 28 U.S.C.

56. *See* Feeney, *supra* note 50 (describing how the circuit courts apply the doctrine in slightly different ways); *id*. (citing HSBC Bank USA, N.A. v. Townsend, 793 F.3d 771, 779 (7th Cir. 2015), cert. denied, 136 S. Ct. 897 (2016)) (applying the doctrine narrowly, requiring both delivery of property and irreparable harm); *id.* (citing United States v. Kouri-Perez, 187 F.3d 1, 11 (1st Cir. 1999)) (noting the First Circuit considers the Forgay-Conrad Doctrine "as articulating a 'practical finality' doctrine, which permits interlocutory appeals from 'immediate payment' orders which threaten a special risk of harm to the appellant.").

57. *Id.*

58. *See supra* Section II.A.3 and accompanying text.

59. *See In re* Forty-Eight Insulations Inc., 115 F.3d 1294, 1299–1300 (7th Cir. 1997) (analyzing the basis for jurisdiction and finding that if the requirements of 28 U.S.C. § 1292(a)(1) are met, appellate jurisdiction over denial of stay exits).

60. *Id.* at 1299–1300 (citing Conn. Nat'l Bank v. Germain, 503 U.S. 249, 254 (1992)).

61. *In re* Lievsay, 118 F.3d 661, 663 (9th Cir. 1997) (noting that neither 28 U.S.C. §§ 1291 nor 1292 applies to appeals from a BAP to the court of appeals.).

62. 28 U.S.C. § 1292(a)(1) (2018).

§ 1292(a)(1).[63]

The Seventh Circuit applied § 1292(a)(1) and reviewed the interlocutory order denying a stay to determine if it had *both* the effect of an injunction as well as the risk of "serious, perhaps irreparable, consequences."[64] The Seventh Circuit found the requirements satisfied in the context of an underlying bankruptcy court order on appeal to the district court that would require a distribution that would deplete a trust.[65] The distribution, if not stayed, would present the risk of serious consequences to the appellant claimants, and thus, jurisdiction was found over the denial of stay by the district court under § 1292(a)(1).[66] Importantly, the Seventh Circuit in its analysis of satisfying § 1292(a)(1) did not focus on the effect of the order on appeal to the Seventh Circuit, which was the denial order.[67] Rather, the court focused on the effect of the underlying bankruptcy court order, which was still on appeal at district court and not even before the Seventh Circuit.[68]

The Seventh Circuit approach is problematic and exemplifies how this basis for jurisdiction is suspect. If a court of appeals focuses solely on the actual order on appeal from district court — the deny of stay order — that order will likely not fit within § 1292(a)(1).[69] The denial of the stay order does not grant or deny an injunction — it merely lets the lower order remain in effect. The status quo of the procedural posture of the underlying case is not disturbed. For a court of appeals to find that § 1292(a)(1) applies to the denial of a stay, the court of appeals must look at the effect of the bankruptcy court that remains on appeal as the Seventh Circuit did.[70] It is critical to the analysis that the bankruptcy court order on appeal at the district court is not before the court of appeals.[71] The court of appeals does not have jurisdiction

63. *See* Conn. Nat'l Bank v. Germain, 503 U.S. 249, 254 (1992) ("So long as a party to a proceeding or case in bankruptcy meets the conditions imposed by § 1292, a court of appeals may rely on that statute as a basis for jurisdiction."); *see also Forty-Eight Insulations*, 115 F.3d at 1299–300.

64. *See Forty-Eight Insulations*, 115 F.3d at 1299-300 (internal quotations omitted).

65. *See id.*

66. *See id.*

67. *See id.* at 1301.

68. *See id.* at 1298–99 (stating that the denial order from the district court that denied stay was not final).

69. *See* 28 U.S.C. § 1292(a)(1) (2018) (stating that an appeals court may have jurisdiction over interlocutory orders when a district court grants, continues, modifies, refuses, or dissolves injunctions).

70. *See In re Forty-Eight Insulations*, 115 F.3d at 1300 (quoting Carson v. American Brands, Inc., 450 U.S. 79, 83–84 (1981) (stating that a court of appeals may review an interlocutory order under § 1292(a)(1) if the order has the effect of an injunction as well as "serious, perhaps irreparable, consequences").

71. *See id.* at 1298–99 (noting that both the order from the bankruptcy court as well

over the bankruptcy court order on appeal; rather, the order on appeal is the denial stay court order, not the bankruptcy court order.[72] Conceptually, it is hard to rationalize finding appellate jurisdiction over a stay denial order based on an order not before the court of appeals, which itself is on appeal to the district court.

Like the Seventh Circuit, the Third Circuit has engaged in a similar analysis under 28 U.S.C. § 1292(a)(1) to determine if a denial of stay order is appealable as an interlocutory order.[73] In the *Black Horse* case, the appellants sought a stay of confirmation proceedings, which the bankruptcy and district courts denied.[74] The stay was sought in the underlying appeal of an adverse judgement in an adversary proceeding that found that $1.5 billion in preferred securities were owned by the debtor and not the appellants.[75] The appellants' arguments that the denial of stay was a final order under § 158(d) or that it fit with the collateral order exception were rejected.[76] And, central to the analysis at hand, the Third Circuit rejected the argument that the denial of stay was an injunction under § 1292(a) in that the denial order "was not designed to accord or protect anything in more than a temporary faction."[77] The exact basis for the Third Circuit's denial of jurisdiction under § 1292(a) is not explained, but it seems that the Third Circuit focused more on the denial order and less on the underlying bankruptcy court order.[78] If the focus is on the denial order to determine jurisdiction, a finding of no jurisdiction under § 1292(a) is expected.

The Second Circuit expressly considered this jurisdictional basis — § 1292(a) — in *Barretta v. Wells Fargo Bank, N.A.*[79] The underlying bankruptcy appeal was of a debtor-appellant appealing the lifting of the

---

as the order from the district court were not final and, as such, remain with the district court).

72. *Id.* at 1299.

73. *See* Black Horse Capital Master Fund Ltd. v. JP Morgan Chase Bank, N.A., No. 12-1263, at *4–5 (3d Cir. Feb. 10, 2012) (finding no jurisdiction of denial of stay order by district court under § 158(d) and the court went on and considered, but rejected the argument that the denial of a stay was an injunction and appealable under § 1292(a)(1)); *see also In re* Revel AC, Inc., 802 F.3d 558, 567 (3d Cir. 2015) (finding that the denial of a stay by the district court was a final order under § 158(d) employing a pragmatic approach, and, therefore did not reach the question of whether the court had jurisdiction to review a stay denial under § 1292(a)(1)); *id.* (indicating that jurisdiction may be found under § 1292(a)(1) "where the underlying appeal could become equitably moot").

74. *See Appeal-Proof*, *supra* note 14.

75. *See id.*

76. *See id.*

77. *Id.*

78. *See id.*

79. Barretta v. Wells Fargo Bank, N.A., 693 Fed. Appx. 26, 27 (2d Cir. 2017).

automatic stay of the debtor-appellant's home.[80] The debtor-appellant sought a stay of that order lifting the automatic stay from the bankruptcy and district courts, which were both denied.[81] The Second Circuit recognized that "it could be argued that [the court of appeals] ha[d] jurisdiction" over the denial of a stay motion by district court under § 1292(a)(1) in a bankruptcy appeal.[82] However, the Second Circuit did not unequivocally find it had jurisdiction of the denial stay order under § 1292(a)(1); rather, the court noted the argument for jurisdiction and went on to find that "to the degree our jurisdiction is in doubt, we would reach the same outcome by exercising hypothetical jurisdiction."[83]

The Second Circuit's failure to unequivocally find jurisdiction under § 1292(a)(1) provides two valuable thoughts for the analysis.[84] First, finding jurisdiction under § 1292(a)(1) clearly gave the court pause.[85] The basis for the pause is not expressly articulated.[86] Perhaps the court, without so writing, was aware of the conceptual problem with applying § 1292(a)(1) to denial of stay orders in the bankruptcy context, as noted above in analysing the Seventh and Third Circuits application of § 1292(a)(1).[87]

Secondly, the Second Circuit provided an additional basis for possible appellate jurisdiction of a denial of a stay order by a district court in a bankruptcy appeal — hypothetical jurisdiction.[88] Under this judicially created doctrine, courts assume jurisdiction for the purpose of deciding the case on the merits even when there are jurisdictional objections.[89] The courts employing this doctrine apply it when "(1) the merits question is more readily resolved, and (2) the prevailing party on the merits would be the same as the prevailing party were jurisdiction denied."[90] When the Second Circuit applied the doctrine to a denial of stay order, it found that both elements were satisfied: first, the merits were readily resolved as denial of stay by district court was correct and affirmed; second, the prevailing party on the merits

80. *Id.* at 27.

81. *See id.*

82. *Id.*

83. *Id.*

84. *See id.* (holding that the conclusion that the Second Circuit had jurisdiction over the case was not unequivocal).

85. *See id.*

86. *Id.* at 27–28.

87. *See supra* notes 55–69 and accompanying text.

88. *Barretta*, 693 Fed. Appx. at 27 (citing Marquez-Almanzar v. I.N.S., 418 F.3d 210, 216 n.7 (2d Cir. 2005)) ("But, in any event, to the degree our jurisdiction is in doubt, we would reach the same outcome by exercising hypothetical jurisdiction.").

89. Steel Co. v. Citizens for a Better Env't, 523 U.S. 83, 93–94 (1998).

90. *Id.* at 93.

was the same as if appellate jurisdiction were denied because the same party objected to jurisdiction and to stay at the lower court.[91]

The Supreme Court has not endorsed hypothetical jurisdiction.[92] A court entering an order "when it has no jurisdiction to do so is, by very definition, for a court to act ultra vires."[93] Applying this doctrine to a denial of a stay order by district court, when there are specific statutory provisions that address the requisites of jurisdiction, is an ultra vires act by the court — the kind which the Supreme Court has been critical of.[94]

C. Review under the All Writs Act

The All Writs Act provides that "all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law."[95] As such, the All Writs Act can serve as a basis for a court of appeals to consider issuing a writ of mandamus ordering the stay of a bankruptcy court order that is on appeal before a district court or BAP that has denied such a stay.[96] Effectively, the argument in this context is one of mootness.[97] The writ directing the district court or BAP to issue a stay is necessary to aid the courts of appeals in their respective jurisdictions over the underlying appeal if it reaches the court of appeals.[98] And, if a writ is not issued, then the court of appeals will not be able to provide relief to the appellant if the appellant is successful in the underlying appeal.[99]

---

91. *See, e.g.*, *Barretta*, 693 Fed. Appx. at 27–28 (stating that the doctrine will only apply when a party "has made a strong showing that he is likely to succeed on the merits" and the prevailing party would "prevail on the merits of her appeal").

92. *Steel Co.*, 523 U.S. at 93–102 (critiquing the "doctrine of hypothetical jurisdiction").

93. *Id.* at 101–02.

94. *See id.*; Tenet v. Doe, 554 U.S. 1, 12 (2005) (Stevens, J., concurring).

95. 28 U.S.C. § 1651 (2018).

96. *See, e.g.*, *In re* Barrier, 776 F.2d 1298, 1299–1300 (5th Cir. 1985) (finding that a mandamus, a drastic remedy, was appropriate because the appellants had no other avenue for review of the bankruptcy and district court's denial of a stay pending appeal, there was the potential for irreparable harm, and the lower courts abused their discretion in denying a stay).

97. *See, e.g.*, *In re* Syncora Guarantee Inc., 757 F.3d 511, 516 (6th Cir. 2014) ("The district court stayed Syncora's appeal '[i]n light of the prospect that any decision of the bankruptcy court may be rendered moot by a subsequent decision of the Sixth Circuit Court of Appeals regarding appellant's eligibility for Chapter 9 bankruptcy.'").

98. *See id.* at 515 (quoting Blay v. Young, 509 F.2d 650, 651 (6th Cir. 1974) (noting that the All Writs Act provides authority for the court of appeals to "'issue writs of mandamus in aid of its existing jurisdiction or in aid of its future appellate jurisdiction'").

99. *See id.* at 517 (citing Roche v. Evaporated Milk Ass'n, 319 U.S. 21, 26 (1943) ("An orderly bankruptcy process depends on a concomitantly efficient appeals process,

Courts consider a host of non-binding factors and employ a flexible approach to the issuance of a writ of mandamus as it is a "'safety valve . . . in the final-judgment rule.'"[100] The factors include the following:

> (1) whether the petitioner has no other means, such as a direct appeal, to obtain the desired relief;
> (2) whether the petitioner will be damaged or prejudiced in any way not correctable on appeal;
> (3) whether the district court's order is clearly erroneous as a matter of law;
> (4) whether the district court's order is an oft repeated error or manifests a persistent disregard of the federal rules; and
> (5) whether the district court's order raises new and important problems or issues of first impression.[101]

In most bankruptcy appeals where the district court or BAP has denied a stay, it will be difficult to make a convincing showing of the factors.[102]

The strongest factors to support a writ will likely be that there are no other means of relief and that damage or prejudice cannot be corrected on appeal — leading again to the mootness argument.[103] The trouble with this argument is when an appellant is petitioning for a writ, the appellant would already have had an opportunity to seek a stay from the bankruptcy and district court or BAP.[104] Therefore, the argument that the appellant had no other means of relief is weak.

Additionally, it is quite possible that both the bankruptcy court and the district court or BAP find no irreparable harm warranting the issuance of a stay. The irreparable harm analysis is quite similar to the mootness factor in the petition for a writ.[105] It is unlikely that both the lower courts committed errors on this point, and the ability to convince a panel of judges on the court of appeals that these factors warrant the issuance of a writ will be an uphill battle.

---

and the district court's stay of Syncora's appeal improperly thwarts both processes.").

100. *In re* Sch. Asbestos Litig., 977 F.2d 764, 773 (3d Cir. 1992) (quoting Maloney v. Plunkett, 854 F.2d 152, 155 (7th Cir. 1988).

101. Perry v. Schwarzenegger, 591 F.3d 1147, 1156 (9th Cir. 2010) (citation omitted).

102. *See, e.g.*, *Appeal-Proof*, *supra* note 14 ("[L]itigants seeking to appeal a bankruptcy court order face an uphill process and may have difficulty bringing the 'moving train' to a stop.").

103. *See supra* notes 1–2, 87 and accompanying text.

104. *See, e.g.*, *Appeal-Proof*, *supra* note 14 ("Frequently, courts considering whether an appeal is equitably moot will look to see whether the appellant diligently sought to preserve its rights, for example, by seeking a stay pending appeal.").

105. *See* Thapa v. Gonzales, 460 F.3d 323, 334 (2d Cir. 2006) (stating that the probability of success argument is inversely proportional to the amount of irreparable injury plaintiff will suffer absent the stay).

The remaining three factors will almost never be satisfied in the denial of a stay by a district court or BAP. The denial is a discretionary decision expressly provided for in the Bankruptcy Rules.[106] There is no "right" to a stay.[107] Showing that the lower court committed a clear error of law or disregard for the rules is a high hurdle. Furthermore, it would be unusual for a stay denial to raise new or important issues of first impression. Even though underlying legal issues will be addressed by the lower court in the denial of the stay,[108] any findings on those legal issues are merely interlocutory in nature and do not resolve the merits. To the extent the underlying appeal raises new or important issues of first impression, those have yet to be decided on the merits and are not decided in the denial of stay context.

Thus, even though the approach to analyzing a petition for a writ of mandamus is flexible and the power of the courts of appeals under the All Writs Act is broad, the issuance of a writ is a highly extraordinary equitable remedy[109] that likely is not warranted in most bankruptcy appeals in the context of a district court or BAP denial of a stay.[110] Even so, at least one court of appeals has issued a writ of mandamus in this context.[111] Among the various jurisdictional arguments for review of the denial of a stay or for requesting a stay by a court of appeals, the All Writs Act is a relatively strong basis to get the request before the court of appeals, but not necessarily to have a writ granted.[112]

D. Review under the Rules of Procedure

1. Federal Rules of Appellate Procedure

Rule 8 of the Federal Rules of Appellate Procedure provides for "a stay of

106. Grippando, *supra* note 14, at 372.

107. *Id.*

108. *See supra* note 23 and accompanying text.

109. The Supreme Court has noted the extraordinary nature of a writ of mandamus. *See* Cheney v. United States Dist. Ct. for D.C., 542 U.S. 367, 380 (2004) (quoting Will v. United States, 389 U.S. 90, 107 (1967)) (stating that the writ of mandamus is "one of 'the most potent weapons in the judicial arsenal.'"); *see also In re* Syncora Guarantee Inc., 757 F.3d 511, 515 (6th Cir. 2014) (noting that mandamus is an extraordinary remedy that is infrequently used).

110. *See, e.g.*, Grippando, *supra* note 14, at 371 (noting that invoking the court of appeals jurisdiction to consider issuing a writ is much easier than actually obtaining a writ in a bankruptcy appeal where the merits of the appeal have not been decided).

111. *In re* Barrier, 776 F.2d 1298, 1299–1300 (5th Cir. 1985).

112. Grippando, *supra* note 14, at 372–74 (discussing the distinction between obtaining a review by the court of appeals under the All Writs Act and the stringent requirements for the issuance of a writ in this context).

the judgment or order of a district court pending appeal . . . [,]" and such relief ordinarily must be brought in the district court before the court of appeals.[113] Under Rule 8, a court of appeals could consider a stay of the district court or BAP denial of a stay — the order that is on appeal to the court of appeals.[114] Rule 8 of the Federal Rules of Appellate Procedure is applicable to an interlocutory denial of stay order.[115] In the context of an appeal of the denial of a stay by the district court or BAP, that appeal is not a "bankruptcy appeal"; it is an appeal of an interlocutory order that arises in the bankruptcy appeal process, but the actual appeal is an appeal of an interlocutory order of the district court or BAP.[116] However, importantly, Rule 8 does not provide a procedure for a court of appeals to grant a stay of a bankruptcy court order that has been appealed to and is pending in the district court or the BAP.[117] The only relief provided by Rule 8 is to stay the effect of the district court or BAP denial of a stay.[118] Such relief, even if granted by a court of appeals, would have no impact on the underlying bankruptcy court order as it would still be in effect.[119] Rule 8 does not provide a basis to seek a stay of an order — the bankruptcy court order — that is not on appeal to the court of appeals.[120]

2. Bankruptcy Rule 8007

The District Court or BAP have already denied a stay order for the appellants seeking review of the denial; per Bankruptcy Rule 8007, the bankruptcy court has likely denied a stay order as well.[121] Under Bankruptcy Rule 8007(b), when the bankruptcy court order on appeal is still pending in

113. FED. R. APP. P. 8(a)(1)–(2) (referencing to district court includes a BAP, if applicable); *see also* FED. R. APP. P. 6(b)(1)(C).

114. *See* FED. R. APP. P. 8.

115. *See id.*

116. *See id.*

117. *See* FED. R. APP. P. 8.

118. *See In re Barrier*, 776 F.2d at 1299 (rejecting consideration of a stay of a bankruptcy court order under Rule 8(a) of the Federal Rules of Appellate Procedure because "the rule only authorizes stays pending appeals to this court." The bankruptcy court order was not on appeal to the court, only the district court interlocutory order denying the stay).

119. *See* Deering Miliken Inc., v. F.T.C., 647 F.2d 1124, 1128–29 (D.C. Cir. 1978) (stating that unless a stay is granted by the court rendering the judgement or the court to which the appeal is taken, the judgement remains operative).

120. *See* FED. R. APP. P. 8.

121. *See* FED. R. BANKR. P. 8007(a)–(b) (explaining the reasoning and procedure behind filing a stay order in bankruptcy court); *see also supra* note 4 and accompanying text (detailing the procedural process typically involving an initial request for a stay from the bankruptcy court).

the district court or the BAP, a request to stay such order pending its appeal may be made only in the district court or BAP.[122] Asking the court of appeals to review the denial of a stay at this posture is effectively asking the court of appeals to usurp the district court or BAP's authority and infringe upon the district court or BAP's jurisdiction over the bankruptcy court order.[123]

Moreover, seeking a stay of the bankruptcy court order in this procedural posture is tantamount to a direct appeal of the underlying bankruptcy court order to the court of appeals. That procedural route — a direct appeal of a bankruptcy court order to the court of appeals — is available to bankruptcy appellants.[124] In that procedural position, an appellant could make a motion for a stay under Bankruptcy Rule 8007(b) that expressly provides that such a motion can be made in the court where the appeal is pending — the court of appeals.[125] If appellants do not choose to take a direct appeal, appellants should not circumvent the requirements of § 158(d)(1)–(2)[126] and Bankruptcy Rule 8006,[127] or run afoul of the procedure detailed in Bankruptcy Rule 8007(b),[128] to obtain review of the underlying bankruptcy court order in the context of a stay motion before the court of appeals.

3. Bankruptcy Rule 8025

After the district court or BAP issues an order in a bankruptcy appeal, Bankruptcy Rule 8025(b) provides that the district court or BAP may stay their order pending appeal to the court of appeals. [129] This is the same authority that the bankruptcy court — the lower court in the initial level of appeal to the district court or BAP — has under Bankruptcy Rule 8007(a).[130]

122. *See* FED. R. BANKR. P. 8007(b)(1) (prescribing that the motion for say "may be made in the court where the appeal is pending").

123. *See generally* FED. R. BANKR. P. 8025 (providing the district court and BAP's authority).

124. *See generally* 28 U.S.C. § 158(d)(1)–(2) (2018); FED. R. BANKR. P. 8006(a) (stating when "[a] certification of judgment, order, or decree of a bankruptcy court for direct review in a court of appeals" is effective).

125. *See* FED. R. BANKR. P. 8007(b)(1) ("A motion for the relief specified in subdivision (a)(1) — or to vacate or modify a bankruptcy court's order granting such relief — *may be made in the court where the appeal is pending*." (emphasis added)).

126. 28 U.S.C. § 158(d)(1)–(2).

127. FED. R. BANKR. P. 8006.

128. *See* FED. R. BANKR. P. 8007(b) (describing the procedure of reviewing a stay motion in the Bankruptcy Court).

129. FED. R. BANKR. P. 8025(b); *see also In re* Anderson, 560 B.R. 84, 88 (S.D.N.Y. 2016) ("Rule 8025 of the Federal Rules of Bankruptcy Procedure ('Rule 8025') permits district courts to stay their own orders pending appeal to the court of appeals.").

130. *See* FED. R. BANKR. P. 8007(a) (providing the bankruptcy court's authority to stay their order).

Under Bankruptcy Rule 8025(d), if the district court or BAP denies a stay of its own order, the court of appeals can issue a stay pending appeal from the district court or BAP to the court of appeals.[131] This is comparable to Bankruptcy Rule 8007(b), which provides authority for the district court or BAP to issue a stay if the bankruptcy court denies a stay.[132]

Bankruptcy Rules 8007 and 8025 do not address the procedural posture presented here: the district court or BAP denial of a stay while the appeal is pending before the district court or BAP.[133] Both Bankruptcy Rules 8007 and 8025 provide an opportunity to seek a stay after denial of a stay by a lower court with the respective appellate court where the appeal is pending.[134] Thus, appellants throughout the bankruptcy appeal process — at each level of appeal — have two opportunities to seek a stay.[135] There is no rule-based authority for seeking a stay from the court appeals while the bankruptcy appeal is still pending in the district court or BAP.[136]

E. Review through 'Bootstrapping'

One approach to seek a stay from the court of appeals when the underlying appeal is still pending in the district court or BAP[137] is to file an appeal of the order denying the stay and then file in the court of appeals a motion for stay of the underlying bankruptcy court order. Effectively, the notice of appeal over the denial of stay order will get the appellant into the court of appeals.[138] And while the appeal of the denial of stay is pending in the court

131. *See* FED. R. BANKR. 8025(d) (clarifying that the Bankruptcy Rules do not in any way limit the authority of the court of appeals); *see also* FED. R. APP. P. 8(a) (providing for motions to stay in the court of appeals from a district court order).

132. *See* FED. R. BANKR. P. 8007(b) ("[I]f a motion was made in the bankruptcy court, either state that the court has not yet ruled on the motion, or state that the court has ruled and set out any reasons given for that ruling.").

133. *See infra* pp. 25–26 and notes 124–25.

134. FED. R. BANKR. P. 8007, 8025.

135. *Id.*

136. *See id.* (omitting any reference to the ability to seek a stay).

137. *See* 28 U.S.C § 158(d) (2018) (establishing that the underlying jurisdictional basis to appeal a denial of stay from a BAP is limited and will require characterizing the denial of stay order as a final order under); 28 U.S.C § 1292(a) (establishing that the court of appeals does not have jurisdiction over interlocutory appeals from the BAP, because § 1292(a) is limited to district court, therefore, the bootstrapping argument will be much more challenging from a denial of stay by a BAP).

138. *See* FED. R. APP. P. 3 (highlighting requirements of filing a notice of appeal in district court); FED. R. APP. P. 4 (detailing the time for filing a notice of appeal in district court); FED. R. APP. P. 6(b)(1) (noting that although Rule 6(b) of the Federal Rules of Appellate Procedure governs bankruptcy appeals, it would not govern the appeal of a denial of stay by a district court or BAP, unless the denial order was considered a final order, as Rule 6(b) expressly applies only to an appeal of a "final judgement, order, or

of appeals, the appellants can seek the very relief they want — a stay of the bankruptcy court order — through a motion in the court of appeals.[139] Rule 8 of the Federal Rules of Appellate Procedure, which provides for filing motions to stay, would not be applicable as the stay would be of an order other than the one on appeal.[140]

This is effectively bootstrapping a motion to stay the bankruptcy court order in the court of appeals with the appeal of the district court or BAP denial of stay in the court of appeals. Without the appeal of the denial of stay order to the court of appeals, there is no way to have a motion to stay the bankruptcy court order considered by the court of appeals, absent some type of motion for a writ of mandamus under the All Writs Act.[141] This is tying the motion for stay with the appeal on the denial of stay.

The difficulty with this approach is that the appellate jurisdiction of the court of appeals over the denial of stay order from the district court or BAP is suspect. In the context of an appeal from a district court order denying a stay to the court of appeals, the order denying the stay may not be a final order under § 158(d)[142] or an appealable interlocutory order under § 1292(a)(1).[143] And in the context of an appeal from a BAP order denying a stay the court of appeals basis for jurisdiction, the order denying the stay may not be a final order under § 158(d),[144] and appeal as an interlocutory order is not available under § 1292(a)(1).[145] If the court of appeals does not have jurisdiction over the underlying appeal of the denial of stay, there would not be jurisdiction over the bootstrapped motion for stay.

In other procedural contexts, courts have rejected comparable bootstrapping for jurisdiction.[146] For example, if a court does not have jurisdiction over an underlying case that court cannot issue a subpoena,

---

decree of the district court or the bankruptcy appellate panel").

139. *See* FED. R. APP. P. 27 (providing authority for filing motions); *supra* notes 85–87 and accompanying text (analyzing the application of Rule 8 of the Federal Rules of Appellate Procedure in this context).

140. *See supra* notes 85–87 and accompanying text (analyzing the application of Rule 8 of the Federal Rules of Appellate Procedure in this context).

141. *See supra* Section II.C and accompanying text (discussing the All Writs Act in the context of appeals of the denial to stay order).

142. *See supra* Section II.A.1 and accompanying text (analyzing whether the denial order is a final order).

143. *See supra* Section II.B and accompanying text (analyzing whether the denial order is an appealable interlocutory order).

144. *See supra* Section II.A.1 and accompanying text (analyzing whether the denial order is a final order).

145. *See supra* Section II.B and accompanying text.

146. *See, e.g.*, Barwood, Inc. v. District of Columbia, 202 F.3d 290, 294 (D.C. Cir. 2000).

absent the need to aid in determining jurisdiction or to issue a temporary restraining order.[147] The key issues discussed above regarding jurisdiction of the court of appeals over the appeal of the denial of stay are all at play, and authority to review of the motion for stay hinges on how the underlying jurisdictional basis is resolved.

Even though there are difficulties with the bootstrapping approach to seeking a stay from the court of appeals, it has worked to at least obtain consideration of the merits of a stay motion in the Eleventh Circuit.[148] The appellants' motions for stay of a bankruptcy court order, which imposed sanctions against the appellants, were denied by both the bankruptcy court and the district court.[149] While the underlying appeal on the merits of the bankruptcy court order was pending in the district court, the appellants appealed the district court denial of stay order and filed a motion for stay of the bankruptcy court order in the court of appeals.[150] The appellee objected to the motion for stay of the bankruptcy court order in the court appeals on the merits of the request[151] and filed a motion to dismiss the appeal of the denial of stay order for lack of jurisdiction asserting that the order was not appealable under §§ 158(d) or 21292(a)(1) as a final order or an interlocutory order respectfully.[152]

The Eleventh Circuit issued an order denying the motion for stay of the bankruptcy court order for the appellants' failure to meet their burden of proof.[153] The court provided no analysis as to the jurisdictional basis to consider the motion.[154] The underlying appeal of the district court denial of the stay was dismissed on procedural grounds for the appellants' failure to file a timely appendix.[155] The appellee's motion to dismiss for lack of jurisdiction was moot, and the merits of the motion were not addressed.[156]

---

147. *See id.*

148. *See generally* Appellants' Motion to Stay Enforcement of Bankruptcy Court Order Pending Appeal, Law Sols. Of Chi., LLC v. Corbett, No. 18-12121-EE (11th Cir. June 20, 2018).

149. *See id.* at 14–16.

150. *Id.* at 1.

151. *See generally* Appellee's Response to Appellants' Motion to Stay Enforcement of Bankruptcy Court Order Pending Appeal, Law Sols. Of Chi., LLC v. Corbett, No. 18-12121-EE (11th Cir. June 25, 2018) (arguing against the motion for stay).

152. Appellee's Motion to Dismiss Appeal for Lack of Jurisdiction at 1, Law Sols. Of Chi., L.L.C. v. Corbett, No. 18-12121-EE (11th Cir. May 25, 2018).

153. Order, Law Sols. Of Chi., LLC v. Corbett, No. 18-12121-EE (11th Cir. Aug. 3, 2018).

154. *See id.*

155. Entry of Dismissal, Law Sols. Of Chi., LLC v. Corbett, No. 18-12121-EE (11th Cir. Aug. 3, 2018).

156. Motion Moot, Law Sols. Of Chi., LLC v. Corbett, No. 18-12121-EE (11th Cir.

In this example from the Eleventh Circuit, we are left to guess what was the jurisdictional basis to consider the motion to stay the bankruptcy court order. In this procedural context, jurisdictional basis to consider the motion to stay was not §§ 158(d) or 1292(a)(1), as those jurisdictional arguments go to whether the Eleventh Circuit had jurisdiction over the appeal of denial of stay by the district court.[157] The basis could be the Eleventh Circuit's authority under the All Writs Act, but it was not articulated, so we are not certain. Regardless, this case shows how bootstrapping can at least get the issue before a court of appeals in some cases.[158] Additionally, it demonstrates that even if an appellant can get the issue before the court of appeals, obtaining a stay is a very high hurdle.[159]

III. CRITIQUE OF INCONSISTENT APPROACHES TO REVIEW

The above analysis clearly shows one thing: whether the appellant's abilities to either have an appeal of a denial of stay by a district court or BAP considered by the court of appeals when the underlying appeal is still pending in the district court or BAP, or have a motion for stay of a bankruptcy court order considered by a court of appeals, will vary among the courts of appeals and will often be fact-driven. Most courts of appeals are in agreement that a denial of stay by a district court or BAP are not appealable final orders,[160] but some courts will consider finality on a pragmatic basis.[161] Other courts of appeals will review the denial of a stay by a district court if it is an appealable interlocutory order.[162] At least two circuits consider the appeal of a denial of a stay under the All Writs Act.[163] And, in one circuit, bootstrapping a motion to stay a bankruptcy court order along with an appeal of the denial order by the district court may get the court of appeals to review the merits of the stay request.[164]

It is disconcerting how varied the courts' of appeals ability is to invoke their jurisdiction to consider the appeal of a denial of a stay (by a district court or BAP) in order to consider the merits of a motion to stay a bankruptcy

---

Aug. 3, 2018).

157. 28 U.S.C. § 158(d) (2018); § 1292(a)(1).

158. Appellants' Motion to Stay Enforcement of Bankruptcy Court Order Pending Appeal, Law Sols. Of Chi., LLC v. Corbett, No. 18-12121-EE (11th Cir. June 20, 2018).

159. *See* Grippando, *supra* note 14, at 374–75 (discussing the difficulty is satisfying the "test for entry of a stay, regardless of the source of judicial power to enter it").

160. *See supra* note 24 and accompanying text.'

161. *See supra* notes 25–26 and accompanying text.

162. *See* discussion *supra* Section II.B.

163. *See* discussion *supra* Section II.C.

164. *See* discussion *supra* Section II.E.

court order. It raises a concern about access to justice in this procedural setting.[165] There is an argument that an access to justice issue does not arise when an appellant has had a chance to obtain a stay from two courts — the bankruptcy court and the district court or BAP. However, if some appellants are able to obtain a review by the court of appeals of a motion for stay or an appeal of a denial of a stay, and other similarly situated appellants are not afforded that opportunity for review, fairness and access to justice are of concern.[166] Disparate approaches to review by the courts of appeals frustrate an appellant's access to justice. Procedural equality in the process of seeking a stay is essential to achieving access to justice. Viewing access to justice through only the procedural lens is inadequate. The procedural shortfall of denying access to justice raises a broader societal concern. Society as the whole values equal justice,[167] and fundamental to equal justice is, at a minimum, a procedural process that does not vary from court to court or case to case.

Access to justice does not mean that a court of appeals must rule in favor of the appellant on the merits of a motion for stay or an appeal from a denial of such a motion.[168] Rather, it simply requires a meaningful opportunity to be heard on the merits through a motion to stay the bankruptcy court order or to have the appeal of the denial of the stay by the district court or BAP considered on the merits.[169] What is needed is an ability for appellants to seek a stay and obtain a ruling on the merits.[170] The ability to seek the relief — a stay from the court of appeals — will provide access, and obtaining a ruling on the merits by the court of appeals will provide justice.[171] The current landscape of the caselaw in this area shows that both "access" and "justice" are hit or miss.[172]

IV. REFORM TO ELIMINATE DISPARATE APPROACHES TO REVIEW

The above critique shows how appellants in different jurisdictions may be

165. *See generally* Robert J. Landry, III & David W. Read, *Erosion of Access to Consumer Bankruptcy's "Fresh Start" Policy in the United States: Statutory Reforms Needed to Enhance Access to Justice and Promote Social Justice*, 7 WM. & MARY POL'Y REV. 51 (2015) (analyzing concepts of access to justice in the consumer bankruptcy context).

166. Grippando, *supra* note 14, at 359.

167. Landry & Read, *supra* note 156, at 55.

168. *See id.*

169. *See id.* (explaining that just because an individual can file for bankruptcy, does not necessarily afford them a meaningful opportunity to avail themselves to the court).

170. *See id.* at 71.

171. *See id.* at 54.

172. *Id.* at 55–56.

subject to disparate treatment in terms of ability to have a denial of stay reviewed by a court of appeals or to bring a motion for stay,[173] when the underlying appeal is still pending in the lower court. A procedural mechanism is needed to ensure that all appellants have the same opportunity to request a stay. The underlying analysis on the merits of issuing a stay is well-settled,[174] and there is a need for a mechanism that will provide a uniformity among all jurisdictions in a bankruptcy appeal.

The mechanism can be included in the Bankruptcy Rules. At first blush, it seems that an amendment to the Bankruptcy Rules would be inadequate and, in fact, go beyond the scope of what the rules can govern and confer jurisdiction on the court of appeals beyond what is provided by statute or the Constitution.[175] However, in this context, an amended Bankruptcy Rule adding a mechanism to seek a stay from the court of appeals would not confer jurisdiction; rather, it would simply provide the instrumentality to implement already existing jurisdiction.

Under 28 U.S.C. § 2075 the Supreme Court has the power to prescribe rules pertaining to the practice and procedure in cases under the Bankruptcy Code; however, "[s]uch rules shall not abridge, enlarge, or modify any substantive right."[176] Bankruptcy rules, like other rules of procedure, have the authority of the federal statute, but the rules do no confer jurisdiction of federal courts.[177] In the stay context of bankruptcy appeals, for example, Bankruptcy Rule 8007(b)(1) does not confer jurisdiction on the district court.[178] Rather, the jurisdiction over the appeal is conferred by § 158.[179] Bankruptcy Rule 8007(b) provides the rules of procedure to implement that jurisdiction statutorily conferred on the district court in the bankruptcy appeal.[180] The ability to consider issuing a stay of the bankruptcy court order, which is an inherent power and statutory power under the All Writs Act of the district court, is integral to the district court appellate

173. *See* discussion *supra* Section II.

174. *See* Hilton v. Braunskill, 481 U.S. 770, 776 (1987) (employing a four-factor test to determine if a stay is warranted, in which the underlying issues of the appeal, legal and otherwise, are part of the analysis); *see also* Nken v. Holder, 556 U.S. 418, 434 (2009) (employing these four factors).

175. Kokkonen v. Guardian Life Ins. Co., 511 U.S. 375, 375 (1994) ("Federal courts are courts of limited jurisdiction. The possess only that power authorized by Constitution and statute.").

176. 28 U.S.C. § 2075 (2018).

177. *See* 1 FED. PROC. § 1:332 (recognizing the rules of procedure as law derived from statute, but the rules do not expand or confer jurisdiction of federal courts).

178. *See* FED. R. BANKR. P. 8007(b)(1).

179. *See* 28 U.S.C. § 158(a) (2006) (detailing when the district court has jurisdiction over an appeal).

180. *See* FED. R. BANKR. P. 8007(b).

jurisdiction.[181] Bankruptcy Rule 8007(b) simply provides the mechanism for the exercise of that power.

Just as Bankruptcy Rule 8007(b) does not confer jurisdiction, an amended rule with a procedural process to seek a stay from the court of appeals would not confer jurisdiction.[182] Unlike the district court and BAP that has jurisdiction over the appeal,[183] the courts of appeals do not have jurisdiction over the appeal that is still pending in the lower appellate court. However, the courts of appeals have authority to consider the issuance of a stay under the All Writs Act. That jurisdictional authority has already been expressly exercised by some courts of appeal in this context.[184] Having a clear rule that details the procedure would permit all appellants to be treated the same and have the same ability to request a stay from the courts of appeals. It would also end the need for the courts of appeals to consider appeals of denials of a stay and the thorny jurisdictional issues that arise.[185] The courts of appeals could consider the merits of a stay of the bankruptcy court order up or down.

Bankruptcy Rule 8007 can be amended to provide that a motion for stay can be filed in the court of appeals when the bankruptcy appeal is pending in the district court or BAP. The ability to file such a motion would be limited to instances when such a motion has already been filed and ruled on by the district court or BAP. This would prevent appellants from going straight to the court of appeals to seek a stay. The current structure of Bankruptcy Rule 8007 has a similar limitation where the stay ordinarily should be sought in the bankruptcy court before the relief is sought in the district court or BAP.[186] The proposed amendment would instead require seeking the relief from the district court or BAP initially and that relief being denied prior to seeking relief from the court of appeals.[187]

Bankruptcy Rule 8007 should be amended, as set forth below.

Rule 8007.

(a) Initial motion in the Bankruptcy Court

(1) In general. Ordinarily, a party must move first in the bankruptcy court for the following relief:

(A) a stay of a judgment, order, or decree of the bankruptcy court

181. *See* 28 U.S.C. § 1659.

182. *See* FED. R. BANKR. P. 8007(b).

183. 28 U.S.C. § 158(a)–(b)(1).

184. *See supra* Section II.C and accompanying text.

185. *See supra* Sections II.A., II.B and accompanying text.

186. FED. R. BANKR. P. 8007 (b)(1).

187. *See contra* FED. R. BANKR. P. 8007 (b)(2)(A).

pending appeal;
(B) the approval of a supersedeas bond;
(C) an order suspending, modifying, restoring, or granting an injunction while an appeal is pending; or
(D) the suspension or continuation of proceedings in a case or other relief permitted by subdivision (e).

(2) Time to file. The motion may be made either before or after the notice of appeal is filed.

(b) Motion in the district court, the BAP, or the Court of Appeals on direct appeal
(1) Request for relief. A motion for the relief specified in subdivision (a)(1)--or to vacate or modify a bankruptcy court's order granting such relief--may be made in the court where the appeal is pending.
(2) Showing or statement required. The motion must:

(A) show that moving first in the bankruptcy court would be impracticable; or
(B) if a motion was made in the bankruptcy court, either state that the court has not yet ruled on the motion, or state that the court has ruled and set out any reasons given for the ruling.

(3) Additional content. The motion must also include:

(A) the reasons for granting the relief requested and the facts relied upon;
(B) affidavits or other sworn statements supporting facts subject to dispute; and
(C) relevant parts of the record.

(4) Serving notice. The movant must give reasonable notice of the motion to all parties.

(c) Motion in the Court of Appeals
(1) Request for relief. A motion for the relief specified in subdivision (a)(1)--or to vacate or modify a bankruptcy court's order granting such relief--may be made in the court of appeals when the appeal is pending in the district court or BAP.
(2) Showing or statement required. The motion must show that such a motion has been made in the district court or BAP and that the has ruled and set out any reasons given for the ruling.
(3) Additional content. The motion must also include:

(A) the reasons for granting the relief requested and the facts relied upon;
(B) affidavits or other sworn statements supporting facts subject to dispute; and
(C) relevant parts of the record.

(4) Serving notice. The movant must give reasonable notice of the motion

> to all parties.
>
> (d) Filing a bond or other security
> The district court, BAP, or court of appeals may condition relief on filing a bond or other appropriate security with the bankruptcy court.
>
> (e) Bond for a trustee or the United States
> The court may require a trustee to file a bond or other appropriate security when the trustee appeals. A bond or other security is not required when an appeal is taken by the United States, its officer, or its agency or by direction of any department of the federal government.
>
> (f) Continuation of proceedings in the bankruptcy court
> Despite Rule 7062 and subject to the authority of the district court, BAP, or court of appeals, the bankruptcy court may:
> (1) suspend or order the continuation of other proceedings in the case; or
> (2) issue any other appropriate orders during the pendency of an appeal to protect the rights of all parties in interest.

Amended Bankruptcy Rule 8007 has a new subsection (c). Subsection (c)(1) provides for a motion for relief from the court of appeals when the appeal is pending in the district court or BAP. Subsection (c)(2) requires that a motion show that a motion was made and ruled upon by the district court or BAP. The remaining subjections of (c) simply mirror those in current Bankruptcy Rule 8007(b).[188] Current Bankruptcy Rule 8007 subsections (c), (d), and (e) become subsections (d), (e), and (f), without any substantive changes.[189]

V. CONCLUSIONS

Amending Bankruptcy Rule 8007 would help ensure that all bankruptcy appellants have the same opportunity to seek a stay from a court of appeals. It would remove the need to appeal a district court or BAP order denying a stay, thereby eliminating the jurisdictional problems and disparate outcomes among the courts of appeals through that process. Litigants would be on a more even playing field, and the outcomes would not be determined by jurisdictional issues unrelated to underlying merits of a stay request. Focusing on the merits of the stay request would give the parties equal access and enhance fairness in this aspect of bankruptcy appellate litigation.

In the meantime, before any type of amended Bankruptcy Rule is put in place, practitioners will need to pay particular attention to the possible

188. *See contra* FED. R. BANKR. P. 8007 (b)(2)(B).

189. *Contra* FED. R. BANKR. P. 8007 (c)–(e).

avenues for obtaining a stay in the applicable circuit to ensure that their clients' interests are advanced as much as possible. However, the most important thing for practitioners to do is to put on a strong and well-documented case for the issuance of a stay in the bankruptcy court initially. The burden is high, but practitioners need to spend the time, and clients the money, to make sure the record is convincing before the bankruptcy court to warrant the issuance of a stay. The affidavits and other evidence in support of a motion for stay need to be quite convincing and show the bankruptcy court why the extraordinary remedy of a stay is warranted. Furthermore, from a practical standpoint, the bankruptcy judge is likely in a better position, as the factfinder in the underlying case, as opposed to an appellate court, to appreciate whether a stay is warranted or not. Once the stay issue advances to the appellate court, obtaining a stay will likely be more difficult, assuming the jurisdictional hurdles can be overcome.

NOT ALL VIRTUAL CURRENCIES ARE CREATED EQUAL: REGULATORY GUIDANCE IN THE AFTERMATH OF CFTC V. MCDONNELL

ALLEN KOGAN*

I. INTRODUCTION

Virtual currencies have emerged as an innovative technological alternative for a multitude of tools and processes used by financial institutions, private businesses, and investors.[1] However, contrary to popular belief, the term "virtual currency" encompasses many distinct, independently developed applications of Distributed Ledger Technology ("DLT").[2] Moreover, the term "cryptocurrency" describes just one subsect of virtual currencies, which itself includes a vast array of different technologies with unique implementations, technological underpinnings, and end-uses.[3] Consumers

*Junior Staff Member, American University Business Law Review, Volume 8; J.D. Candidate, American University Washington College of Law 2020. B.A. in International Affairs, George Washington University 2015.

1.*See* Antoine Bouveret & Vikran Haksar, *What Are Cryptocurrencies?*, 55 INT'L MONETARY FUND FIN. & DEV. MAG. 26, 26–27 (June 2018), available at https://www.imf.org/external/pubs/ft/fandd/2018/06/what-are-cryptocurrencies-like-bitcoin/basics.pdf; *see also In re* Griffin Trading Co., 683 F.3d 819, 821 (7th Cir. 2012) (noting that the Euro initially operated only as a virtual currency) (internal citation omitted).

2. *See* FIN. ACTION TASK FORCE, KEY DEFINITION AND POTENTIAL AML/CFT RISKS 4 (2014) (defining "virtual currency") [hereinafter KEY DEFINITIONS]; *see also infra* Section II.A (discussing key distinctions between networks and explaining DLT).

3. *See Cryptocurrency*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cryptocurrency.asp (last visited Sept. 5, 2018).

can already use one prominent virtual currency, Bitcoin, to make online purchases from a variety of popular online retailers, travel-booking sites, and even dating sites, with many others currently testing virtual currency payment-processing systems.[4]

As virtual currencies continue to gain popularity, major financial institutions are working with developers to further broaden the variety of financial tools and investment vehicles based on blockchain networks.[5] Foreseeably, a major question arose soon after individual investors began to speculate on virtual currency prices: how will they be regulated?[6] Though United States ("U.S.") federal courts and agencies are struggling to establish clear, definitive oversight of these digital assets, securities and commodities regulators have flexed their self-asserted regulatory muscle by bringing successful actions against developers.[7] In one such action, *Commodity Futures Trading Comm'n v. McDonnell*,[8] a federal court held for the first time that all virtual currencies are commodities, which are subject to the Commodity Futures Trading Commission's ("CFTC") jurisdiction.[9]

Part II of this Comment defines key terms and underscores that many virtual currencies are designed for drastically different purposes with highly distinct technological protocols. Part III discusses notable efforts by federal authorities to expand regulatory jurisdiction to virtual currencies, the sources of law they rely upon in doing so, and their successes in federal court thus far. Part IV analyzes the primary legal and practical issues with broadly classifying all virtual currencies as commodities, and Part V underscores the significant flaws in the *McDonnell* court's reasoning in doing so. Part VI briefly analyzes the applicability of U.S. securities laws to virtual currencies and related investment offerings. Lastly, Part VII recommends that (1)

4. Steve Fiorillo, *How to Use Bitcoin for Purchases*, THE STREET (Apr. 18, 2018), https://www.thestreet.com/investing/bitcoin/what-can-you-buy-with-bitcoin-14556706 (discussing Bitcoin payments on sites like Overstock, Expedia, and OKCupid).

5. *See* Rakesh Sharma, *A Cryptocurrency Derivatives Boom Might Be On Its Way*, INVESTOPEDIA (May 1, 2018), https://www.investopedia.com/tech/cryptocurrency-derivatives-boom-might-be-its-way/.

6. *See generally* Kate Rooney, *Your Guide to Cryptocurrency Regulations Around the World and Where They Are Headed*, CNBC (Mar. 27, 2018), https://www.cnbc.com/2018/03/27/a-complete-guide-to-cyprocurrency-regulations-around-the-world.html (describing various regulations on the validity of bitcoin and policies on exchanges in different countries).

7. *See, e.g.*, United States v. Mansy, 2:15-CR-198-GZS, 2017 WL 9672554 (D. Me. May 11, 2017); United States v. Budovsky, 13CR00368, 2016 WL 386133 (S.D.N.Y. Jan. 28, 2016).

8. Commodity Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213 (E.D.N.Y. 2018).

9. *Id.* at 229–30.

future case law resolve outstanding legal issues relevant to virtual currency classification and narrow the holding in *McDonnell*, and (2) that regulators develop a more precise regulatory scheme that accounts for the significant differences between individual virtual currency networks.

II. VIRTUAL CURRENCIES — IN GENERAL

Understanding key terms, technological distinctions between individual networks, and current efforts by U.S. regulators is essential to implementing a precise and effective classification mechanism for virtual currency regulation.

A. What Are Virtual Currencies?

The terms "virtual currency," "cryptocurrency," and "tokens," inter alia, each refer to individual aspects of entirely distinct networks, which themselves are specific applications of a broader system known as "blockchain technology," or simply "the blockchain."[10] Moreover, the blockchain is just one particular application of DLT for the narrow purpose of peer-to-peer information transfer through decentralized online networks.[11] DLT is essentially a "consensus validation system" designed to replace centralized validation authorities with distributed ledgers, which exist across several online nodes — mainly computers — and maintain identical copies of user transactions to validate them in the future.[12]

Rather unintuitively, and likely the source of much confusion among

10. *Cryptocurrencies*, AUSTL. SEC. & INV. COMMISSION (last updated Oct. 24, 2018), https://www.moneysmart.gov.au/investing/investment-warnings/virtual-currencies (explaining that a blockchain is a virtual recording system which allows users to continuously add new records of data (the "blocks") to its ledger (the "chain") while permanently retaining all previously recorded transactions).

11. Michael J.W. Rennock et al., *Blockchain Technology and Regulatory Investigations*, PRACTICAL LAW – LITIGATION, at 36 (Feb./Mar. 2018) (explaining that other applications of DLT act similarly to many popular blockchain networks but do not actually employ a blockchain); *see also* LABCFTC, COMMODITY FUTURES TRADING COMMISSION, *A CFTC Primer on Virtual Currencies* 4, 8 (Oct. 17, 2017) (citing I.R.S. Notice 2014-21, https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies) (listing "Potential Use Cases of Blockchain/DLT Technology"), https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf; *see also* Brian Curran, *What is the Tangle? Complete Guide to IOTA's Directed Acyclic Graph (DAG)*, BLOCKONOMI (July 24, 2018), https://blockonomi.com/iota-tangle/ (explaining IOTA, a Directed Acyclic Graph ("DAG"), which employs DLT but not blockchain technology).

12. Shaan Ray, *The Difference Between Blockchains & Distributed Ledger Technology*, TOWARDS DATA SCI. (Feb. 19, 2018), https://towardsdatascience.com/the-difference-between-blockchains-distributed-ledger-technology-42715a0fa92; LABCFTC, *supra* note 11, at 6.

courts, not all virtual currencies use DLT; many cannot be used in place of fiat currency, and some even entirely lack monetary functionality.[13] Instead, a virtual currency is simply "a digital representation of value" that exists only online, has no legal government-tender status, and can be traded as "(1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value."[14] "Cryptocurrencies" are a specific subset of virtual currencies that utilize DLT and secure transactions with cryptography, making them extremely difficult to counterfeit and therefore highly effective for use in financial transactions.[15] A "token" is a tool most often used as a transactional unit on a virtual currency network.[16] Tokens may represent virtually any asset or interest and exist in many different forms, dictated entirely by their intended use.[17] Lastly, the term "digital currency" is often used to describe the digital (or online) representation of either a virtual or fiat currency.[18]

B. Permissioned, Convertible, Both, or Neither?

Blockchain networks generally exist in two main forms: "permissioned" networks, which outside users cannot access without the owner's permission, and "permission-less" networks, which "anyone can access and use."[19] Further, certain virtual currencies are "convertible," meaning they can be either exchanged directly for fiat currencies or used entirely in their place to

13. *See infra* text accompanying notes 45–48 (discussing networks that, while lacking monetary value, can be traded as a "medium of exchange" of *information*); *see also* Mason v. Mach. Zone, Inc., 140 F. Supp. 3d 457, 465 (D. Md. 2015) (involving an non-DLT virtual currency which users purchase with fiat currency and can only employ within a closed virtual casino and cannot transfer elsewhere).

14. *See* KEY DEFINITIONS, *supra* note 2, at 4; *see also* LABCFTC, *supra* note 11, at 4 (citing I.R.S. Notice 2014-21, https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies) (providing the same definition); *In re* Coinflip, Inc., CFTC No. 15-29, 2015 WL 5535736, at *2 n.2 (Sept. 17, 2015) (providing the definition of Bitcoin as a virtual currency) [hereinafter *Coinflip Order*].

15. *See Cryptocurrency*, *supra* note 3.

16. *Id.*

17. *Id.*; *Cryptographic Tokens*, BLOCKCHAIN HUB, https://blockchainhub.net/tokens/ (last visited Feb. 4, 2019) (describing different types of tokens and their use by cryptocurrency networks).

18. *See* KEY DEFINITIONS, *supra* note 2, at 4. However, due to its relatively inconsistent use and negligible import here, "digital currency" will not be used in this Comment. *See, e.g.*, Andrew Tar, *Digital Currencies vs. Cryptocurrencies, Explained*, COINTELEGRAPH (Dec. 13, 2017), https://cointelegraph.com/explained/digital-currencies-vs-cryptocurrencies-explained (defining "digital currency" as synonymous with "virtual currency").

19. *See* KEY DEFINITIONS, *supra* note 2, at 4; *see also infra* text accompanying notes 37–39 (discussing Ripple, a permissioned network); Mason v. Mach. Zone, Inc., 140 F. Supp. 3d 457, 465 (D. Md. 2015) (involving a permissioned network that users could only access with the owner's permission, granted to those purchasing in-game currency).

trade for physical goods or services.[20] "Non-convertible" virtual currencies cannot be exchanged for fiat currencies, physical goods, or services because they are specifically designed for use within a closed (usually entirely virtual) domain.[21]

C. Key Distinctions Between Prominent Networks

1. Bitcoin

The Bitcoin Network is the first-ever established cryptocurrency and the most popular virtual currency among speculative investors, consumers, and, consequently, financial regulators.[22] This network is a permission-less blockchain designed to facilitate anonymous peer-to-peer financial transactions without reliance on a centralized authority to verify these transactions.[23] The network's token, Bitcoin, is convertible and transferable between individual virtual wallets that exist either online or locally on a computing device.[24] This enables users to buy, sell, and exchange Bitcoin with each other directly for cash and through online exchanges using a credit card or a bank account.[25]

Individuals can also "mine" Bitcoin by using computers (usually designed to generate enormous amounts of computing power) to solve complex algorithms that each generate one Bitcoin when solved.[26] Because Bitcoins are finite in supply, they derive their value from: (1) supply and demand on the open market, (2) overall cryptocurrency market conditions, and (3) the network's user-base, which pools assets to create, sustain, and change the

20. *See* KEY DEFINITIONS, *supra* note 2, at 4; *see also infra* text accompanying note 24 (describing Bitcoin's convertibility).

21. *See* KEY DEFINITIONS, *supra* note 2, at 4; LABCFTC, *supra* note 11, at 4; *see, e.g.*, Mason, 140 F. Supp. 3d at 465 (involving a non-convertible currency only useable in a virtual casino).

22. *See Top 100 Cryptocurrencies by Market Capitalization*, COINMARKETCAP, https://coinmarketcap.com/ (last visited Feb. 4, 2019) (listing Bitcoin's market capitalization at $60 billion, more than triple that of second-place XRP at $12 billion); Bernard Marr, *A Short History of Bitcoin and Crypto Currency Everyone Should Read*, FORBES (Dec. 6, 2017, 12:28 AM), https://www.forbes.com/sites/bernardmarr/2017/12/06/a-short-history-of-bitcoin-and-crypto-currency-everyone-should-read/ (reporting that Bitcoin is the first-ever functioning cryptocurrency); *see also* LABCFTC, *supra* note 11, at 2 (focusing on Bitcoin).

23. *See* Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN 8 (2008), https://bitcoin.org/bitcoin.pdf (explaining Bitcoin's design and purpose).

24. *Id.*

25. *Id.*

26. *Id.* at 3.

token's value against fiat currencies.[27] Currently, Bitcoin is mainly purchased specifically for returns on potential value appreciation by speculative investors.[28] The price of Bitcoin — as well as that of most other cryptocurrencies — varies significantly based on the particular country, and even the particular exchange within a country, from which they are purchased.[29] Bitcoin's development also prompted later cryptocurrencies known as "alt-coins," which seek to improve on specific aspects of Bitcoin's coding protocol (such as user privacy or transaction speed, for example) while maintaining all of Bitcoin's fundamental attributes discussed in this section.[30] These, collectively with Bitcoin, are referred to as "Bitcoin-class networks" for the purposes of this Comment.

2. Ethereum & Smart Contracts

"Smart-contract" networks are a narrower subset of cryptocurrencies designed to accomplish a range of tasks vastly different from that of Bitcoin-class networks, and therefore employ entirely distinct coding protocols.[31] Specifically, smart-contract cryptocurrencies seek to replace traditional paper contracts by offering two main advantages: (1) dramatically reduced costs associated with traditional contractual transactions, and (2) extensive security measures for securing these transactions.[32]

---

27. David Prather, *Expert Q&A: Bitcoin Compensation*, Practical Law Article 0-573-7085, PRACTICAL LAW – LABOR & EMPLOYMENT (July 8, 2014); John Kelleher, *Why do Bitcoins Have Value?*, INVESTOPEDIA (last updated Mar. 7, 2018), https://www.investopedia.com/ask/answers/100314/why-do-bitcoins-have-value.asp; *The Bitcoin Phenomenon: How Cryptocurrencies Gain Value*, CORNELL UNIVERSITY (Nov. 25, 2016), https://blogs.cornell.edu/info2040/2016/11/25/the-bitcoin-phenomenon-how-cryptocurrencies-gain-value/ (discussing factors that determine cryptocurrency values).

28. Fiorillo, *supra* note 4, at 1; Martha C. White, *How to Invest in Bitcoin: Here's What You Need To Know*, TIME (Dec. 14, 2017), http://time.com/money/5063203/how-to-invest-in-bitcoin/.

29. *See* Bob Pisani & Todd Haselton, *Here's Why Bitcoin Prices Are Different on Each Exchange*, CNBC (Dec. 12, 2017), https://www.cnbc.com/2017/12/12/why-bitcoin-prices-are-different-on-each-exchange.html (explaining how prices vary depending upon liquidity, inefficiency, and uncommon pricing).

30. *See* Prableen Bajpai, *The 10 Most Important Cryptocurrencies Other Than Bitcoin*, INVESTOPEDIA (last updated Aug. 27, 2018), https://www.investopedia.com/tech/most-important-cryptocurrencies-other-than-bitcoin/ (explaining and comparing coding protocols of popular alt-coins with that of Bitcoin).

31. *See* ETHEREUM, https://ethereum.org/ (last visited Sept. 20, 2018) (explaining that smart-contract cryptocurrencies run smart contracts on their networks).

32. *See* Ari Juels & William Marino, *Understanding Smart Contract Mechanics*, Practical Law Practice Note w-005-3262, PRACTICAL LAW – FINANCE (Mar. 1, 2017) (explaining that smart contracts are "a form of computer code run in a framework that resembles execution by a trusted third party" and are "helping enforce the terms of traditional legal agreements"); *see also* LabCFTC, *A Primer on Smart Contracts*, CFTC (Nov. 27, 2018), at 4–10 [hereinafter *Primer on Smart Contracts*] (explaining smart

The most popular smart-contract cryptocurrency among investors is Ethereum, a permission-less blockchain that operates on a coding protocol largely distinct from that of Bitcoin-class networks.[33] Specifically, the Ethereum network stores not only transactional data regarding a native token, as Bitcoin-class networks do, but also code for "smart contracts," which users can employ for a wide-range of tasks.[34] This enables Ethereum's native token, Ether, to be used not just for financial transactions (like tokens on Bitcoin-class networks), but also for facilitating virtual contract transactions, which enforce party obligations without reliance on a traditional central authority (such as a court or a mediator), while minimizing the counterparty risk associated with doing so.[35] Like Bitcoin, Ether and similar smart-contract tokens operate on cryptocurrency networks, can be mined and are convertible.[36]

3. Other Networks

Beyond the scope of convertible cryptocurrencies based on permission-less and Smart-contract networks, developers continue to create a broad array of new virtual currencies with entirely distinct coding protocols for drastically different and highly innovative uses.[37] Ripple, for example, is a convertible cryptocurrency token based on a permissioned blockchain.[38]

---

contracts and how developers are applying blockchain technology to create decentralized Smart-contract networks).

33. *See Top 100 Cryptocurrencies by Market Capitalization*, *supra* note 22, at 3; *see also* Julianne Harm et al., *Ethereum vs. Bitcoin*, THE ECONOMIST, 3–6 https://www.economist.com/sites/default/files/creighton_university_kraken_case_study.pdf (last visited May 13, 2019) (explaining coding protocol distinctions between Bitcoin and Ethereum); ETHEREUM, *supra* note 31, at 4 (listing Ethereum's intended uses, including the registry of debts, transactions under provided instructions — in a will or futures contact, for example, and the development of markets).

34. Juels & Marino, *supra* note 32, at 4.

35. *Id.*; *see also Primer on Smart Contracts*, *supra* note 32, at 11–16 (listing potential benefits and uses of smart contracts, including derivatives, securities, supply chain management, record keeping, trade clearing, and insurance automation).

36. *See* Juels & Marino, *supra* note 32, at 4 (providing that these tokens are referred to as "Smart-contract networks"); *see, e.g.*, *Primer on Smart Contracts*, *supra* note 32, at 4 ("Fundamentally, a 'smart contract' is a set of coded computer functions."); *see also* Ryan Smith, *What is Tezos (XTZ)? A Beginner's Guide to the Controversial Coin*, COINCENTRAL (Aug. 20, 2018), https://coincentral.com/what-is-tezos-xtz-a-beginners-guide-to-the-controversy-coin/ (explaining Tezos, a smart-contract cryptocurrency similar to Ethereum which allows users to self-govern the network through voting).

37. Andrew Medal, *10 Incredible Uses for Cryptocurrency and Blockchain You Probably Haven't Thought Of*, ENTREPRENEUR (Dec. 11, 2017), https://www.entrepreneur.com/article/305859.

38. RIPPLE, https://ripple.com/ (last visited Sept. 18, 2018). *See* Phil Fersht, *The Top 5 Enterprise Blockchain Platforms You Need to Know*, HORSES FOR SOURCES (Mar. 16,

Accordingly, Ripple and similar networks offer the transactional efficiency and security of Bitcoin, but lack Bitcoin's (almost complete) user-anonymity due to their reliance on a centralized authority for verifications.[39] Ripple's coding protocol was specifically designed to facilitate fast, secure data and financial transfer transactions between large financial institutions, many of which are currently exploring the implementation of Ripple.[40]

Certain virtual currencies issue tokens that derive their value from real-world assets, entirely irrespective of supply, demand, consumer popularity, and other external factors regarding the tokens themselves.[41] Tether, for example, is a permission-less blockchain designed to enable businesses to efficiently access fiat currencies by supporting three different tokens on its network, each of which is fully backed by real-world fiat currency assets held in Tether's reserve account.[42] Accordingly, users of asset-backed networks cannot (theoretically, at least) manipulate the price of tokens.[43]

Other virtual currency networks do not support tokens at all, and therefore have no monetary value.[44] For example, the Estonian government is

---

2018), https://www.horsesforsources.com/top-5-blockchain-platforms_031618 ("[The company] aims to connect banks, payment providers, digital asset exchanges and corporates through RippleNet, with nearly-free global transactions without any chargebacks. It enables global payments through its digital asset called 'Ripples or XRP' that has become one of the most popular cryptocurrency just behind Bitcoin and Ether.").

39. *See* Scott D. Hughes, *Cryptocurrency Regulations and Enforcement in the U.S.*, 45 W. St. L. Rev. 1, 4–5 (2017). Ripple and similar networks are referred to as "Ripple-class networks" for the purposes of this Comment.

40. *See What Are the Advantages of Ripple?*, FX TRADE ONLINE (Jan. 4, 2018), https://fx-tradeonline.com/what-are-the-advantages-of-ripple; *see also* Victor Tangermann, *The U.S. Challenges Iran's Attempt to Develop a Cryptocurrency*, FUTURISM (Dec. 22, 2018), https://futurism.com/us-congress-iran-sanctions-crypto currency (reporting on Iran's plans to launch a state-backed, permissioned cryptocurrency network).

41. *See From Network-Backed to Asset-Backed: Will Security Tokens Take Crypto Mainstream?*, LCX (Oct. 3, 2018), https://medium.com/lcx/from-network-backed-to-asset-backed-will-security-tokens-take-crypto-mainstream-37f5547c2948. These tokens are referred to as "Asset-backed networks" for the purposes of this Comment. *See id.*

42. *FAQs*, TETHER, https://tether.to/faqs/ (last visited Jan. 22, 2019) (listing Tether's tokens, USD₮, EUR₮, and JPY₮, which are backed by (and pegged to the price of) U.S. Dollars (USD), Euros (EUR), and Japanese Yen (JPY), respectively).

43. *See id. But see* Neer Varshney*, Report Suggests Tether Market Manipulation on Kraken Cryptocurrency Exchange*, THE NEXT WEB (June 29, 2018, 3:46 PM), https://thenextweb.com/hardfork/2018/06/29/tether-kraken-market-manipulation/ (discussing signs of market-manipulation on Tether's network and related investigations by U.S. regulators).

44. Virtual currencies may also employ tokens which lack monetary value because they are not convertible. *See*, *e.g.*, Mason v. Mach. Zone, Inc., 140 F. Supp. 3d 457, 465 (D. Md. 2015) (involving a non-convertible in-game currency only useable in a virtual casino).

currently implementing a permissioned cryptocurrency network called Keyless Signature Infrastructure ("KSI") to store and protect all public-sector data.[45] Because it records only the "hash values" of data records and prevents its (previously approved) users from accessing the actual information on these records, KSI does not employ tokens of any kind, and its only possible use is for tracking changes — the newly added blocks — made to its records — the chains.[46] Another similar network is R3, an open-source blockchain network developed cooperatively by a group of the world's largest financial institutions to efficiently manage complex internal financial agreements.[47] Like KSI, R3 is permissioned network that has no native token, allowing only for informational transactions.[48] KSI, R3, and other similar networks are referred to "Information blockchains" for the purposes of this Comment.

D. DLT-based Derivatives & Investment Vehicles

Financial institutions and private investment funds are now using virtual currencies as the basis of financial tools and investment vehicles. In December 2017, for example, the only virtual currency-based futures available to the public — Bitcoin futures — were officially listed for sale.[49] Developers are also increasingly providing the public with access to Initial Coin Offerings ("ICOs"), which involve the crowd-funding of new networks through pre-release sales of tokens to early investors at a (speculatively) low-cost price.[50] Further, many financial institutions and private investors now offer public access to cryptocurrency-based investment funds, or "crypto-funds," which act exactly as traditional investment funds but instead rely on

45. *See* Steve Cheng et al., *Using Blockchain to Improve Data Management in the Public Sector*, MCKINSEY (Feb. 2017), https://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/using-blockchain-to-improve-data-management-in-the-public-sector.

46. *See KSI Technology Stack*, GUARD TIME, https://guardtime.com/technology (last visited Feb. 4, 2019); *see also Hash Values*, TRENDMICRO, https://www.trendmicro.com/vinfo/us/security/definition/hash-values (last visited Feb. 4, 2019) (explaining hash values).

47. *See The R3 Story*, R3, https://www.r3.com/about/ (last visited Jan. 4, 2019).

48. *Id.*; *see also* Fersht, *supra* note 38 ("There is no built-in token or cryptocurrency for [R3], and it is a permissioned blockchain as it restricts access to data within an agreement to only those explicitly entitled to it, rather than the entire network.").

49. John McCrank, *Cboe, CME to Launch Bitcoin Futures Contracts*, REUTERS (Dec. 7, 2017, 1:16 AM), https://www.reuters.com/article/us-bitcoin-futures-contracts/cboe-cme-to-launch-bitcoin-futures-contracts-idUSKBN1E10KC.

50. *See* Michael R. Meadows, *The Evolution of Crowdfunding: Reconciling Regulation Crowdfunding with Initial Coin Offerings*, 30 LOY. CONSUMER L. REV. 272, 273 (2018) (explaining ICOs).

the global cryptocurrency market as the source of their underlying investment vehicles.[51] One notable crypto-fund that presented investors with a relatively unique opportunity was the Decentralized Autonomous Organization ("DAO"), an online venture capital fund designed to raise start-up capital for emerging blockchain projects.[52] The DOA's network provided each investor with DAO tokens in proportion to their existing Ether holdings, representing the investors' interests in (1) voting on which projects the DAO will fund on its network and (2) collecting returns on successful investments.[53]

III. FEDERAL COURTS & REGULATORS

Lacking legislative guidance, numerous federal agencies — including the Federal Reserve, Internal Revenue Service, Financial Crimes Enforcement Network — and several state legislatures impose their own distinct (and often conflicting) classifications and regulatory frameworks for virtual currencies.[54] Despite the resulting confusion among investors, regulators, and federal courts, the current regulatory landscape has developed mainly around efforts by securities and commodities regulators to expand their jurisdictional purviews to encompass virtual currencies, crypto-funds, and other related investment vehicles.[55]

---

51. *See* Surbhi Jain, *Rise of the Cryptocurrency Investment Fund: These Are 5 of the Largest*, FRONTERA (Dec. 3, 2017), https://frontera.net/cryptocurrency/rise-of-the-crypto currency-investment-fund-these-are-5-of-the-largest/.

52. Laila Metjahic, Note, *Deconstructing the DAO: The Need for Legal Recognition and the Application of Securities Laws to Decentralized Organizations*, 39 CARDOZO L. REV. 1533, 1542–46, 1544. The DAO initially raised $150 million worth of Ether before hackers found an exploit it its coding protocol and stole $60 million worth of funds, ultimately collapsing the network. While the DAO is no longer operational, it will be used for analysis because its extensive consumer popularity, unique nature, and resulting attention from the SEC provides unparalleled insight into the agency's legal basis for regulating such networks, ICOs, and virtual currencies overall. *See generally*, Michael del Castillo, *The Developers Behind the DAO Are Launching a New DAO*, COINDESK (Nov. 18, 2016), https://www.coindesk.com/dao-developers-launching-new-dao (discussing the collapse of the DAO).

53. *Id.* at 1545–46. The DAO and similar networks are known as "DAOs." *See, e.g.*, *What is a DAO?*, BLOCKCHAIN HUB, https://blockchainhub.net/dao-decentralized-autonomous-organization/ ("A DAO (Decentralized Autonomous Network) can be seen as the most complex form of a smart contract . . . .").

54. *See* Rooney, *supra* note 6; *see also* David Morgan, *Congress Sets Sights on Federal Cryptocurrency Rules*, REUTERS (Feb. 19, 2018), https://www.reuters.com/ article/us-crypto-currencies-congress/congress-sets-sights-on-federal-cryptocurrency-rules-idUSKCN1G31AG (discussing congressional efforts).

55. *See* Trevor Dodge, *SEC and CFTC Chairmen Testify Before Senate on Cryptoasset Regulation*, PROSKAUER (Mar. 22, 2018), https://www.blockchainand thelaw.com/2018/03/sec-and-cftc-chairmen-testify-before-senate-on-cryptoasset-

A. Securities & Exchange Commission ("SEC")

As the primary regulator of U.S. securities markets, the SEC derives its regulatory authority in two main ways.[56] First, in passing the Securities Exchange Act of 1934 — the federal statute which grants the SEC regulatory authority over trading markets, financial reporting obligations, insider trading, and broker conduct — Congress explicitly classified certain financial instruments as securities.[57] Second, the SEC now employs the Supreme Court's "*Howey* test" to classify newly emerging financial products as "investment contracts" subject to its oversight, consequently "determin[ing] the purview of its jurisdiction."[58] *Howey*'s central inquiry is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[59] If so, "it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value."[60] In practice, *Howey* is broken down into four essential elements: (1) an investment of money; (2) an investment in a common enterprise; (3) an expectation of profits from the investment; and (4) profits that are generated solely from the efforts of others.[61]

The SEC maintains that most tokens and all ICOs are securities because they satisfy *Howey*.[62] In July 2017, the agency released a report regarding

---

regulation/.

56. *See generally What We Do*, U.S. SEC. & EXCHANGE COMM., https://www.sec.gov/Article/whatwedo.html (last visited Sept. 1, 2018) (describing the SEC's mission, duties, and jurisdiction).

57. *See* Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78c(a)(10) (2018).

58. *See also* SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946) (establishing and applying the Howey Test to deem shares in a farming enterprise "investment contracts," which are synonymous with "securities" for regulatory purposes); SEC v. Edwards, 540 U.S. 389, 393 (2004) (reaffirming and applying *W.J. Howey*); Stephen O'Neal, *SEC, CFTC, IRS and Others: A Guide to US Regulating Bodies*, COINTELEGRAPH (May 26, 2018), https://cointelegraph.com/news/sec-cftc-irs-and-others-a-guide-to-us-regulating-bodies.

59. *W.J. Howey*, 328 U.S. at 301 (internal citations omitted).

60. *Id.* For the purposes of this Comment, "security" is used to describe a valid "investment contract" under *Howey* and/or the Exchange Act because, unlike the Commodity Futures Trading Commission ("CFTC") jurisdiction regarding commodities, all securities fall within SEC jurisdiction. *See generally infra* Section III.B (discussing CFTC jurisdiction).

61. *See Securities Litigation: Jurisdictional Defenses*, Practical Law Practice Note w-000-6535, PRACTICAL LAW – LITIGATION (2019) (citing SEC v. W.J. Howey Co., 328 U.S. 293 (1946)).

62. *See Why the SEC Thinks Most Tokens Are Securities and When the SEC Thinks a Token Might Stop Being a Security*, WILSON SONSINI GOODRICH & ROSATTI (Aug. 1, 2018) [hereinafter *SEC Thinks Most Tokens Are Securities*"]; Dodge, *supra* note 55

its investigation of the DAO where it reported its findings that DAO tokens are securities.[63] In January 2018, SEC Chairman Jay Clayton Giancarlo warned in a multi-agency op-ed concerning DLT products that his agency "will vigorously pursue [ICOs that] seek to evade the registration, disclosure and anti-fraud requirements of our securities laws," which he believes are wide-spread.[64] Shortly after, the SEC's Director of Corporate Finance released a statement detailing four central factors that the SEC considers in evaluating a specific token under *Howey*: whether its issuers (1) play a significant role in developing and maintaining the token and its potential to increase in value; (2) retain an interest so that they have financial incentive to increase its value; (3) raise funds in excess of those needed to launch the platform; and (4) market the tokens to the public as opposed to specific users of the platform.[65]

B. Commodities Futures Trading Commission

As the regulatory agency tasked with oversight of U.S. commodity futures trading, the CFTC derives its jurisdiction from the Commodity Exchange Act (the "CEA"),[66] which Congress enacted in 1936 to regulate "the trading of commodity futures" and establish the "statutory framework under which the CFTC operates."[67] Section 1(a)(9) of the CEA defines a "commodity" as — in addition to an extensive list of physical products such as wheat, cotton, and rice — "all other goods and articles, except onions . . . and all services, rights, and interests . . . in which contracts for future delivery are

(noting SEC Chairman testimony to Congress that he "has not seen an ICO issue a token that is not a security") (internal quotations omitted).

63. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, 117 SEC Docket 5 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf [hereinafter The DAO Report] (outlining the SEC's legal basis for regulating DAOs and ICOs). Though the report concerns only DAOs and ICOs, its rationale can be imported to virtual currencies where they present attributes focused on by the report. *See id.*; *supra* Section VI (applying The DAO Report's rationale).

64. Jay Clayton & J. Christopher Giancarlo, *Regulators Are Looking at Cryptocurrency*, WALL ST. J. (Jan. 24, 2018, 6:26 PM), https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363; *see, e.g.*, Rensel v. Centra Tech, Inc., No. 17-24500-CIV-KING/SIMONTON, 2018 U.S. Dist. LEXIS 106642, at *5 (S.D. Fla. June 25, 2018) (alleging violations of Security Act §§ 12(a) and 15(a) by ICO issuers); *Floyd Mayweather and DJ Khaled Pay SEC Cryptocurrency Penalties*, BBC NEWS (Nov. 29, 2018), https://www.bbc.com/news/business-46394879.

65. *See SEC Thinks Most Tokens Are Securities*, *supra* note 62.

66. Commodity Exchange Act, 7 U.S.C. § 1 (2018).

67. *Commodity Exchange Act & Regulations*, U.S. COMMODITY FUTURES TRADING COMMISSION, https://www.cftc.gov/LawRegulation/CommodityExchangeAct/index.htm. (last visited May 14, 2019) (discussing CFTC jurisdiction).

presently or in the future dealt in."[68] In expanding its jurisdiction to emerging products beyond those enumerated in § 1(a)(9) and those that fall outside its statutory authority over price-manipulation of commodities in interstate commerce,[69] the CFTC currently interprets § 1(a)(9) definition as broadly encompassing both assets currently underlying a regulated futures market — usually referred to as a Designated Futures Market ("DCM")[70] — and those capable of doing so in the future.[71] The agency definitively has "exclusive jurisdiction regarding accounts, agreements[,] . . . and transactions involving swaps[,]"; the term "swap" is defined in part as: "any agreement, contract, or transaction— (i) that is a . . . option of any kind . . . [or] (ii) that provides for any purchase, sale, payment, or delivery . . . dependent on . . . a contingency . . . ."[72]

The CFTC may also regulate certain "retail commodity transactions," which include, inter alia, "transaction[s] in any commodity that is — entered into with . . . a person that is not an eligible contract participant or eligible commercial entity; and entered into . . . on a leveraged or margined basis . . . ", and exclude certain exceptions under § 2(h)(4).[73] "Eligible contract participants" are, inter alia, individuals with discretionary investments of more than $10 million or more than $5 million if the

68. 7 U.S.C. § 1(a)(9) (known as the "Dealt-in Requirement"); *see, e.g.*, Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 497 (D. Mass. 2018) ("Congress' approach to defining 'commodity' signals an intent that courts focus on categories—not specific items—when determining whether the 'dealt in' requirement is met.").

69. 7 U.S.C. § 13(a)(2).

70. For the purposes of this Comment, assets used as the basis of a DCM are referred to as "DCM-underliers." *See Trading Organizations*, U.S. COMMODITY FUTURE TRADING COMMISSION, https://www.cftc.gov/IndustryOversight/TradingOrganizations/DCMs/index.htm (last visited Feb. 5, 2019) (defining "DCM" and discussing relevant CFTC compliance standards).

71. *See Statement of the Commission*, U.S. COMMODITY FUTURES TRADING COMMISSION, 2 (June 14, 2010), https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/ifdocs/mdexcommissionstatement061410.pdf; LABCFTC, *supra* note 14, at 11. *But see* David E. Aron & Matthew Jones, *The CFTC's Characterization of Virtual Currencies as Commodities: Implications under the Commodity Exchange Act and CFTC Regulations*, 38 No. 5 FUTURES & DERIVATIVES L. REP. NL 1, § I-B (May 2018) (noting statements by two commissioners that the CFTC "should interpret the statutory definition of commodity to have some limit or . . . [it] would be superfluous.").

72. 7 U.S.C. §§ 1(a)(47)(A), 2(a)(1)(A); *see also* SEC, *The Regulatory Regime for Security-Based Swaps* 3 (2012), http://www.sec.gov/swaps-chart/swaps-chart.pdf (defining derivative swaps as a derivative "in which two counterparties agree to exchange or 'swap' payments with each other as a result of such things as changes in a stock price, interest rate or commodity price").

73. 7 U.S.C. § 2(c)(2)(D)(i).

transactions were intended to manage risk associated with ownership of an asset,[74] while "eligible commercial entities" are eligible contract participants who meet additional requirements.[75] However, § 2(h)(3) provides that "nothing in this Act shall apply to . . . transaction[s] in an exempt commodity . . . entered into on a principal-to-principal basis solely between persons that are eligible commercial entities . . . and executed or traded on an electronic trading facility."[76]

In 2015, the CFTC deemed virtual currencies commodities subject to its jurisdiction under the CEA.[77] Despite failing to provide clear guidance, the agency established its view that: (1) virtual currencies are commodities; (2) sales of options on virtual currencies fall within its purview; and (3) virtual currencies are not "real" currencies.[78] However, the agency failed to provide much analytical support for its primary finding — that virtual currencies are commodities — arguing only that the CEA's definition is broad and citing to a single case.[79] In late 2017, the CFTC released a primer detailing the agency's guidance on DLT networks and virtual currencies.[80] The primer states that §1(a)(9) properly encompasses "Bitcoin and other virtual currencies," meaning the CFTC has jurisdiction over cryptocurrencies when they (1) are used in a derivatives contract; or (2) involve fraud or manipulation, so long as they are traded in interstate commerce.[81] Notably, the primer warns consumers that online exchanges may not be "subject to the supervision which applies to regulated exchanges," including those that "engage in only certain spot or cash market transactions and do not utilize margin, leverage, or financing."[82] Referencing The DAO Report, the primer also notes that "[t]here is no inconsistency between the SEC's analysis and the CFTC's determination."[83] In November 2018, the CFTC released a second primer regarding DLT networks, this time listing potential legal frameworks which may apply to Smart-contract networks and noting when they may fall within its jurisdiction.[84]

---

74. *Id.* § 1(a)(18)(A)(xi).

75. *Id.* § 1(a)(17).

76. *Id.* § 2(h)(3).

77. *See Coinflip Order*, *supra* note 14, at 3.

78. *Id.* at 2–3, n.2; *see also infra* notes 175–76 and accompanying text (discussing the CFTC's implied classification of virtual currencies as "exempt commodities").

79. *See Coinflip Order*, *supra* note 14, at 3 (citing Bd. of Trade of City of Chi. v. Sec. & Exch. Comm'n, 677 F.2d 1137, 1142 (7th Cir.) (1982)).

80. *See* LABCFTC, *supra* note 11.

81. *Id.* at 11.

82. *Id.*

83. *Id.* at 14.

84. *See Primer on Smart Contracts*, *supra* note 32, at 22, 25.

C. CFTC v. McDonnell

In March 2018, the CFTC alleged that a virtual currency trader developed a deceptive scheme to defraud investors by misappropriating their funds under the guise of a legitimate advisor for the trading and purchasing of cryptocurrencies.[85] The resulting case, *McDonnell*, yielded the first (and so far, only) final judgement, in which a federal court formally recognized the CFTC's broad classification of virtual currencies as commodities that are subject to the agency's jurisdiction.[86] Most importantly, the court held that: (1) virtual currencies are commodities subject to CFTC regulation under § 1(a)(9); and (2) the Dodd-Frank Act's amendments to the CEA permit the CFTC to regulate fraud beyond the sale of futures or derivative contracts, including "fraud related to virtual currencies sold in interstate commerce" under § 6(c)(1).[87]

McDonnell relies exclusively on two forms of factual authority in its reasoning on this issue. First, the court cites Black's Law Dictionary's and Merriam Webster's definitions of "commodity."[88] Second, it cites two legal commentators, noting their arguments that virtual currencies should be regulated as a commodity "based on [the term's] common usage, . . . because virtual currencies provide a 'store of value'[, and] . . . because they serve as a type of monetary exchange."[89] The only further support is the court's

85. Commodity Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 216, 230 (E.D.N.Y. 2018) (internal citation omitted).

86. *See* Michael W. Brooks, *CFTC v. McDonnell: Amidst All the Hype, Don't Forget Commodity is a Defined Term*, NAT'L L. REV. (Apr. 12, 2018), https://www.natlawreview.com/article/cftc-v-mcdonnell-amidst-all-hype-don-t-forget-commodity-defined-term.

87. *McDonnell*, 287 F. Supp. 3d at 213. Though other jurisdictions have challenged *McDonnell*'s application of § 6(c)(1) to the facts in that case because they did not involve allegations of market manipulation, this issue requires extensive analysis and is beyond the scope of this comment. *See, e.g.*, Commodity Futures Trading Comm'n v. Monex Credit Co., 311 F. Supp. 3d 1173, 1189 (C.D. Cal. 2018) (internal citation omitted) ("[T]he CEA unambiguously forecloses the application of § 6(c)(1) in the absence of actual or potential market manipulation."). *But see id.* at 1189 n.12 (noting that the *pro se* defendant in *McDonnell* neglected to raise this issue, which may explain why the court did not consider it more closely); Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 498 (D. Mass. 2018) (citing *McDonnell* in rejecting that the CFTC's § 6(c)(1) anti-fraud authority requires allegations of market manipulation).

88. *McDonnell*, 287 F. Supp. 3d at 224 (alteration in original) (internal citations omitted) ("Black's Law Dictionary defines a commodity as 'an article of trade or commerce.' Merriam Webster defines it as '[a]n economic good . . . [or] an article of commerce . . . .'").

89. *Id.* at 224–25; *see also id.* (quoting Mitchell Prentis, *Digital Metal: Regulating Bitcoin As A Commodity*, 66 CASE W. RES. L. REV. 609, 626, 628–29 (2015) ("'It would make sense for regulators to treat Bitcoin as a commodity. Commodities are generally defined as "goods sold in the market with a quality and value uniform throughout the

mention of legislative and judicial expansion of the CEA from its original purpose of overseeing agricultural commodities trading to regulating other goods, services, and interests, including intangible assets.[90] Next, *McDonnell* discusses the CFTC's own interpretation and expansion of its § 1a(9) jurisdiction before briefly concluding:

> Virtual currencies are 'goods' exchanged in a market for a uniform quality and value. They fall well-within the common definition of 'commodity' as well as the CEA's definition of 'commodities' as 'all other goods and articles . . . in which contracts for future delivery are presently or in the future dealt in.[91]

The court then moves directly to the issue of concurrent jurisdiction, which is beyond the scope of this Comment and not discussed here.

D. Other Case Law

Aside from *McDonnell*, federal regulators have thus far secured favorable rulings only on pre-trial motions.[92] Federal courts have, however, issued ultimate decisions in several cases involving CFTC and SEC jurisdiction over other goods and services. These decisions are highly useful for analyzing virtual currency classification because they involve the very same issues regulators must confront in classifying virtual currencies.[93]

---

world." This . . . realistically reflects the economic behavior of Bitcoin users' . . . . 'Bitcoin should primarily be considered a commodity because it serves the function of money . . . .'"); *id.* at 224 (quoting Jeff Currie, *Bullion Bests Bitcoin, Not Bitcoin*, GOLDMAN SACHS TOP MIND, Mar. 11, 2014, at 7, https://www.paymentlawadvisor.com/files/2014/01/GoldmanSachs-Bit-Coin.pdf) ("'A commodity is any item that "accommodates" . . . the need for a store of value . . . . In contrast, a security is any instrument that is "secured" against something else . . . . [B]itcoin . . . is a commodity and not a currency . . . .'").

90. *Id.* at 225 (citing United States v. Brooks, 681 F.3d 678, 694 (5th Cir. 2012)); *In re* Barclays Bank PLC, CFTC Docket No. 15-24, 2015 WL 2445059 (May 20, 2015)).

91. *Id.* at 226–28 (citing Mitchell Prentis, *Digital Metal: Regulating Bitcoin As A Commodity*, 66 CASE W. RES. L. REV. 609 (2015); citing 7 U.S.C. § 1a(9) (2012)).

92. *See, e.g.*, Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 494 (D. Mass. 2018) (denying defendant's motion to dismiss because the CFTC alleged sufficient facts for a fact-finder to deem the cryptocurrency at issue a commodity under CEA § 1a(9)) (hereinafter "*My Big Coin*"); Commodity Futures Trading Comm'n v. Gillespie, No. 18-cv-10077, ECF No. 106, at 4-9 (D. Mass. Sept. 26, 2018) (same); United States v. Zaslavskiy, No. 17-CR-647, 2018 WL 4346339, at *1 (E.D.N.Y. Sept. 11, 2018) (denying defendant's motion to dismiss because the SEC alleged sufficient facts for a fact-finder to classify the ICOs at issue as securities under *Howey*).

93. *See infra* Sections IV.A.2, IV.B, VI (discussing issues with the commodities classification, securities classification, and relevant case law).

1. Securities

Though the SEC and others have applied the *Howey* decision to legally recognize a broad variety of assets as securities, as discussed, the SEC's legal victories regarding virtual currency jurisdiction are currently limited to pre-trial rulings.[94] However, the agency has taken significant steps outside of court to expand its reach to virtual currencies, particularly regarding ICOs.[95] In The DAO Report, the agency briefly notes Bitcoin satisfying *Howey*'s first factor — the investment of money — by citing Tenth Circuit and Texas District Court decisions.[96] The DAO Report entirely disregards *Howey*'s second factor: the need for "a common enterprise."[97] This is particularly notable because circuits remain split on whether the SEC must show "horizontal commonality"[98] or "vertical commonality"[99] to satisfy this factor.[100] Some jurisdictions further delineate this factor by requiring that a

94. *See, e.g.*, *Securities Litigation: Jurisdictional Defenses*, *supra* note 61 (citing SEC v. Merch. Capital, LLC, 483 F.3d 747, 772 (11th Cir. 2007) (interests in corporate partnerships); Wuliger v. Eberle, 414 F. Supp. 2d 814, 820–24 (N.D. Ohio 2006) (viatical settlement interests in life-insurance policies); Gilmore v. MONY Life Ins. Co. of Am., 165 F. Supp. 2d 1276, 1284–88 (M.D. Ala. 2001) (variable annuities); SEC v. SG Ltd., 265 F.3d 42, 54–55 (1st Cir. 2001) (Ponzi schemes); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478–85 (5th Cir. 1974) (pyramid and multi-level marketing schemes).

95. *See, e.g.*, *The DAO Report*, *supra* note 64.

96. *Id.* at 11 (citing Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564 (10th Cir. 1991)); *Id.* (citing SEC v. Shavers, No. 4:13-CV-416, 2013 WL 4028182, at *2 (E.D. Tex. Aug. 6, 2013)).

97. *Id.*; *see also Securities Litigation: Jurisdictional Defenses*, *supra* note 61 (discussing the *Howey* factors).

98. "Horizontal commonality" considers whether investors' fortunes are tied together by *their pooling of assets*. *See* Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994) (requiring horizontal commonality and defining it as "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets").

99. "Vertical commonality" instead focuses on whether the investors' gains or losses are inseparable from *the effectiveness of the investment's promoter*. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974) (focusing on whether the "fortunes of all investors are inextricably tied to the efficacy" of the investment's promoter).

100. *Compare Revak*, 18 F.3d at 87 (noting the Second Circuit's horizontal commonality requirement and holding that "broad" vertical commonality is insufficient), *and* Hart v. Pulte Homes of Michigan Corp., 735 F.2d 1001, 1004 (6th Cir. 1984) (describing the Sixth Circuit as "requiring . . . horizontal commonality"), *with* Long v. Shultz Cattle Co., Inc. 881 F.2d 129, 140 (5th Cir. 1989) ("This court, together with the Ninth and Eleventh Circuits, has explicitly rejected the view that horizontal commonality is a prerequisite . . . within the meaning of *Howey* and has focused instead on the 'vertical commonality' . . . ."), *and* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974) (establishing the Fifth Circuit's vertical commonality requirement), *and* SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973) (noting that the Ninth Circuit requires vertical commonality); *see also* Ori Oren, *ICO's, DAO's, and the SEC: A Partnership Solution*, 2018 COLUM. BUS. L. REV. 617, 639 (noting outstanding

more specific type of vertical commonality, either "broad" or "strict," be shown.[101]

Similarly, the SEC also dismissed the third *Howey* factor — the expectation of profit — with relative ease, simply noting that investors expected an increase in the value of their investments.[102] The report's analysis focused almost entirely on arguing that The DAO Report satisfied *Howey*'s fourth factor — the sole efforts of others — because its founder's efforts were essential to the enterprise, and investor's voting rights were generally limited.[103] It also underscores that, despite *Howey*'s original language, courts no longer require that investors expect profits from the "sole efforts of others," literally, to satisfy the fourth *Howey* factor.[104] However, while this assertion is technically accurate, circuit courts remain divided on precisely how much effort by others is necessary and how much investor effort is allowable.[105] Lastly, The DAO Report includes a brief discussion regarding the "foundational principles of the securities laws" and their direct applicability to "capital raising entities making use of [DLT]."[106]

2. Commodities

As discussed, the Coinflip Order relied largely on *Board of Trade v. SEC*, 677 F.2d 1137, 1142 (7th Cir.),[107] where the court found that the CEA's

---

legal questions and concerns regarding the second *Howey* factor's applicability to virtual currencies).

101. *See Revak*, 18 F.3d at 87–88 (2d Cir. 1994) (citing Long v. Shultz Cattle Co., Inc., 881 F.2d 129, 140-41 (5th Cir.1989); Brodt v. Bache & Co., Inc., 595 F.2d 459, 461 (9th Cir.1978)) ("To establish 'broad vertical commonality,' the fortunes of the investors need be linked only to the *efforts* of the promoter. 'Strict vertical commonality' requires that the fortunes of investors be tied to the *fortunes* of the promoter.") (emphasis in original) (citations omitted); *see generally* Ryan Borneman, *Why the Common Enterprise Test Lacks a Common Definition*, 5 U.C. DAVIS BUS. L. J. 16 (2005) (discussing jurisdictional splits on the vertical commonality requirement).

102. *See* The DAO Report, *supra* note 63, at 11–12.

103. *Id.* at 12–15.

104. *Id.* at 12 (citing SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir. 1973); *see also* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (citing SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946)) ("[I]n searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality.").

105. *Compare Glenn W. Turner Enter., Inc.*, 474 F.2d at 482 (allowing investors to contribute to sales activities and governance decisions), *with* SEC v. Life Partners, Inc., 102 F.3d 587, 588 (D.C. Cir. 1996) (interpreting the word "solely" to mean "predominantly").

106. *See* The DAO Report, *supra* note 63, at 11 ("This definition [of investment contract] embodies a flexible rather than static principle.").

107. *See Coinflip Order*, *supra* note 14; *see also supra* note 78 and accompanying text.

definition of commodity includes "literally anything[,] other than onions[,]" underlying a DCM.[108] Given the lack of case law directly on point, courts and legal analysts have centrally relied upon a relatively recent line of cases involving the commodities classification as applied to natural gas.[109] For example, in *United States v. Valencia*,[110] a defendant charged with commodity-related fraud claimed that, while natural gas traded on the New York Mercantile Exchange ("NYMEX") is clearly a commodity under the CEA, no futures contracts existed on her firm's natural gas (West Coast gas), specifically, and therefore it fell outside CFTC jurisdiction.[111] However, the District Court rejected these arguments because "natural gas is fungible" and has traded on the NYMEX since 1990.[112]

Five years later, a defendant argued on appeal in *United States v. Futch*,[113] that the natural gas at issue was not a commodity under the CEA because a clause in the futures contracts traded on NYMEX described them as being "for gas 'delivered at the Henry Hub, Louisiana' and the gas in this case was delivered at [another location]."[114] As in *Valencia*, the Fifth Circuit rejected these arguments once more, going as far as labelling them "frivolous."[115]

---

108. *See* Bd. of Trade v. SEC, 677 F.2d 1137, 1142 (7th Cir. 1982) (citing 7 U.S.C § 2 (1982)).

109. *See, e.g.*, Aron & Jones, *supra* note 71, at 4–5 (citing Bd. of Trade, 677 F.2d 1137, 1145 (7th Cir. 1982); United States v. Valencia, No. Civ.A. H-03-024, 2003 WL 23174749, at *1 (S.D. Tex. Aug. 25, 2003), *vacated in part on reconsideration*, No. H-03-024, 2003 WL 23675402 (S.D. Tex. Nov. 13, 2003), *rev'd and remanded*, 394 F.3d 352 (5th Cir. 2004); United States v. Brooks, 681 F.3d 678, 694–95 (5th Cir. 2012); Commodities Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 227 (E.D.N.Y. 2018) (noting commodity classification cases involving natural gas and their applicability to virtual currency regulation); Commodities Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 495–96 (D. Mass. Sept. 26 2018) (relying on commodity cases involving natural gas in considering 7 U.S.C. § 1a(9)'s applicability to networks other than Bitcoin).

110. United States v. Valencia, 394 F.3d 352 (5th Cir. 2004).

111. *Valencia*, 2003 WL 23174749, at *4 (noting the defendants' argument that, otherwise, "nothing is excluded from CFTC oversight and CEA regulation" because the CEA would be "applicable to any goods capable of being traded on a futures market, even if not currently traded . . . ."); *NYMEX*, CME GROUP, https://www.cmegroup.com/company/nymex.html (last visited Feb. 9, 2019) (describing NYMEX as a DCM which offers energy products, metals, and agricultural contracts).

112. *Valencia*, 2003 WL 23174749 at *8 n.13 (concluding that "[w]hile futures traders apparently do not buy and sell West Coast natural gas on the NYMEX, there is no evidence that West Coast gas could not in the future be traded on a futures exchange.").

113. United States v. Futch, 278 F. App'x 387 (5th Cir. 2008).

114. *Id.* at 395.

115. *See id.* ("Henry Hub is the nexus of several major gas pipelines [and the clause defendant cited] merely specifies the location for gas delivery and does not in any way limit the type of commodity in question, natural gas.").

Four years later, that court again cited *Futch* in rejecting the same argument and essentially solidifying the CFTC's regulatory jurisdiction over natural gas transactions in *United States v. Brooks*.[116] Supporting its holding with three reasons, the court first underscored that "natural gas may be moved . . . to Henry Hub[,] . . . . [t]hus it would be peculiar that natural gas . . . is not a commodity, but suddenly becomes [one when] it passes through Henry Hub, and ceases to be [one] once it moves [elsewhere]."[117] The court then noted that the CEA's inclusion of an exemption for certain commodities, known as "exempt commodities," supports its holding because, otherwise, such an exemption would be unnecessary.[118] Finally, the decision concludes by noting that prior case law did not support that gas at hubs other than Henry Hub is outside the CEA's purview despite failing to confront the issue, specifically.[119] Notably, courts have also limited the CFTC's jurisdiction over commodities in interstate commerce under CEA § 1a(19), holding that the provision does not apply to cash forwards, cash transactions, and spot transactions.[120]

IV. ARE VIRTUAL CURRENCIES COMMODITIES?

To demonstrate that the CFTC's classification of all virtual currencies as commodities lacks a substantial legal basis, this section analyzes the commodities classification and its impact on CFTC jurisdiction over virtual currency transactions.

A. Bitcoin is a Commodity

Given that the Bitcoin Network's attributes clearly satisfy the statutory

116. *See* United States v. Brooks, 681 F.3d 678, 693–94 (5th Cir. 2012) (citing United States v. Futch, 278 F. App'x 387, 392 (5th Cir. 2008)).

117. *Id.* at 694–95.

118. *Id.* at 695. Notably, in rejecting a different (but related) claim in regarding exempt commodities, which will not be discussed here, *Brooks* cited reasoning from *Futch*, which was later overturned. *Id.*

119. *Id.* (citing United States v. Futch, 278 F. App'x 387, 390 (5th Cir. 2008); United States v. Valencia, 394 F.3d 352, 353 (5th Cir. 2004); United States v. Radley, 659 F. Supp. 2d 803, 806 (S.D. Tex. 2009); Commodity Futures Trading Comm'n v. Reed, 481 F. Supp. 2d 1190, 1195 (D. Colo. 2007); Commodity Futures Trading Comm'n v. Atha, 420 F. Supp. 2d 1373, 1377 (N.D. Ga. 2006); Commodity Futures Trading Comm'n v. Bradley, 408 F. Supp. 2d 1214, 1220 (N.D. Okla. 2005); Commodity Futures Trading Comm'n v. Johnson, 408 F. Supp. 2d 259, 264 (S.D. Tex. 2005)). For the purposes of this comment, these cases are collectively referred to as the "Natural Gas Cases."

120. *See*, United States v. Reliant Energy Servs., Inc., 420 F. Supp. 2d 1043, 1062 ("The definition of 'future delivery' expressly excludes 'any sale of any cash commodity for deferred shipment or delivery.' This is known as the 'cash forward' exclusion . . . . [C]ourts . . . have never doubted that § 4 does not apply to transactions in cash or spot markets.") (internal citations omitted).

definition of commodity as broadly interpreted by courts and regulators, Bitcoins are likely commodities subject to CFTC regulation.

1. Commodities Exchange Act § 1a(9)

Under the CFTC's own interpretation of CEA § 1a(9), Bitcoin is a commodity and falls within the agency's jurisdiction.[121] Because § 1a(9) does not specifically enumerate the term "virtual currency" or any of its subsets, to be classified as commodities, blockchain networks must fall within the CEA's jurisdiction over "all other goods and articles, except onions . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in."[122] As discussed, the CFTC interprets its statutory jurisdiction to mean that any asset underlying a DCM is consequently a commodity.[123] Assuming that, when held by private investors, Bitcoin falls within one of these prescribed product categories, it is well-within this reading of § 1a(9) commodity definition simply because it underlies a DCM.[124]

2. Case Law

The CFTC's interpretation of § 1(a)(9) commodity definition regarding DCM-underliers is also well-supported by case law. In *Board of Trade of Chicago*, which remains good law, the Seventh Circuit held that "literally anything other than onions could become a 'commodity' . . . simply by its futures being traded on some exchange."[125] Though that decision was ultimately vacated by the Supreme Court for mootness, the Natural Gas Cases confronted the very same issue regarding natural gas and held that it is a commodity simply based on its DCM-underlier status, as discussed above.[126] Accordingly, CFTC actions and relevant case law strongly support that § 1(a)(9) grants the CFTC regulatory jurisdiction over Bitcoin simply because it is currently a DCM-underlier.

---

121. 7 U.S.C. § 1a(9) (2018).

122. *Id.*; *see also* Aron & Jones, *supra* note 71, at Section II.A (underscoring that cryptocurrencies must fall within the second prong of 7 U.S.C. § 1a(9) to be commodities).

123. *See Statement of the Commission*, *supra* note 71.

124. *See* McCrank, *supra* note 49; *see also* Aron & Jones, *supra* note 71, at Section IV.A ("Because the CFTC's futures jurisdiction keys off of the sale of a 'commodity' (for future delivery) and the word 'commodity' is defined in 7 U.S.C. § 1a(9) in terms of futures on the thing in question being dealt in, the [CFTC] has jurisdiction over cryptocurrency futures from the moment they were dealt in.").

125. 677 F.2d at 1142.

126. *See* Bd. of Trade of Chic. v. SEC, 459 U.S. 1026 (1982); *see also* Natural Gas Cases, *supra* note 119.

B. But CFTC Jurisdiction Stops There — The Dealt-in Requirement[127]

When distinctions in the technical attributes of virtual currencies and the numerous unsettled questions fundamental to establishing CFTC jurisdiction over virtual currencies are accurately considered, the agency's regulatory authority under § 1(a)(9) currently encompasses only Bitcoin and, regardless, can never include networks that cannot serve as DCM-underliers sometime in the future. The Natural Gas Cases perfectly demonstrate the fundamental concern here: what exactly does the Dealt-in Requirement — "presently or in the future dealt in" — mean?[128] Definitive precedent on this issue is essential to accurately classifying virtual currencies as commodities because, currently, Bitcoin is the only network that underlies a DCM.[129] Accordingly, when practically applied to virtual currencies, this question actually requires two separate, equally important inquiries: (1) whether § 1a(9) commodity definition requires that the product already underlies a DCM, or that it is simply capable of doing so in the future;[130] and (2) whether § 1(a)(9) commodity definition is general and categorical rather than product-specific.[131] Most importantly, the former inquiry — as well as an affirmative answer to the latter — raises a third inquiry, which is of central concern to this Comment: whether "virtual currency" may serve as a product category of commodities under § 1a(9).[132]

---

127. *See supra* note 68 and accompanying text (citing the Dealt-in Requirement).

128. *See* David L. Beam et al., *Court Finds That Virtual Currency Is a Commodity — For the Time Being*, Legal Update, MAYER BROWN LLP (Nov. 5 2018), https://www.mayerbrown.com/court-finds-that-virtual-currency-is-a-commodityfor-the-time-being-11-05-2018/ (reporting on *My Big Coin*'s consideration and broad application of the CEA's commodity definition); Natural Gas Cases, *supra* note 119 (noting ambiguities of the CEA's commodity definition and interpreting it broadly). *See generally*, 7 U.S.C. § 1a.

129. *See* McCrank, *supra* note 49.

130. *See* Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492 (D. Mass. Sept. 26 2018) (considering whether current DCM-underlier status is required by 7 U.S.C. § 1a(9)); United States v. Brooks, 681 F.3d 678 (5th Cir. 2012) (underscoring that "whether the CEA requires a commodity to be the subject of a currently existing futures market" remains an open question).

131. *See*, *e.g.*, United States v. Futch, 278 F. App'x 387 (5th Cir. 2008) (considering whether 7 U.S.C. § 1a(9) applies only to specific products or to general product classes, and whether a natural gas product class sufficient for broad commodity status existed there); *see also My Big Coin Pay, Inc.*, 334 F. Supp. 3d at 496–98 (agreeing with the CFTC's position that the CEA's commodity definition is general and categorical by citing its explicit reference to "livestock," which does not enumerate any particular species of animal). *But see* Beam et al., *supra* note 127 (concluding that "it remains to be seen how persuasive other court's find [*My Big Coin*]'s holding" given the lesser standard imposed on pre-trial motions).

132. *See My Big Coin Pay, Inc.*, 334 F. Supp. 3d at 492 (reading 7 U.S.C. § 1a(9) broadly before considering whether the network at issue was of the same product class

1. "Can Be" or "Are Being?"

While regulators continue their long-standing efforts to resolve these questions definitively, courts remain divided. For example, despite *Board of Trade*'s sweeping language that anything (other than onions) can be a commodity simply by underlying a DCM, the court exclusively focused on the SEC's concession that — under the CEA's definition — the product at issue "became a commodity *when the Board of Trade began trading [its] futures*."[133] However, the court failed to explicitly clarify whether an underlying asset could be a commodity without underlying an active DCM.[134] Notably, a literal reading of the court's language — that commodity status is enabled "simply by its futures being traded" — as well as its ultimate finding regarding the product at issue, as noted above, could only support the conclusion that *Board of Trade* requires that an active DCM already exists.[135]

Contrarily, the Southern District of Texas held in *Valencia* that the CEA's commodities definition "includes goods that *can be* the subject of futures contracts."[136] There, however, the court failed to provide a test (or even mere guidance) for making this determination regarding non-traditional and/or emerging products, thereby leaving open a substantial gap in *Valencia*'s practical applicability to virtual currencies.[137] Primarily, the decision sheds no light on whether an existing DCM for one network is sufficient to regulate others as commodities and, if so, how to deal with networks that can never underly a DCM.[138] Moreover, given that virtually anything with monetary value "can be the subject of futures contracts,"[139] *Valencia* essentially

---

as Bitcoin).

133. Bd. of Trade v. SEC, 677 F.2d 1137, 1143 (7th Cir. 1982) (emphasis added).

134. *See* Aron & Jones, *supra* note 71, at 4. *Board of Trade*, therefore, should be read narrowly as establishing that *existing* DCM-underlier status enables commodity classification under the CEA. 677 F.2d at 1142–43.

135. Commodities Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 228 (E.D.N.Y. 2018).

136. *See* Aron & Jones, *supra* note 71, at 4 (citing United States v. Valencia, 394 F.3d 352 (5th Cir. 2004)) (emphasis in original).

137. *See id.*

138. DCM-underlier status requires monetary value, excluding certain networks. *Underlying Asset*, INVESTOPEDIA, https://www.investopedia.com/terms/u/underlying-asset.asp (last visited Sept. 7, 2018) ("Underlying assets give derivatives their value . . . [and are] used to determine the value of the option up till expiration. The value of the underlying asset may change . . . affecting the value of the option . . . . The price of an option or futures contract is derived from the price of an underlying asset . . . ."); *see also KSI Technology Stack*, *supra* note 46 (discussing KSI, which has no monetary value and therefore could never be a DCM-underlier).

139. United States v. Valencia, No. Civ. A. H-03-024, 2003 WL 23174749, at *17 (S.D. Tex. Aug. 25, 2003); *see also Underlying Asset*, *supra* note 138 (explaining that

extends CFTC jurisdiction to all products with monetary value. But had Congress intended to grant the CFTC such broad authority, why did it not simply say so and avoid the much more nuanced (and clearly controversial) language: "presently or in the future dealt in?"[140]

Futch provides even less clarity here because the decision focused entirely on the fact that a DCM on natural gas already existed (and on the defendant's prior admission of this in pre-trial pleadings) to deem it a commodity.[141] Similar to *Board of Trade*, a prima facie reading of the *Futch* decision could only support that the DCM market must already exist to enable the underlying asset's commodity status.[142] *Brooks* was the most clear, stating explicitly (in dicta) that "whether the CEA requires a commodity to be the subject of a currently existing futures market" remains an open question.[143] Therefore, while Bitcoin's commodity classification, specifically, remains well-founded under *Board of Trade*, *Valencia*, *Futch*, and *Brooks*, the CFTC has no present legal basis for extending this classification to other virtual currencies.[144]

2. General or Specific?

Notably, however, the Natural Gas Cases appear to definitively establish that § 1(a)(9) commodity definition is general and categorical rather than product-specific. For example, as discussed, *Valencia* held that the natural gas at issue was a commodity within CFTC jurisdiction because "natural gas is fungible," clearly indicating the court's view that a particular good's DCM-underlier status on any U.S. futures market is sufficient to deem it a commodity under § 1(a)(9).[145] The court in *Futch* deemed the defendant's natural gas a commodity subject to CFTC oversight under the exact same reasoning, going as far as labelling the defendant's arguments "frivolous."[146] And as *Brooks* concluded in deeming the gas there a commodity, finding

---

derivatives rely on an underlying asset's value).

140. *See also infra* notes 204–08 and accompanying text (noting dramatic practical consequences of *McDonnell*, all of which also apply to *Valencia*).

141. United States v. Futch, 278 F. App'x 387, 395 (5th Cir. 2008).

142. *Id.*

143. United States v. Brooks, 681 F.3d 678, n.11 (5th Cir. 2012).

144. *See* Natural Gas Cases, *supra* note 119. *But see* Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 494 (D. Mass. 2018) (denying defendant's motion to dismiss and agreeing with the CFTC's position that Bitcoin futures enable broad virtual currency regulation because "Congress's approach to defining 'commodity' signals an intent that courts focus on categories — not specific items.").

145. *See* United States v. Valencia, No. Civ.A. H-03-024, 2003 WL 23174749, at *8 n.13 (S.D. Tex. Aug. 25, 2003).

146. *Futch*, 278 F. App'x at 395.

otherwise would have the absurd effect of changing the commodity status of natural gas as it travelled through a pipeline hub specified in a futures contract.[147]

3. Is "Virtual Currency" a Product Category?

While Bitcoin is a commodity under subject to CFTC oversight CEA § 1a(9), this jurisdiction does not axiomatically extend from Bitcoin to any (let alone all) other virtual currencies because it fails to meet both essential requirements for doing so, as enumerated by federal courts.[148] Fundamentally, while one virtual currency presently underlies a DCM (thereby satisfying the first requirement), the second requirement — "fungibility"[149] — simply cannot, as a factual matter, apply to virtual currencies more broadly.[150] The most relevant case law on point involved natural gas — a product that (like all other presently recognized commodities) is generally consistent in composition, potential uses, transferability, availability, and investment-earning potential.[151] As those cases specifically emphasized as controlling in their reasoning, the "actual nature" of natural gas does not change based on who extracts, uses, or sells, and where they are doing so.[152] In direct contrast, many virtual currencies are entirely distinct from one another by their very nature, varying drastically in coding protocol and, consequently, in potential end-uses, transferability,

147. United States v. Brooks, 681 F.3d 678 (5th Cir. 2012) (internal citations omitted).

148. *See Valencia*, 2003 WL 23174749 at *1, 4 (holding that natural gas is a commodity because at least some of it underlies a DCM and, by its very nature, natural gas is a fungible good); Natural Gas Cases, *supra* note 119 (finding the same).

149. *See Valencia*, 2003 WL 23174749 at *8.

150. *See supra* Section II.C (noting distinctions between popular networks).

151. *See Valencia*, 2003 WL 23174749 at *8 (articulating, first, the meaning of "fungible," which natural gas clearly is); *see also Legal Alert: Virtual Currencies as Commodities — CFTC Wins Battle in the Fight to Define Cryptocurrencies as Commodities but Has it Won the War?*, EVERSHEDS SUTHERLAND (Oct. 2, 2018), https://us.eversheds-sutherland.com/NewsCommentary/Legal-Alerts/214772/Legal-Alert-Virtual-currencies-as-commoditiesCFTC-wins-battle-in-the-fight-to-define-cryptocurrencies-as-commodities-buthas-it-won-the-war ("A finding that 'gas is gas' as a commodity category may not be an appropriate analogy when applied to all crypto-asset tokens that do not have characteristics that are common with Bitcoin.") [hereinafter *Virtual Currencies as Commodities*].

152. *See* Commodities Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 227 (E.D.N.Y. 2018) (citing United States v. Brooks, 681 F.3d 678, 694–95 (5th Cir. 2012) ("'[I]t would be peculiar that natural gas at another hub is not a commodity, but suddenly becomes a commodity solely on the basis that it passes through [a hub], and ceases to be a commodity once it moves onto some other locale . . . . [T]he actual nature of the 'good' does not change.'")); United States v. Futch, 278 F. App'x 387, 395 (5th Cir. 2008); *Valencia*, 2003 WL 23174749 at *26–28.

accessibility, and investment-earning potential.[153] Moreover, Bitcoin is currently the only virtual currency that serves as a DCM-underlier, which can (as a result) be directly regulated under CEA § 1a(9).[154] Accordingly, the CFTC's basis for deeming Bitcoin a commodity — its DCM-underlier status — does not broadly extend to other entirely distinct networks simply because they fall under the incredibly broad "virtual currency" umbrella.[155]

Even assuming that (1) the mere possibility of a virtual currency underlying a DCM in the future — i.e. it has monetary value — is sufficient for commodity status, and (2) "virtual currency" is an acceptable product category, several networks could still never be commodities within § 1(a)(9) definition.[156] The most demonstrative examples mentioned in this Comment are KSI, R3, and other information blockchain networks that, by design, could never underly a DCM (or any other derivative, for that matter).[157] Unlike Bitcoin-class, Smart-contract, and Ripple-class networks, information blockchains are neither convertible nor freely-transferable, and therefore have no real-world value, either monetary or otherwise.[158] Given that the very existence and value of a derivative fundamentally relies on an underlying-asset's real-word monetary value, information blockchains are

153. *See, e.g.*, Harm, *supra* note 33, at 3–6 (explaining coding protocol and end-use distinctions between Bitcoin and Ethereum). Though *My Big Coin* found otherwise, it considered a motion to dismiss and was therefore required to accept the CFTC's factual allegation — that Bitcoin and the network at issue are fungible — as true. Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492 (D. Mass. 2018); *see also Virtual Currencies as Commodities*, *supra* note 151 (noting *My Big Coin*'s standard of review, and that "the definition of virtual currency that it relied on was provided '[f]or the purposes of the complaint at issue.") (alteration in original).

154. *See supra* Section IV.A.

155. *See* Mason v. Mach. Zone, Inc., 140 F. Supp. 3d 457, 460 (D. Md. 2015) (defining "virtual currency"); *see also Virtual Currencies as Commodities*, *supra* note 151 ("When it comes to the thousand or more different crypto-asset tokens in circulation, it is not so clear that they all function . . . in the nature and category of Bitcoin."); *cf.* David L. Beam et al., *Court Finds That Virtual Currency Is A Commodity — For The Time Being*, MAYER BROWN (Nov. 12, 2018), https://www.mondaq.com/unitedstates/x/753430/Commodities+Derivatives+Stock+Exchanges/Court+Finds+That+Virtual+Currency+Is+a+CommodityFor+the+Time+Being (discussing an additional question outside the scope of this comment that even if all virtual currencies were in fact fungible would CME's delisting of Bitcoin futures, thereby removing its DCM-underlier status, mean that Bitcoin and all other virtual currencies are no longer commodities).

156. *See* Sec. Indus. & Fin. Mkts. Ass'n v. CFTC, 67 F. Supp. 3d 373, 385 (D.D.C. 2014) (internal citation omitted) ("Derivatives are types of 'contracts deriving their value from underlying assets.'").

157. *See KSI Technology Stack*, *supra* note 46 (discussing KSI); *The R3 Story*, *supra* note 47 (discussing R3); *see also* Mason v. Mach. Zone, Inc., 140 F. Supp. 3d 457, 465 (D. Md. 2015) (involving an in-game currency which cannot be used or transferred outside of a virtual casino).

158. *Id.*

simply unusable as DCM-underliers.[159] Accordingly, certain virtual currencies are not — and will never be — commodities. Moreover, while technically possible, using asset-backed networks like Tether as DCM-underliers is outright illogical. Their value correlates directly to that of an underlying asset (which can itself simply serve as the DCM-underlier) while providing only greater liability, including added transaction costs and risks of a default or cyber-intrusion, for example.[160]

C. Does It Even Matter?

Because the CFTC enjoys broad oversight jurisdiction over futures, swaps, and other derivatives, it may regulate virtual currency derivatives regardless of their commodity status.[161] Contrarily, certain provisions in the CEA grant the CFTC authority over commodities more broadly and thus rely specifically on a virtual currency's commodity status to regulate it.

1. Futures & Swaps

The CFTC has relatively broad regulatory authority over all transactions involving futures, swaps, and other financial derivatives under CEA § 4, which grants the CFTC jurisdiction over "transactions in 'contract[s] for the purchase or sale of a commodity for future delivery.'"[162] Accordingly, if a virtual currency transaction involves a futures contract, the CFTC can regulate it regardless of whether that particular network is a commodity under §1a(9).[163] However, one notable exception is the CEA's explicit exclusion of cash forwards and cash or spot transactions from § 4 jurisdiction.[164] Accordingly, where any such transaction involves a virtual

159. *See Underlying Asset*, *supra* note 138 ("Underlying assets give derivatives their value . . . [and are] used to determine the value of the option up till expiration. The value of the underlying asset may change . . . affecting the value of the option . . . . The price of an option or futures contract is derived from the price of an underlying asset . . . .").

160. *E*.g., *Primer on Smart Contracts*, *supra* note 34, at 28–30 (listing risks of Smart-contract networks, including insider manipulation, software vulnerabilities, human error in coding protocols, and technology failures such as internet connectivity, computer stability, and interface compatibility); Castillo, *supra* note 52 (discussing the collapse of The DAO).

161. *See* 7 U.S.C. § 1a(47)(A) (2018).

162. United States v. Reliant Energy Servs., Inc., 420 F. Supp. 2d 1043, 1062 (N.D. Cal. 2006); *see also id.* (noting that Section 4 of the CEA is "exclusively concerned with futures contracts.").

163. *See* Inv. Co. Inst. v. CFTC, 720 F.3d 370, 372 (D.C. Cir. 2013) (citing 7 U.S.C. § 2(a) (2012)) ("[T]he Commission has regulatory jurisdiction over a wide variety of markets in futures and derivatives, that is, contracts deriving their value from underlying assets."); Sec. Indus. & Fin. Mkts. Ass'n v. CFTC, 67 F. Supp. 3d 373, 385 (D.D.C. 2014) (same).

164. *See Reliant Energy Servs., Inc.*, 420 F.Supp.2d at 1062.

currency, the CEA can never assert § 4 jurisdiction — even where a corresponding DCM market exists.[165]

Swap transactions involving virtual currencies already fall within the CFTC's jurisdiction regardless of whether they are § 1a(9) commodities.[166] Given that the CEA's jurisdictional grant of swap authority makes no mention of reliance on the underlying asset's commodity status, all swaps involving virtual currencies fall within the CFTC's jurisdiction.[167] Accordingly, a virtual currency's commodity status is irrelevant to the CFTC's swap jurisdiction over it.[168]

2. Interstate Commerce Jurisdiction

Certain CEA provisions grant the CFTC regulatory authority only when the transaction involves a commodity and are therefore the most relevant to virtual currency regulation.[169] Arguably, the most significant role § 1a(9) commodity status has in determining CFTC regulatory authority over virtual currencies under CEA § 13(a)(2), which grants the CFTC broad enforcement power over cases involving price manipulation of any commodity in interstate commerce.[170] This authority is also well-supported by case law, some of which has even expanded § 13(a)(2) to an arguably unreasonable degree.[171] Because § 13(a)(2) jurisdiction fundamentally relies on a

165. Of course, in such a case, and notwithstanding additional complications, the CFTC would likely have an incredibly strong claim to § 1a(9) jurisdiction and could avoid § 4 entirely. *See supra* Section IV.A.1.

166. *See* §§ 1a(47)(A), 2(a)(1)(A).

167. *See* Aron & Jones, *supra* note 71, at 6 (providing and analyzing examples of language in the 7 U.S.C. § 1a(47)(A) that disregards an underlying asset's commodity status for CFTC swap jurisdiction); 7 U.S.C. § 2(a)(1)(A) (underscoring the CFTC's swap jurisdiction over all virtual currency swaps).

168. § 2(a)(1)(A); *See* Aron & Jones, *supra* note 71, at 6.

169. *See* 7 U.S.C. § 2(b); *Reliant Energy Servs., Inc.*, 420 F. Supp. 2d at 1062.

170. *See Reliant Energy Servs., Inc.*, 420 F. Supp. 2d at 1062 ("Although certain provisions of the CEA are concerned exclusively with transactions in futures . . . other provisions, including those dealing with price manipulation, are not so limited in scope.") (internal citation omitted); 7 U.S.C. § 2(b) ("[A] transaction in respect to any article shall be considered to be in interstate commerce if such article is . . . sent from one State, with the expectation that they will end their transit, after purchase, in another . . . .").

171. *See, e.g.*, Inv. Co. Inst. v. CFTC, 720 F.3d 370, 372 (D.D.C. 2013); Sec. Indus. & Fin. Mkts. Ass'n v. CFTC, 67 F. Supp. 3d 373, 385 (D.D.C. 2014); *Reliant Energy Servs., Inc.*, 420 F. Supp. 2d at 1062; *see also* Commodities Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 227 (E.D.N.Y. 2018) (citing 7 U.S.C. §§ 6(C), 9(1); 17 C.F.R. § 180.1) (finding that the CEA grants CFTC unfettered jurisdiction over any commodity in interstate commerce regardless of DCM-underlier status or price-manipulation); Commodity Futures Trading Comm'n v. My Big Coin, 334 F. Supp. 3d 492, 498 (D. Mass. 2018) (rejecting that CFTC § 6(c)(1) anti-fraud authority requires allegations of market manipulation). *But see* Commodity Futures Trading Comm'n v.

commodity's presence in interstate commerce, and most (if not all) virtual currencies rely on internet connectivity for transferability,[172] deeming a particular virtual currency a § 1a(9) commodity would allow the CFTC to bring enforcement actions in cases with alleged price manipulation and — if the current trend of expanding § 13(a)(2) beyond price manipulation continues — potentially even those without it.[173]

3. Retail Jurisdiction & Exempt Commodities

Classifying virtual currencies as commodities would extend CFTC jurisdiction to leveraged or margined retail transactions not involving eligible contract participants or commercial entities, barring any exceptions under § 2(h)(4).[174] However, the Coinflip Order strongly implies the agency will treat virtual currencies as "exempt commodities"[175] because it considered whether offerings at issue satisfied the Trade Option exemption under CFTC Rule 32.3 (which applies only to exempt commodities), and not as "excluded commodities" (which include currencies and exchange rates)[176] because it stated that virtual currencies are not "real currency."[177] Most notable here is that this classification would preclude CFTC jurisdiction in certain situations unless it asserts that jurisdiction under § 1(a)(9) because,

---

Monex Credit Co., 311 F. Supp. 3d 1173, 1189 (C.D. Cal. 2018) (arguing that *McDonnell* erroneously applied § 6(c)(1), which "the CEA unambiguously forecloses . . . in the absence of actual or potential market manipulation" and finding that "the only plausible interpretation of the Dodd-Frank amendments mandates that § 4b alone prohibits fraud and deceptive conduct, [and] § 6(c)(1) prohibits fraud-based manipulation.").

172. *See* United States v. Nosal, 676 F.3d 854, 859 (9th Cir. 2012) (citing Computer Fraud & Abuse Act ("CFAA"), 18 U.S.C. § 1030(e)(2) (2012)) (holding that the CFAA's statutory definition of computers as those "used in or affecting interstate foreign commerce" includes any computers connected to the world wide web).

173. *See Reliant Energy Servs., Inc.*, 420 F. Supp. 2d at 1062.

174. *See supra* notes 73–75 and accompanying text; *see also* Commodity Futures Trading Comm'n v. Yorkshire Grp., Inc., No. 13-CV-5323, 2016 WL 8256380, at *3 (E.D.N.Y. Aug. 19, 2016) (interpreting § 1a and finding valid CFTC retail jurisdiction).

175. *See* 7 U.S.C. § 1a(20) (defining "exempt commodity" as one that is not an "excluded" or agricultural commodity).

176. *See id.* § 1a(19) (defining "excluded commodity" as an interest rate, exchange rate, or currency, *inter alia*).

177. *In re* Coinflip, Inc., CFTC Docket No. 15-29, at *1, 2 n.2 (Sept. 17, 2015); *see also Frequently Asked Questions on Virtual Currency and CFTC Jurisdiction*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP 1, 3 (2017), https://www.skadden.com/insights/publications/2017/11/faqs-on-virtual-currency-and-cftc-jurisdiction (discussing the CFTC's implied classification of virtual currencies as exempt as opposed to excluded commodities); Editor, *Show Me the Money*, 35 No. 11 FUTURES & DERIVATIVES L. REP. 1, 1 (2015) (arguing that the Coinflip Order demonstrates the CFTC's placing virtual currencies "in the same regulatory category as precious metals rather than as legal tender currencies or financial instruments").

as discussed, § 2(h)(3) specifically excludes transactions in exempt commodities entered into directly between eligible commercial entities and executed through an electronic trade facility.[178] Accordingly, so long as a virtual currency transaction is entered into by such entities, does not involve an indirect transaction — such as one involving financial derivative, for example — and is executed on an electronic trading facility, its exempt commodity classification excludes it from CFTC jurisdiction.[179]

V. WHY MCDONNELL GOT IT WRONG

The central issues with *McDonnell*'s holding — that all virtual currencies are commodities subject to CFTC jurisdiction — appear to result entirely from the court's (understandably) weak comprehension of an emerging technology, its nuances, and relevant technical definitions. Specifically, *McDonnell*'s holding is erroneous because the court (1) relied on and misapplied inadequate factual authorities that failed to account for nuances important to regulatory classification, and (2) oversimplified, and thereby misinterpreted, case law regarding commodities regulation more broadly.

A. Misapplied Facts

1. Erroneous Reliance on Dictionary Definitions

Due to its reliance on insufficient factual authorities that provide broad definitions of important technical terms, *McDonnell* overgeneralized and misapplied the facts at issue as well as the definition and scope of the term "virtual currency."[180] First and most concerning is the court's reliance on factual sources that, while certainly reliable, were clearly neither intended nor claimed to account for the specific nuances of virtual currencies or provide the in-depth understanding of these products required for an accurate legal analysis and regulatory classification of any emerging technological product.[181] Rather than sufficiently identify the precise facts, terms, and technical distinctions at issue, the court relied on just two sources: one classified as a "general-purpose dictionary," designed to provide a "complete inventory of a language" and word-use,[182] and another designed to "provide

178. *See supra* note 76 and accompanying text.

179. *See* Fed. Energy Regulatory Comm'n v. Barclays Bank PLC, 105 F. Supp. 3d 1121, 1144–45 (E.D. Cal. 2015), *as amended* (May 22, 2015) ("'Markets that satisfy the initial and ongoing requirements of section 2(h)(3) . . . are excluded from the Act's other requirements.'") (internal citation omitted).

180. KEY DEFINITIONS, *supra* note 2, at 4 (defining "virtual currency").

181. *See supra* note 86 and accompanying text (discussing *McDonnell*'s reliance on dictionary definitions).

182. *Dictionary*, ENCYCLOPEDIA BRITANNICA, https://www.britannica.com/topic/

definitions of words in their legal sense," rather than serve as factual bases for properly understanding the actual nature of complex new technologies.[183] Therefore, while a court may certainly employ dictionaries and similar sources for determining precise definitions to operative terms in cases involving complex financial and technological products (just as this Comment does in the following section),[184] these operative terms must first be identified and properly contextualized by reference to more topic-specific sources with specialized, in-depth knowledge of the issue at hand (such as a treatise, for example).

Moreover, the court's reliance on dictionary definitions is misplaced because the court erroneously overgeneralizes all virtual currencies as "articles of trade or commerce" or "economic goods."[185] While certain virtual currencies like Bitcoin-class, Smart-contract, and Ripple-class networks are well-within these definitions because they are convertible, others like information blockchains are not.[186] Following *McDonnell*'s own reasoning by applying Black's Law Dictionary's definitions, information blockchains are not articles of "trade" or "commerce" because they do not involve barters, purchases, sales, or exchanges in any form, between individuals or otherwise.[187] Nor are they "economic goods" under Merriam Webster's definition because they cannot "be paid for," as it explicitly requires.[188] Moreover, employing these definitions as a legal basis for regulating a novel, complex product is generally concerning because, in

dictionary/Kinds-of-dictionaries#ref31967 (last visited May 15, 2019) (referencing kinds of dictionaries).

183. Shameema Rahman, *Using Secondary Legal Resources to Locate Primary Sources*, LIBRARY OF CONGRESS (June 18, 2012), https://blogs.loc.gov/law/2012/06/using-secondary-legal-resources-to-locate-primary-sources/.

184. *See infra* note 212.

185. *See* Commodities Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 224 (E.D.N.Y. 2018).

186. *See* KEY DEFINITIONS, *supra* note 2, at 4 (defining convertible currencies); *KSI Technology Stack*, *supra* note 46 (discussing KSI).

187. *See Trade*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "trade" as "[t[he act or business of exchanging commodities by barter; or the business of buying and selling for money; traffic; barter."); *see also Commerce*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "commerce" as "[i]ntercourse by way of trade and traffic between different peoples or states and the citizens or inhabitants thereof, including not only the purchase, sale, and exchange of commodities, but also the instrumentalities and agencies by which it is promoted and the means and appliances by which it is carried on, and the transportation of persons as well as of goods . . . ."); *see also KSI Technology Stack*, *supra* note 46 (discussing KSI).

188. *See Economic Good*, MERRIAM-WEBSTER (defining an "economic good" as "a commodity or service that is useful to man but that must be paid for — usually used in plural."), https://www.merriam-webster.com/dictionary/economic%20good (last visited May 15, 2018); *KSI Technology Stack*, *supra* note 46 (discussing KSI).

addition to the generalized nature of these sources, Black's Law Dictionary's definitions of "commodity" relies on the words "trade" and "commerce," and vice versa.[189] Accordingly, relying on definitions which depend directly on one another for determining regulatory jurisdiction (or as the primary basis of a federal court opinion on any matter of first impression, for that matter) directly employs circular reasoning and is legally unsound.[190]

2. Misinterpreted Legal Commentary

McDonnell appears to have applied the attributes of just one virtual currency, the Bitcoin Network, to all virtual currencies, generally.[191] This is most apparent in the only reasoning other than the definitions discussed above that the court provides for deeming virtual currencies commodities.[192] *McDonnell* reasons that virtual currencies should be deemed commodities due to their common usage for monetary exchange and ability to store value.[193] However, the court supports these assumptions exclusively with legal commentary regarding Bitcoin, specifically, rather than all virtual currencies or even the narrower cryptocurrency subset.[194] Even assuming that these commentators are accurate and Bitcoin is a commodity (as is likely the case), the court failed to provide any sound reasoning or legal basis for extending commodity status to virtual currencies, broadly.[195]

Further, *McDonnell*'s relied-upon legal commentaries that contradict its holding in-part and, regardless, are not sufficiently accurate enough to serve as a factual basis for deciding precedential (and undeniably consequential) legal issues. First, one cited commentator opines that Bitcoin should be regulated as a commodity because the term is "generally defined as 'goods sold in the market with a quality and value uniform throughout the world' . . . . [Which] realistically reflects the economic behavior of Bitcoin users."[196] However, the price of Bitcoin varies dramatically between

189. *See Trade*, *supra* note 186; *see also Commerce*, *supra* note 186.

190. *See generally Circular Reasoning*, LOGICALLY FALLACIOUS, https://www.logicallyfallacious.com/tools/lp/Bo/LogicalFallacies/66/Circular-Reasoning (last visited Oct. 1, 2018) (discussing circular reasoning by providing descriptions, examples, and explanations).

191. *See* Commodities Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 224–28 (E.D.N.Y. 2018) (describing the court's reasoning).

192. *Id.*

193. *Id.*

194. *Id.*

195. *Id.*

196. *See* Mitchell Prentis, *Digital Metal: Regulating Bitcoin As A Commodity*, 66 CASE W. RES. L. REV. 609, 626 (2015).

countries and even individual exchanges within one country.[197] Therefore, even if *McDonnell* had properly distinguished Bitcoin from other virtual currencies, relying exclusively on the cited legal commentary would still yield an inaccurate analysis of the facts at issue.[198] Moreover, one commentator defines a commodity as any item that assists with storing value before applying this definition to Bitcoin and then emphasizes that, "in contrast, a security is any instrument that is 'secured' against something else."[199] Accordingly, under *McDonnell*'s own factual basis, asset-backed tokens like Tether's USD₮, are securities and, in contrast, not commodities.

B. Misapplied Law

McDonnell oversimplified and resultingly misapplied the law regarding the legal commodities classification. Specifically, the court erred in disregarding a central, unresolved question in commodities regulation: does the commodity classification apply only to current DCM-underliers, or to any product capable of underlying a DCM in the future?[200] While courts may rationally consider classifying goods with generally fungible characteristics — such as natural gas, for example — as commodities without an established resolution to this question, this approach is entirely implausible when applied to non-fungible products.[201] Given that Bitcoin is currently the only virtual currency serving as a DCM-underlier and is thus a commodity under *Board of Trade* and its progeny, this is a particularly fundamental question in virtual currency classification and *McDonnell*'s ultimate holding.[202] However, as discussed, certain virtual currencies could never serve as a DCM-underlier and are therefore entirely inapplicable to the court's reasoning.[203] Because *McDonnell* overlooks this issue, a reasonable assumption is that the court erroneously overgeneralized all virtual currencies as sufficiently similar (if not entirely interchangeable) to regulate

197. *See* Pisani & Haselton, *supra* note 29 and accompanying text.

198. *But see* United States v. Brooks, 681 F.3d 678, 694–95 (5th Cir. 2012) (finding that natural gas is still a commodity regardless of its location because "[w]hile the price of that commodity may fluctuate with its location, and the forces of supply and demand at that location, the actual nature of the "good" does not change).

199. *See* Commodities Futures Trading Comm'n v. McDonnell, 287 F. Supp. 3d 213, 224 (E.D.N.Y. 2018).

200. *See Brooks*, 681 F.3d at 695 n.11.

201. *See* discussion cited *infra* Section III.B.3 (underscoring the non-fungible nature of virtual currencies with comparison to natural gas).

202. *See McDonnell*, 287 F. Supp. 3d at 224–28 (describing how the court determined that Bitcoin should be considered a commodity because of how users utilize it as money).

203. *See* Sec. Indus. & Fin. Mkts. Ass'n, v. CFTC, 67 F. Supp. 3d 373, 385 (D.D.C. 2014); *see also Underlying Asset*, *supra* note 138 (describing the nature of underlying assets).

all virtual currencies as commodities based on Bitcoin's DCM-underlier status.

Notably, *McDonnell*'s sweeping decision presents some surprising, likely unintended legal consequences.[204] For example, given the existence of housing futures and freight-based derivatives, *McDonnell*'s reasoning theoretically permits CFTC actions against real-estate brokers and shipping companies simply by alleging some form of fraud against their customers.[205] The CFTC could argue that, as DCM-underliers, housing and freight transactions are commodities under § 1a(9), and therefore any fraud involving these commodities is actionable under § 6(c)(1). Moreover, given that *McDonnell*'s interpretation of § 6(c)(1) removes the requirement of an existing futures contract,[206] the CFTC could rely on its reasoning to bring enforcement actions against any services on which DCM markets exist, such as legal services, for example.[207]

VI. SO, ARE THEY SECURITIES?

Several major cryptocurrencies, as well as DAOs, likely fall well within the legal definition of "security" — or, more precisely, "investment contract" — and thus within the regulatory purview of the SEC regardless of their commodity status.[208] This is because all *convertible* cryptocurrencies, such as Bitcoin-class and Smart-contract networks, which investors currently employ almost exactly as they do conventional public stocks and other investment vehicles well-within SEC jurisdiction, likely satisfy all four *Howey* factors.[209] However, applying *Howey* to other categories of virtual currency requires more nuanced analyses and demonstrates that certain networks — such as information blockchains, for example — are not securities.

Notably, if all virtual currencies, or even just convertible cryptocurrencies, specifically, are categorically deemed securities within SEC jurisdiction,

204. *See* Brooks, *supra* note 85.

205. *Id.*

206. *Id.*

207. *Id.*

208. Because the issue of regulating crypto-funds other than the DAO, which function as conventional investment funds while investing in cryptocurrencies, relies on settling the commodities and securities classification issues analyzed here, it is outside the scope of this Comment. *See generally* Edmund Mokhtarian & Alexander Lindgren, *Rise of the Crypto Hedge Fund: Operational Issues and Best Practices for an Emergent Investment Industry*, 23 STAN. J.L. BUS. & FIN. 112 (2018) (arguing for a new regulatory scheme for crypto-funds).

209. *See* White, *supra* note 28 (describing speculative Bitcoin trading as similar to highly-volatile public stock trading).

DAOs are almost certainly securities as well because they are simply online crowdfunding platforms where, instead of fiat currency and submitted products, investors are employing one convertible cryptocurrency — Ethereum — and one non-convertible cryptocurrency — the DAO token — to fund new projects and determine voting interests in funding emerging cryptocurrency networks.[210] Congress made it clear in 2012 that online crowdfunding platforms, which issuers use as intermediaries in the offer and sale of securities, are well within SEC jurisdiction in carving out the "Crowdfunding exemption" to the Security Act § 4.[211]

A. Investment of Money

1. Convertible Cryptocurrencies, Asset-backed Tokens, & DAOs

Convertible cryptocurrencies, asset-backed tokens, and DAOs likely satisfy the first *Howey* factor, which requires the "investment of money," rather easily.[212] First, many networks and all convertible cryptocurrencies, including asset-backed networks, clearly require an "investment" because (unless gifted) they can only be obtained in exchange for some other property of value.[213] Second, while still generally clear, one question here arises when users exchange other cryptocurrencies rather than fiat money for tokens: are these other networks "money" as provided in *Howey*?[214] However, courts have long held that this factor broadly encompasses any

210. *See generally* Metjahic, *supra* note 52 (explaining the DAO).

211. *See* Jumpstart Our Business Startups Act, 17 C.F.R. §§ 200, 227, 232, 293, 240, 249, 269, 274 (2018) (providing "a framework for the regulation of registered funding portals and broker-dealers that issues are required to use as intermediaries in the offer and sale of securities in reliance on Section 4(a)(6) [of the Securities Act]."). *But see* The DAO Report, *supra* note 63, at 4 n.11 ("[The DAO] would not have met the requirements of Regulation Crowdfunding . . . because, among other things, it was not a broker-dealer or a funding portal registered with the SEC and the Financial Industry Regulatory Authority ("FINRA").").

212. *See Securities Litigation: Jurisdictional Defenses*, *supra* note 61; *see also* White, *supra* note 28 (describing Bitcoin speculation as similar to trading highly-volatile public stocks).

213. *See Investment*, BLACK'S LAW DICTIONARY (10th ed. 2014); *see What is Capital, N?*, BLACK'S LAW DICTIONARY, (2d ed.) (defining "capital," "with respect to the property of individuals . . . [as] the property taken from other investments or uses and set apart for an invested in the special business, and in the increase, proceeds, or earnings . . . ."); *see also supra* Section I.B (defining "convertible" networks); Section 0-0 (explaining how users can access popular network tokens).

214. *See* Fiorillo, *supra* note 4; *see also* United States v. Murgio, 209 F. Supp. 3d 698, 707–08 (S.D.N.Y. 2016) ("[B]itcoins 'clearly qualif[y] as 'money' or 'funds' . . . ."); Nicole Mirjanich, Comment, *Digital Money: Bitcoin's Financial and Tax Future Despite Regulatory Uncertainty*, 64 DEPAUL L. REV. 213, 242 (Fall 2014) (arguing that Bitcoin is a currency and should be regulated as such).

"exchange of value,"[215] and the SEC has already established in court that an investment in Bitcoin is sufficient to satisfy the first prong of *Howey*.[216] Notably, proponents of Bitcoin-class networks generally support the SEC's position here because it furthers the legitimacy of the overall cryptocurrency market.[217] DAOs also satisfy the first factor because, just like those in *Howey* itself, their participants invest personal capital to access them and to ultimately up-start emerging networks.[218]

2. Information Blockchains

Most noteworthy, information blockchains such as KSI and R3 do not satisfy the first *Howey* factor because their use does not involve an investment of money.[219] These networks do not issue tokens, and their users cannot (lawfully, at least) convert any aspect of the virtual currency network to fiat currency or other asset with real-world value.[220] Courts would therefore need to expand the definition of investment from "any exchange in value" to intangible factors — such as time spent using the network or volume of information exchanged, for example — to extend *Howey*'s first factor to information blockchains and other networks that do not involve an investment of money.

B. Investment in a Common Enterprise

As mentioned above, the SEC disregards the second *Howey* factor in The DAO Report entirely,[221] likely because it views DAOs as clearly a "common enterprise" under each of the terms' various legal standards,[222] as well as its

215. Hocking v. Dubois, 885 F.2d 1449, 1471 (9th Cir. 1989); *see also* Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel, 439 U.S. 551, 560 n.12 (1979) (stating that an investment may take the form of goods and services).

216. *See* SEC v. Shavers, Case No. 4:13-CV-416, 2013 WL 4028182, at *1 (E.D. Tex. 2013) (holding that Bitcoin satisfies *Howey*'s first prong); Fiorillo, *supra* note 4; *see generally* Nikolei M. Kaplanov, *Nerdy Money: Bitcoin, The Private Digital Currency, And the Case Against its Regulation*, 25 LOY. CONSUMER L. REV. 111 (2012) (discussing legal considerations in classifying "virtual currency" as "money").

217. Oren, *supra* note 99, at 638.

218. *See* Metjahic, *supra* note 52, at 1564 (explaining that investors purchase Ether with fiat-currency and the DAO issues each investor shares based on their individual Ether holdings).

219. *See KSI Technology Stack*, *supra* note 46 (discussing KSI); *The R3 Story*, *supra* note 47 (discussing R3).

220. *See KSI Technology Stack*, *supra* note 46 (discussing KSI); *The R3 Story*, *supra* note 47 (discussing R3).

221. *See* The DAO Report, *supra* note 63, at 11 (outlining the SEC's reasoning).

222. *See supra* note 98 and accompanying text (describing the circuit split on the definition of "common enterprise").

common usage.[223] However, this issue is less clearly settled as a legal matter (and, consequently, as applied to virtual currencies) than may first appear, primarily because of the circuit split over whether it requires a showing of horizontal or vertical commonality and, if the latter, whether it must be broad or strict.[224] Second, while less crucial here, it is worth noting that courts hesitate to interpret *Howey*'s language literally, and instead focus specifically on the "economic reality" of the industry at issue.[225]

1. Convertible Cryptocurrencies & DAOs

Convertible cryptocurrencies likely satisfy horizontal commonality rather easily because their adoption by a user-base investing its personal assets in exchange for tokens is precisely what creates, sustains, and changes their value against fiat currencies, thereby directly tying investors' fortunes together by their pooling of assets.[226] Further, these networks likely satisfy both broad and narrow vertical commonality inquiries as well because (1) their success and value depend directly on the efficacy of the network's promoter, and (2) investors' fortunes are tied to that of the promoter.[227] The Eleventh and Fifth Circuits found that investors relying on promoters' advertisements of the investments and recruitment of others to gain a greater return was sufficient to show "broad vertical commonality."[228] Given that investors currently purchase tokens on these networks mainly to profit from

223. *See*, *e.g.*, *Common Enterprise*, BUSINESS DICTIONARY http://www.businessdictionary.com/definition/common-enterprise.html (last visited Jan. 15, 2019) (defining "common enterprise" in-part as requiring "common objectives", which "may be implied by the . . . sharing of profits . . . [or] joint ownership").

224. *See supra* notes 97–99 and accompanying text; *see also* Long v. Shultz Cattle Co., 881 F.2d 129, 140 n.11 (5th Cir. 1989) ("The Supreme Court has thus far declined to resolve this split in authority although three justices expressed a desire to do so.").

225. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (citing SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946)) ("[I]n searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality.").

226. *See The Bitcoin Phenomenon: How Cryptocurrencies Gain Value*, *supra* note 27 (discussing factors controlling cryptocurrency values); *see also* Revak v. SEC Reality Corp., 18 F.3d 81, 87 (2d Cir. 1994) (quoting Hart v. Pulte Homes of Mich. Corp., 735 F. 2d 1001, 1004 (6th Cir. 1984) (applying horizontal commonality and defining it as "t[ying] the fortunes of each investor in a pool . . . to the success of the overall venture . . . [which] requires a sharing or pooling of funds.") (internal quotation omitted).

227. *See supra* notes 97–99 and accompanying text (providing the legal standards of broad and narrow vertical commonality).

228. Oren, *supra* note 99, at 639 (citing Villeneuve v. Advanced Bus. Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974)); *see also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 855 (1975) (holding that, for determining security status, "profit" can be either income from, or capital appreciation of, an investment).

the appreciation of their value, which in turn relies directly on the developer's ability to successfully market the product to its intended users, investor's reliance here is likely sufficient for broad vertical commonality.[229] Moreover, because developers of these networks rely on the exact same factor — the token's open-market price — to earn a profit, their fortunes are tied directly to that of investors, and therefore these networks likely satisfy strict vertical commonality as well.[230]

DAOs likely satisfy horizontal commonality because, similar to investors in convertible cryptocurrencies, members of these funds invest personal capital for a share of future profits from blockchain ventures successfully funded by their pooled assets.[231] DAOs, however, may not satisfy *broad* vertical commonality because the success of its members' investment in the network depends not on the efficacy of the *network's* promoter, but rather on the overall success of the blockchain projects successfully funded on network.[232] Accordingly, courts must decide whether only the efficacy of the promoter of a member's primary investment — Ether purchased to access the DAO, for example — is sufficient to satisfy broad vertical commonality, or whether the efficacy of promoters of the member's secondary investment — networks crowdfunded on the DAO — may suffice as well. However, such crypto-funds likely satisfy a *strict* vertical commonality inquiry because, similar to those of convertible cryptocurrencies, developers of DAOs only profit when investors on the network successfully fund a project which generates a return on investment and dividends for those involved.

2. Information Blockchains & Asset-backed Tokens

Information blockchains and asset-backed blockchains do not satisfy *Howey*'s second factor because, as discussed, tokens on information blockchains have absolutely no monetary value (if they even exist), and the value of tokens on asset-backed networks is derived entirely from the value

229. *See* Fiorillo, *supra* note 4 (discussing Bitcoin capital appreciation); Prather, *supra* note 27 (discussing impacts of market conditions on token values); White, *supra* note 27 (describing speculative Bitcoin trading); Prather, *supra* note 28 (discussing impacts of market conditions on token values).

230. *See*, *e.g.*, Jeff Kauflin, *Here Today, Gone Tomorrow: Crypto Billionaires' Net Worth Falls by Billions*, FORBES (Mar. 30, 2018), https://www.forbes.com/sites/jeffkauflin/2018/03/30/here-today-gone-tomorrow-crypto-billionaires-net-worth-falls-by-billions/ (reporting on the impact of declining Ethereum prices on its developer's net worth).

231. *See* Metjahic, *supra* note 52 (explaining The DAO).

232. Notably, however, the argument can be made that DAOs do in fact rely on the efficacy of their promoters because, if a promoter fails to attract a sufficient investor pool to join a network, projects could never be successfully funded. *See* Metjahic, *supra* note 52 (explaining The DAO).

of an underlying real-word asset.[233] These networks do not satisfy horizontal commonality simply because users do not pool assets and, therefore, their fortunes cannot possibly be tied together by doing so.[234] Similarly, these networks do not satisfy vertical commonality — whether broad or strict — because neither the efficacy nor fortunes of their promoters have any bearing on the investors' (non-existent) fortunes.[235]

C. Expectation of Profits

Applying *Howey*'s third factor to virtual currency investments is seemingly straight-forward and, accordingly, receives little attention from regulators and courts.[236] The Supreme Court has provided that the term "profits" in *Howey* refers specifically to "the profits that investors seek on their investment, not the profits of the scheme in which they invest."[237] Accordingly, when investors purchase tokens of a particular convertible cryptocurrency with the intention of earning a return on those tokens when their value increases, their expectation of profit is sufficient to satisfy *Howey*'s third prong.[238] And given that most investors currently purchase tokens on convertible cryptocurrency networks specifically for this purpose, these networks likely satisfy *Howey*'s third prong.[239] Likewise, DAOs and all other crypto-funds satisfy *Howey*'s third prong because, similar to any other venture capital or investment fund, members explicitly join these ventures to profit on their investments.[240]

Notably, however, this *Howey* factor's applicability to convertible cryptocurrencies may present regulators with one particular issue because, in addition to speculative trading, convertible cryptocurrencies are often used simply to transfer payments for goods or services without any expectation of profit or return on investment.[241] There, users are induced to purchase tokens

233. *See KSI Technology Stack*, *supra* note 46 (discussing KSI)*; The R3 Story*, *supra* note 47 (discussing R3).

234. *See* Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994); *KSI Technology Stack*, *supra* note 46 (discussing KSI)*; The R3 Story*, *supra* note 47 (discussing R3).

235. *See* Fersht*, supra* note 47 (discussing information blockchains); *see also The R3 Story*, *supra* note 47.

236. *See* The DAO Report, *supra* note 63; *see also* Oren, *supra* note 99, at 639 (only briefly discussing the third *Howey* factor).

237. SEC v. Edwards, 540 U.S. 389, 394 (2004) ("We used 'profits' in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.").

238. *See* White, *supra* note 27 (describing Bitcoin speculation as similar to trading highly-volatile public stocks).

239. *See id.*

240. *See* Metjahic, *supra* note 52 (explaining The DAO).

241. *See* Fiorillo, *supra* note 4 (discussing Bitcoin payment-processing).

simply to acquire interests, goods, or services, which the Supreme Court has long held does not invoke the applicability of securities laws.[242] Contrarily, information blockchains and asset-backed networks clearly do not satisfy this *Howey* factor because their users have no expectation of profits whatsoever, instead employing these networks to exchange information and to move capital between other virtual networks and one another, respectively.[243]

D. Sole Efforts of Others

Despite the SEC's focus on *Howey*'s fourth factor in The DAO Report, its applicability to virtual currencies appears to be generally straight-forward.[244] While courts are divided on exactly how much effort investors themselves may exert or others must exert to satisfy this factor, each type of virtual currency discussed thus far with the exception of information blockchains[245] seems to fall well-within standards which are relatively consistent across jurisdictions.[246]

1. Asset-backed Tokens & DAOs

This is particularly apparent in applying *Howey*'s fourth factor to asset-backed tokens because their value may rely directly on the actions of those entirely uninvolved in the network itself, such as a state government (when backed by fiat currency) or a farming collective (when backed by agricultural commodities), for example.[247] Such tokens are functionally equivalent to derivative securities, such as options — financial instruments that create

242. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975) (holding that, despite having the term "stock" in its name, a venture was not a security because "the inducement to purchase was solely to acquire [an interest]; it was not to invest for profit.").

243. *See KSI Technology Stack*, *supra* note 46 (discussing KSI); *The R3 Story*, *supra* note 47 (discussing R3).

244. *See* The DAO Report, *supra* note 63, at 12–14 (focusing on *Howey*'s fourth factor by underscoring investors' limited voting rights and strong reliance on cryptocurrency developers to realize profits). *But see* Oren, *supra* note 99, at 642–43 (noting and arguing against the SEC's attempts to dismiss the fourth *Howey* factor).

245. As discussed, information blockchains have no monetary value and therefore users have no expectation of profits — from the sole efforts of others or otherwise. *See supra* notes 45–48 and accompanying text (discussing information blockchains).

246. *Compare* SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 477, 482 (allowing investors to contribute to sales activities and governance decisions), *with* SEC v. Life Partners, Inc., 102 F.3d 587, 588 (D.C. Cir. 1996) (interpreting the word "solely" to mean "predominantly").

247. *See KSI Technology Stack*, *supra* note 46 (discussing KSI); *The R3 Story*, *supra* note 47 (discussing R3).

contract rights to buy or sell underlying securities at a "strike" price[248] — in that they are pegged to the price of underlying assets and therefore "derive their value" from them.[249] Courts widely recognize that options are securities as well as the SEC's long-held view that "transactions involving derivative securities could be equated to the purchases and sales of the underlying securities for the purposes of incurring liability under [the Securities Act]" because "holding [them] is functionally equivalent to holding the underlying security."[250] There is therefore no reason to believe that holding security derivatives involves sufficient effort by others to deem them securities, while the same does not apply to asset-backed tokens.[251] Accordingly, asset-backed tokens almost certainly satisfy *Howey*'s fourth factor and are well-within SEC jurisdiction when based on separately recognized securities.

Likewise, DAOs are similar if not identical to conventional online crowdfunding platforms, which, as discussed, fall within SEC jurisdiction where they are used as an intermediary in the offer and sale of securities.[252] Accordingly, it would appear contrary to Congress's intent to find that DAOs do not involve sufficient effort by others while other crowdfunding platforms performing exactly the same function do. Moreover, circuit court precedent regarding corporate partnerships strongly suggests that investor interests in projects successfully funded on a DAO satisfy *Howey*'s fourth factor.[253]

2. Convertible cryptocurrencies

The fourth *Howey* factor's applicability to convertible cryptocurrencies

248. *See* James Chen, *Call Option Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/c/calloption.asp (last updated Aug. 4, 2018) (explaining call options).

249. Magma Power Co. v. Dow Chem. Co., 136 F.3d 316, 321 (2d Cir. 1998); *see also id.* (holding that the financial instrument at issue, which was pegged to the price of a public stock, was a derivative security); *supra* notes 41–43 and accompanying text (discussing Asset-backed tokens).

250. Roth v. Goldman Sachs Grp., Inc., 873 F. Supp. 2d 524, 530–31 (S.D.N.Y. 2012) (citing *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 34-28869, Investment Company Act Release No. 35-25254, 56 Fed. Reg. 7242-01, 7248 (Feb. 21, 1991)).

251. While, of course, options are used for price speculation specifically because they require a pre-determined strike price, there is no indication that this is a dispositive factor in their satisfaction of *Howey*. *See Roth*, 873 F. Supp. 2d at 530–31 (providing the rationale behind deeming derivatives as falling within SEC jurisdiction).

252. *See supra* notes 210–11 and accompanying text.

253. SEC v. Merch. Capital, LLC, 483 F.3d 747, 757 (11th Cir. 2007) (distinguishing general partnership interests, which are presumed not to be investment contracts due to the typically active role of general partners in managing the business, from limited partnerships, which leave sufficiently "little power in the hands of the partner") (internal citation omitted).

appears similarly straight-forward. Just as traditional securities such as common stocks, an investor's level of control over a token's price (and therefore overall return) on a convertible cryptocurrencies' networks varies widely based on their specific ownership status.[254] Developers can dramatically increase a token's price by upgrading the network with new capabilities, resolving a previously concerning issue, or promoting the token for a new purpose — functionally equivalent to a corporation releasing a successful new product or announcing a strategic acquisition, for example.[255] Developers can also impact a token's price negatively by making changes to the network that are unpopular with users.[256] Similarly, cryptocurrency "whales" have substantial control over a token's price — functionally equivalent to the control and influence enjoyed by corporate majority shareholders.[257] And in both scenarios, average investors with modest holdings — and, in the case of cryptocurrencies, little involvement in the greater community surrounding a network — generate their profits and losses entirely from the sole efforts of others.[258]

VII. MOVING FORWARD — AN EFFECTIVE (I.E. PRECISE) REGULATORY SCHEME

Fundamentally, *McDonnell* overgeneralized the function and scope of the term "virtual currency" and extended arguments from legal commentary regarding Bitcoin, specifically, to all virtual currencies, generally.[259]

254. *See generally* Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002) (analyzing discrepancies in stockholder control of day-to-day operations). This issue becomes more complicated, however, when examining networks which allow self-governance. *See, e.g.*, Smith, *supra* note 35 (discussing Tezos).

255. *See, e.g.*, Jacob Sonenshine, *SEC Sues Tesla CEO Elon Musk*, THESTREET (last updated Set. 27, 2018), https://www.thestreet.com/markets/the-sec-is-suing-elon-musk-14726561 (reporting on the SEC's suit against Tesla's CEO for issuing "misleading statements" regarding his securing financing for privatization, resulting in significant stock-price shifts).

256. *Id.*; EDITORIAL TEAM, *The Howey Test and Cryptocurrency: Which Coins May Apply?*, COINBUREAU (May 6, 2018), https://www.coinbureau.com/analysis/*Howey*-test-cryptocurrency/.

257. *See* EDITORIAL TEAM, *How Bitcoin Whales Can Manipulate the Price*, COINBUREAU (Dec. 17, 2017), https://www.coinbureau.com/analysis/bitcoin-whales-can-manipulate-price/ (discussing the ability of "whales," or those holding significant portions of a token's global supply, to easily manipulate the overall value of that virtual currency); *see generally* James Chen, *Majority Shareholder*, INVESTOPEDIA (last updated July 25, 2018), https://www.investopedia.com/terms/m/majorityshareholder.asp (discussing majority shareholders).

258. *See* EDITORIAL TEAM, *supra* note 255 (explaining that because their profits depend on actions, including market-manipulation and network upgrades, by whales and developers).

259. *See supra* Section IV.A.

Moreover, *McDonnell* misapplied the law by erroneously extending well-established precedent regarding *fungible* goods to a non-fungible field of products while avoiding inconvenient, yet vital legal questions that remain unsettled.[260] The holding in *McDonnell* that all virtual currencies are commodities subject to CFTC jurisdiction should therefore be narrowed, if not completely overturned, and replaced with case law that accounts for these issues. Perhaps even more significantly, courts must resolve the numerous outstanding legal questions that, while potentially avoidable when dealing with other goods, are essential to determining CFTC jurisdiction over virtual currencies.[261] These include whether CEA § 1a(9) commodity definition requires present or only potential DCM-underlier status, whether it should be read broadly as a categorical rather than product-specific grant of jurisdiction, and — most importantly — whether "virtual currency" may serve as one such product category under the CEA.[262]

First, courts should limit CEA § 1a(9) to include only those goods that currently serve as DCM-underliers, aligning with Congress's original intent in first establishing the CFTC, as well as avoiding the inconceivable practical implications of deeming anything capable of underlying a futures market (or essentially anything with monetary value) a commodity under the CEA.[263] Second, courts should uniformly establish that CEA § 1a(9) is a categorical definition that encompasses fungible goods, thus enabling the CFTC to regulate fraudulent activity undertaken by those selling products into interstate commerce while aligning with precedent such as the Natural Gas Cases.[264] Lastly, and as noted repeatedly throughout this Comment, courts should hold that, while Bitcoin is a commodity due to its DCM-underlier status, the term "virtual currency" may not serve as a general product category under § 1a(9) because many networks falling within it are entirely distinct products developed for varying purposes and often countervailing potential uses.[265]

Similarly, applying *Howey* to categories of virtual currency beyond major cryptocurrencies, DAOs, and other crypto-funds makes clear that certain

260. *See supra* Section IV.B.

261. *See supra* Section III.B.

262. *Id.*

263. *See* 7 U.S.C. § 1a(9) (discussing Congress's intent and grant of jurisdiction in establishing the CFTC); *see also* Hunter v. Fed. Energy Regulatory Comm'n, 711 F.3d 155, 157 (D.C. Cir. 2013) ("Congress crafted CEA section 2(a)(1)(A) to give the CFTC exclusive jurisdiction over transactions conducted on futures markets like the NYMEX.").

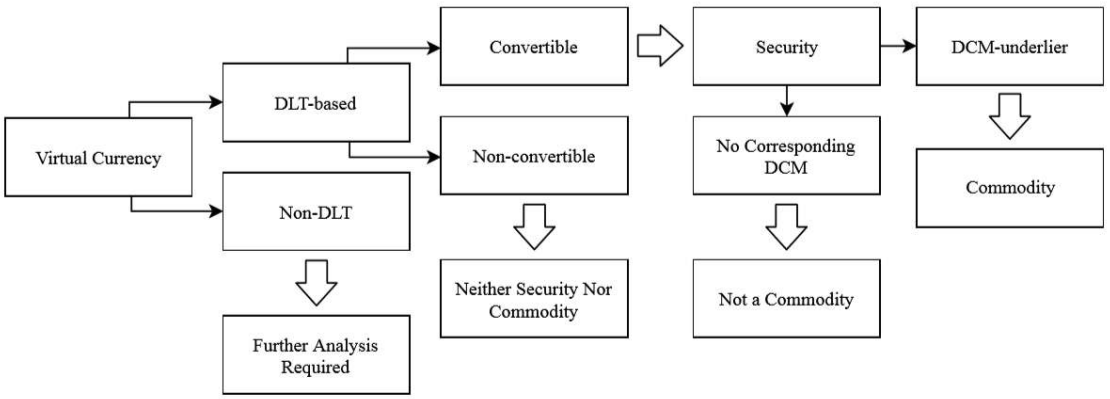
264. *See supra* Section II.D.2 (providing factual background on the Natural Gas Cases).

265. *See supra* Sections I.C, III.B, IV.

networks, such as information blockchains, could never be securities under existing case law and requires clarification of outstanding legal questions.[266] Primarily, courts — at this junction, likely the Supreme Court — must uniformly resolve whether an "investment in a common enterprise" may be shown with horizontal commonality, broad vertical commonality, strict vertical commonality, or a different standard entirely.[267] SEC regulators, on the other hand, must confront the central issue concerning the application of securities laws to even the most popular cryptocurrencies when used exclusively to transfer payments for goods or services without any expectation of profit, directly in the face of Supreme Court precedent specifically excluding such transactions in a different context.[268]

Accordingly, perhaps the following regulatory framework, which accounts for the technological attributes of distinct virtual currency networks and agency jurisdiction under existing case law, may be applied in the interim, as demonstrated by Figure 1:

Figure 1:



CONCLUSION

Regulators are often confronted with myriad of newly arising technical nuances, existing legal questions, and long-term practical considerations with innovative new products, goods, and services introduced into the global marketplace and made available to the general public. However, not all (if

266. *See supra* Section V.

267. *See supra* notes 88–100 and accompanying text.

268. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975) (holding that securities laws are not invoked when "the inducement to purchase was solely to acquire [an interest]; it was not to invest for profit.").

any) bring forth as substantial a need for understanding the complex, fundamental technological underpinnings involved as the development of DLT and related financial products such as Bitcoin, Smart-contract networks, information blockchains, and DAOs. *McDonnell*'s difficulty with identifying the appropriate language and technical distinctions involved in the broad "virtual currency" category is neither condemnable nor surprising; courts are not and cannot possibly be subject-matter experts on even long-standing, let alone newly emerging and highly complex technological innovations that can act as legal contract intermediaries, internal systems of exchange, information recording systems, monetary systems, and — in just one specific application — financial investment products. The *McDonnell* court was simply doing its job, perhaps too well, in seeking to extend adequate legal protections for consumers to an emerging new field. Likewise, the SEC and CFTC's attempts to expand their reach beyond existing statutory grants of jurisdiction and case law only further exhibit the tenacity with which regulators seek to fulfill their role of protecting American consumers from fraud and misconduct related to complex financial transactions. However, the outstanding legal questions in commodities law, related defects in *McDonnell*'s holding, and practical concerns in applying securities law to an innovative new product present regulators and courts with an optimal opportunity to establish an effective, accurate, and precise regulatory framework to govern virtual currencies.

AMERICAN UNIVERSITY BUSINESS LAW REVIEW

SUBSCRIPTION ORDER FORM

Subscription Options (check one):

_____ $30.00 Alumni Subscription

_____ $45.00 Domestic Subscription

_____ $50.00 Foreign Subscription

_____ $20.00 Single-Issue Only

_____ **Please check here if you would like to enclose a check for the amount selected.**

Please complete the form below and send it with your check made payable to *American University Business Law Review* at:

American University Business Law Review
Washington College of Law
4300 Nebraska Avenue, NW
Suite CT11
Washington, D.C. 20016
Attn: Journal Coordinator

_____ **Please check here if you would like to receive an invoice for the amount selected.**

Please complete the form below and email it to Sharon Wolfe, the Journal Coordinator, at shuie@wcl.american.edu.

Please begin my subscription with Volume _____ Single-Issue only _____

Name:
_____

Institution:
_____

Address:
_____

City, State, Zip:
_____

*Subscriptions are automatically renewed unless cancellation is requested.

* * *

Order through Hein!

American University Business Law Review

is available from Hein!

Back issues and individual volumes available! Contact Hein for details!

1-800-828-7571
order@wshein.com

American University Business Law Review is also available electronically in HeinOnline!

William S. Hein & Co., Inc.
1285 Main Street, Buffalo, New York 14209
Ph: 716.882.2600 » Toll-free: 1.800.828.7571 » Fax: 716.883.8100
mail@wshein.com » wshein.com » heinonline.org

* * *

American University Business Law Review
Washington College of Law
4300 Nebraska Avenue, N.W.
Suite CT11
Washington, D.C. 20016
www.aublr.org

Volume 8, Issue 2 **AMERICAN UNIVERSITY BUSINESS LAW REVIEW** Pages 119–244 2019