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Initial Coin Offerings: SEC and Other Regulatory Guidance on Registration of Blockchain Tokens as Securities

WEDNESDAY, NOVEMBER 7, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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INSIGHT: Structuring Secondary Token Sales: How to Monetize Digital Tokens Under U.S. Securities Laws

BY ALFREDO B. D. SILVA AND F. DARIO DE MARTINO

With over $20 billion raised from the sale of digital, blockchain-enabled tokens since 2014, of which more than $14 billion was raised in the first two quarters of 2018 alone, it should not be surprising that these transactions (commonly referred to as initial coin offerings, ICOs, cryptocurrency crowdfunding, token sales, or token offerings) have become a fundraising tool that, at least theoretically, offers significant opportunities not only for the blockchain companies who will use these funds, but also to the investors, founders, engineers, and other stakeholders acquiring, earning, mining, and receiving the tokens in question.

For some that acquire tokens, the token value lies primarily in their utility (*e.g.*, the rights to obtain membership in a distributed platform or to pay for products or services offered by the company with tokens in lieu of cash). For many, however, the intent of the buyer is to achieve significant return on money or time invested by selling the tokens for a profit, and the intent of the issuer is to raise capital to develop or operate their business.

At this point, most market participants understand that when tokens are primarily sold for these latter purposes, these transactions are classified as sales of securities under U.S. federal securities laws. Accordingly, there is now wide legal consensus that organizations that seek to sell tokens for capital-raising purposes in the United States should register their tokens with the U.S. Securities and Exchange Commission (the SEC) or rely on available registration exemptions, such as Regulation D under the Securities Act of 1933 (the ''Securities Act'') for sales to accredited investors.

What many token investors and other recipients of tokens may not realize is that to the extent a token is a security, any sale that the *holder* makes of the token (*i.e.*, any ''secondary sale'') must also be in compliance with similar securities laws and regulations, just as the initial, or ''primary,'' sale of the token to the holder must have been. Although this basic requirement for secondary sales is similar to the requirement applicable to the organization selling the token in the first instance—*i.e.*, the sale must either be registered or made pursuant to an exemption—the exemptions available for secondary sales and primary sales differ.

In addition, token sellers must also comply with insider trading limitations, market manipulation rules, and other provisions of the U.S. federal securities laws, including, in some cases, requirements that the token issuer's audited financial statements be publicly disclosed. In the context of sales of stock and other traditional securities, these rules tend to be well understood and have been systematized, but they have not been adequately implemented and respected by many token market participants.

If a token holder fails to comply with securities rules and regulations that apply to secondary sales of that token, the holder may be subject to rescission rights and damages claims by third-party transferees as well as enforcement actions by federal, state, or non-U.S. securities regulators, which may result in fines, injunctions, and jail time.

And make no mistake: although the SEC's forays into ICO enforcement actions to date have focused on primary issuers of tokens, those efforts are only a first wave and—as this market matures—resales of tokens not in compliance with U.S. securities laws likely will be the focus of such efforts before long.

Registration, Available Exemptions, and the R-Token

To address the issues presented by the U.S. securities laws, market participants may consider a few alternatives, none of which, however, is perfectly suited for the blockchain world.

First, an investor could theoretically acquire tokens that had been sold in a transaction registered by the issuer under the Securities Act: tokens acquired in such a manner will not be ''restricted securities'' for purposes of the Securities Act Rule 144, permitting non-affiliates to resell without registration or limitation (although certain limitations would be imposed on affiliates). As of the date of this article, however, the SEC has not yet declared effective any registered ICO, or qualified any offering of tokens conducted in reliance on Regulation A. Thus, as a practical matter, investors who wish to participate actively in this market cannot wait to buy tokens in a registered transaction, nor should they assume they will be able to register the resale of their tokens in a timely or cost-effective manner.

Absent registration, a holder will generally be limited to certain exempt sale transactions, including public sales where the holder would not be deemed an underwriter or distributor for the issuer, private placements or overseas transactions. While these exemptions may seem to cover a broad range of potential secondary sales, the devil is in the details, as the qualifications of each exemption are both restrictive and complex.

Due in part to the difficulty for the average investor to understand these exemptions, and the need for issuers in good faith to seek to enforce them, in addition to turning to counsel, some issuers are considering technological means that leverage smart contract technology to enforce securities law requirements and restrictions on the trading of tokens.

Public Resales Under Rule 144

Rule 144 promulgated under Section 4(a)(1) of the Securities Act is a non-exclusive safe harbor designed to permit security holders to resell to the general public without being deemed an underwriter or distributor for the original issuer (and, therefore, without being subject to all of the rules, restrictions, and liabilities applicable to an underwriter or distributor for the original issuer). Once a security has been acquired in a transaction complying with Rule 144, it is cleared for resale in subsequent transactions, as long as the holder is not an affiliate of the original issuer.

A Rule 144 sale must satisfy both holding period requirements and manner of sale restrictions. The holding period requirement depends on whether the issuer has registered the tokens under Section 12 of the Securities Exchange Act of 1934 (the ''Exchange Act''), and is current in its public reporting obligations. If so, the holding period is six months. If not—which will likely be the case for most tokens—the tokens must be held for a full year before resale without registration is permitted.

In certain cases, sellers are allowed to ''tack'' the holding period of an issued security to the holding period of a related derivative security. The crux of the matter relates to the timing of the investment decision and payment of consideration for the shares. Accordingly, while the SEC has not issued guidance on this point, there are good arguments to be made that the holding period for tokens delivered pursuant a SAFT (''Simple Agreement for Future Tokens'') or certain convertible debt instruments or issued upon the settlement of an employee restricted token unit (''RTU'') would start with the date the SAFT or convertible debt instrument was purchased or the RTU awarded, not the date the token was actually delivered. Since many SAFTs, convertible notes, and RTUs will be subject to time-based vesting requirements or token release schedules, in some cases it may well be that the Rule 144 holding period will already be met by the time the holder has received the underlying tokens and is ready and able to sell. (Note that tacking would likely not be applicable for the exercise of any employee token options or the cash exercise of warrants to purchase tokens.)

Market participants tend to be aware of the one-year holding period under Rule 144, and it has become standard to impose a post-issuance one-year lock-up in the investment contract for the tokens—or, more recently, even in the code of the token itself. Many market participants do not seem to realize the lock-up period may actually start with the initial issuance of the SAFT, and that therefore one potential advantage of the SAFT is that it permits the issuer to raise money before conducting an ICO while effectively shortening the post-ICO lock-up period.

Market participants also do not yet widely understand the more onerous information requirements and volume restrictions for resales under Rule 144 by certain insiders. Due to the fact that insiders generally have significantly greater access to information regarding the issuer and own significantly more securities relative to other security holders, affiliates of the issuer, including directors, officers, and certain controlling shareholders (often including the founders), are further restricted in their ability to sell. The key goal of these provisions is to protect other security holders from insider trading and market manipulation.

Accordingly, in order for Rule 144 to be available to affiliate resellers, the issuer must either be subject to the reporting requirements under the Exchange Act and current in its reports, or must make publicly available (*i.e.*, to potential unaffiliated token buyers) information regarding the issuer analogous to what would have been required for a public company. This means disclosure regarding the number of outstanding tokens, the nature of the issuer's business, including its products and services offered and its facilities, the name of the issuer's chief executive officer and its board members, information regarding broker or dealer affiliations, and, most importantly, two fiscal years' financial statements in addition to the most recently available interim financial statements. Further, in any three-month period, these affiliate token holders may only sell up to the greater of 1 percent of all outstanding tokens and the average weekly trading volume over the four weeks preceding sale, as determined in accordance with Rule 144. Affiliate sellers may also be required to file a Form 144 with the SEC to provide disclosure about the terms of the sale. Notably, in signing a Form 144, an affiliate seller is required to represent that the seller does not know of any non-disclosed material adverse information about the issuer. That representation may be problematic for issuers that are not reporting companies.

In our experience, founders, directors, and officers are often surprised to hear that they will have a more difficult path to achieving liquidity from their tokens without the issuer making its financial information available to the world, particularly given that financial information regarding a token issuer may be viewed as far less relevant to the value of a token as other data related to the token platform the issuer has created.

Assuming holding periods have been met, and, in the case of affiliates, adequate information is available, token holders have largely satisfied the requirements for relying on Rule 144. However, note that Rule 144 sales are not available for issuers with no or nominal operations and no assets or solely or predominantly cash assets (*i.e.*, a shell company). This last requirement may preclude the availability of Rule 144 for tokens of issuers who may have issued tokens prior to commencement of operations, or operating companies who have structured the tokens to be issued through a subsidiary that itself has no meaningful operations.

Qualified Institutional Buyer Resales Under Rule 144A

Rule 144A under the Securities Act serves as a complement to Rule 144. The rule provides another non-exclusive safe harbor under the Section 4(a)(1) exemption that allows financial intermediaries to resell tokens to a potentially infinite number of qualified institutional buyers (''QIBs''). Generally, QIBs are entities that fall within the category of ''accredited investors,'' as defined in Rule 501 of Regulation D, and are either foreign or domestic institutions (not individuals) that own and invest on a discretionary basis at least $100 million in securities of non-affiliates of such entity. QIBs often include, but are not limited to, investment companies registered under the Investment Company Act of 1940, investment advisors or business development companies as described in the Investment Advisers Act of 1940, employee benefit plans within the meaning of the Employee Retirement Income Security Act of 1974, and other regulated entities. Because QIBs are relatively financially sophisticated, the information requirements for Rule 144A are less onerous than for Rule 144, but still include disclosure of recent financial statements.

Unlike tokens sold under Rule 144, tokens sold under Rule 144A will be restricted securities in the hands of the purchaser and cannot be freely resold to the public without registration or further reliance on the Section 4(a)(1) exemption. However, QIBs generally may freely buy and sell tokens from and to each other so long as the QIB reseller determines that the purchaser is also a QIB and makes the QIB purchaser aware of the reseller's reliance on Rule 144A in the certain resale of the tokens.

Despite the potential advantages of reliance on Rule 144A and reports that institutional investors are increasingly interested in the cryptocurrency markets, QIBs presently do not appear to make up a large portion of the token trading market. Part of this issue may be that many QIBs are themselves regulated entities, and would face significant challenges when incorporating tokens into portfolios that are subject to complex liquidity, valuation, custody, or reporting requirements. Recently, a number of companies have announced products and services that attempt to solve some of these problems for institutional market participants. We expect that Rule 144A will play a more prominent role in token resales once those issues have been addressed.

Private Sales Under Section 4(a)(7) and Section ''4(a)(1½)''

Where Rule 144 or Rule 144A are not available, token holders wishing to resell tokens that qualify as securities in the United States without registration will need to structure such sales as ''private placement'' transactions that do not qualify as public offerings. In this regard, it is important to note that Section 4(a)(2), the general private placement exemption, is available only to issuers of securities and not to resellers.

Instead, resellers may rely on Section 4(a)(7) of the Securities Act, which is a specific provision applicable to resales in private transactions. As compared to Rule 144, a key advantage of Section 4(a)(7) is that the required holding period for tokens that have not been registered under the Exchange Act is only 90 days, not a full year. However, similar to the information requirement for affiliate resellers under Rule 144, a Section 4(a)(7) transaction requires the organization that initially issued the tokens to make certain information available to the purchaser, including the organization's audited financial statements—and if issuers are already reticent to do so even to more freely permit resale transactions by their officers, directors, and founders, they would have much less motivation to do so for others.

Due to the restrictive information requirements of Section 4(a)(7), we believe many holders may argue that their token resale transactions qualify under the so-called ''Section 4(a)(1½)'' exemption. This exemption is not a statutory safe harbor for secondary transactions, as with Rule 144 and Rule 144A promulgated under Section 4(a)(1), but has been developed by case law to permit secondary transactions that generally conform with the requirements of a primary private placement by an issuer under Section 4(a)(2)—hence the name.

It is unclear whether the ''Section 4(a)(1½)'' case law exemption will remain available for token sales, as Section 4(a)(7) is a recent addition to the Securities Act that was largely intended to codify the former case law exemption. But to the extent it can be relied on, a Section 4(a)(1½) transaction would need to be made to a limited number of purchasers and without public advertising or general solicitation, the purchasers should be provided with some set of information regarding the tokens available to the reseller and the token issuer to enable such purchasers to evaluate the merits of the investment, and the purchasers should be sophisticated enough to evaluate the merits of the investment based on that information, and should represent their intent to hold the tokens for an indefinite period of time, without immediate intent to resell or distribute.

It is difficult to imagine that these conditions could be met in connection with a token holder's resale on a token exchange. Instead, this exemption is more likely to be relied upon by investors making ''block trades'' of tokens to other interested buyers in negotiated transactions of sizeable value, for example, where a venture capitalist that has acquired tokens in connection with a distribution from a portfolio company sells its token wallet to another investment firm.

Note that because it is not a codified safe harbor, there is no specified period of time for which tokens must be held before they could arguably be resold under the Section 4(a)(1½) exemption. In order to support the argument that the exemption should remain available and the resale transaction is not merely a distribution on behalf of the original issuer, a minimum 90-day holding period, matching the period under Section 4(a)(7), seems reasonable. This means that the one-year holding period associated with Rule 144 compliance should not be viewed as mandatory for all secondary transactions. Accordingly, while token investors may agree to certain lock-up or holding periods in connection with their original purchase of tokens from issuers for business reasons (*i.e.*, so the issuing organization can better control the flow of tokens into the market), in an ideal world, investors would wish for acquired tokens to enable exemptions to compliance-based one-year holding periods where secondary sales could be conducted pursuant to a valid exemption from U.S. securities laws other than Rule 144. On the other hand, while companies may in theory be amenable to this carve out, they would also want any investor selling outside of reliance on Rule 144 to provide the company with a legal opinion supporting the validity of the transfer under U.S. securities laws, given that exemptions other than Rule 144 are particularly dependent on facts and circumstances relating to the transfer.

As a practical matter, however, it is not clear yet that the available technology for token transferability terms is sophisticated enough to allow for this level of nuance; the smart contracts may need to get smarter.

Offshore Resales Under Regulation S

In addition to certain exempt public and private sales in the United States, a U.S. token holder can resell tokens in ''offshore transactions'' under Regulation S promulgated under the Securities Act. Typically, this means that the reseller reasonably believes that the purchaser is offshore at the time of the offer or sale (a so-called ''non-U.S. person''), or that the transaction is executed on a physical trading floor of an established foreign securities exchange or on a ''designated offshore securities market.''

Presently, most offshore resales of tokens occur through offshore exchanges and trading markets, rather than as direct sales to a known non-U.S. person. However, these transactions are problematic for a variety of reasons. For example, under Rule 902(b) of Regulation S, ''designated offshore securities market'' refers to: (i) certain enumerated foreign securities exchanges of international recognition, such as the London Stock Exchange or the Eurobond market; and (ii) any other foreign securities exchange or non-exchange market designated by the SEC. As of today, we are not aware of any offshore securities markets covered by Rule 902(b) that permit trading of tokens.

As a result, U.S. investors may currently only be able to rely on Regulation S for overseas sales to individually identified and verified investors in privately negotiated transactions, and, for the time being, generally will need to rely on Rule 144 for most resales through token exchanges and other systems.

''Security Tokens''

In light of the complex landscape outlined above, both market participants and regulators face challenges in keeping secondary token transfers compliant with the Securities Act. New technologies have emerged that seek to rise to those challenges by introducing tools to build compliance into token transactions.

Primarily, these tools assist issuers in building so-called ''security tokens,'' a misnomer in that whether or not a token uses technology to comply with securities laws has little - if any - bearing on whether the token is itself a security under those same laws. A typical product consists of a series of components, including a token architecture and an on-blockchain regulatory service or protocol that the token references. The regulatory service can generally be configured for regulatory, statutory, and even extra-legal compliance across jurisdictions, so that, for example, the ''security token'' can be traded only via transactions that comply with one or more specific rules promulgated under the Securities Act (typically Rule 144). These technologies may also include services intended to verify potential investors, identify which regulatory requirements apply to the token transactions, and execute the appropriate permissions.

In theory, these technologies can help ensure that token issuances and resales comply with laws, regulations, policies, and standards in various jurisdictions. At the same time, such technologies may not be a silver bullet given that some market participants view such measures as discouraging decentralization. Compliance also may be more difficult to achieve as laws and token holders' circumstances (such as jurisdiction of residence) change.

Insider Trading Identifying proper exemptions from the Securities Act's registration requirements is only the first hurdle in token resales. Sellers must also be mindful of the Exchange Act's anti-fraud provisions: if a security token holder is an ''insider'' with access to non-public material information of the issuer—as is likely to be the case if a holder is or was recently an executive officer, director, or major shareholder of the issuer—the holder will need to disclose such material non-public information to prospective purchasers.

This presents a number of problems. First, if the holder is seeking to resell on a token exchange, as opposed to in a privately negotiated transaction, the seller cannot practically make the information available to the prospective purchaser. Instead, the holder would need the token issuer to disseminate the information through press releases, website updates, or even official social media channels, to ensure that the market had access to the information.

In many cases, however, the token issuer may not be willing to make that information public, as it may be of a confidential or proprietary nature. Even in the case of privately negotiated transactions, the holder may be subject to a nondisclosure agreement with the issuer (particularly if the holder is a current or former employee) that precludes the sharing of material non-public information without express consent.

Further, the type of information that a reasonable investor would consider ''material'' in considering purchasing tokens from a seller may actually be something both an issuer and a seller may wish to keep confidential. For example, terms of token lock-up releases are often heavily negotiated and highly variable—in some cases staged over the course of a number of years, vastly more than the standard 90- to 180-day lockups for stock deals. Information regarding the timing and volume of lock-up releases is highly material to prospective token investors because of the impact on future supply and market price. However, issuers are naturally inclined to restrict knowledge about future token supply, and investors may not wish for companies to know what terms they have agreed to in the past.

Effectively, then, the insider trading rules can serve to lock-up an insider even beyond a commercially negotiated lock-up period or the holding period imposed by Rule 144. Insiders would therefore be well advised to ensure that the issuers are periodically reporting material information about the issuer, its business, and its tokens to the public, to be careful, when possible, about the extent to which the insider is made aware of material non-public information, and to negotiate carve-outs to confidentiality agreements permitting sharing this information to prospective buyers.

To the extent an issuer is generally making public disclosures of material information regarding its token, insiders may be able to take advantage of Rule 10b5-1 under the Exchange Act to facilitate future sales of tokens. This rule permits the implementation of a program, typically referred to as a ''10b5-1 Plan,'' that enables an administrator to sell securities on a holder's behalf even while the holder might otherwise be prohibited from selling due to possession of material non-public information. Such plans are commonplace with respect to sales of stock by executive officers of public companies. A plan would need to be established during a period in time in which the insider was *not* in possession of material non-public information (*i.e.*, after the token issuer had already begun making public disclosures), to have sufficient detail on terms governing the amount and timing of future sales, and to have an administrator to implement its terms and coordinate Form 144 filings and other compliance with Rule 144. At this time, however, we are not aware of any administrators offering these services, likely in part due to most token issuers not making the information regarding the token as required by Rule 144 publicly available.

While the market is still too young to have seen insider trading litigation related to token resales, if and when these suits arise—as well as suits related to sales by insiders without proper reliance on the information and volume restriction requirements of the Rule 144 safe harbor—they will be distracting and likely costly for issuers whose tokens are involved, and will disrupt the ability of insiders subject to the litigation to manage the business. Issuers therefore have an interest in ensuring that their directors and officers will be restricted, through contractual agreements, insider trading policies, and other mechanisms, in their ability to resell tokens underlying awards while in possession of any material, non-public information.

Smart contracts can potentially ease compliance efforts by enforcing blackout periods on insiders. Indeed, some ''security tokens'' are being designed to deny certain trades where a designated regulatory service has determined that resales should not be permitted, for example, in the days surrounding an earnings report.

Market Manipulation Whereas many token re-sellers are inadvertently selling tokens in violation of the registration requirements of the Securities Act and the insider trading requirements of the Exchange Act, a different category of re-sellers are likely acting in bad faith violation of market manipulation rules.

Market manipulation, as provided under the Exchange Act, is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security. Techniques include pump and dump schemes or painting the tape (promoting the tokens to drive the price up), or in the inverse less common to the token world than the stock world, token bashing (posting false or misleading information about an issuer to drive down the price), churning or wash trades (buying and selling tokens at about the same price to magnify price shifts by increase in activity), spoofing (placing bids or orders in bad faith with the intent to cancel before filled), and other schemes to spread false or misleading information about a company, its business, or its tokens, or to rig quotes, prices, or trades to create a false or deceptive picture of token demand.

While the SEC has not to date said much publicly to caution against improper resales of tokens under the Securities Act, investigations and civil and criminal enforcement actions against token market manipulators have been top priorities of the SEC's recently formed Cyber Unit. Furthermore, the Commodities Futures Trading Commission has also asserted jurisdiction over fraudulent and manipulative activity in token markets, and should this jurisdiction be upheld by the courts, it will apply regardless of whether tokens are deemed to be securities as defined under the rules and regulations of the SEC.

The Challenge: Identifying and Providing Meaningful Disclosure A common theme of the rules and regulations applicable to the resale of tokens covered by U.S. securities laws is the desire to protect investors by correcting inherent information asymmetries between the buyer and seller. For this reason, as discussed above, disclosure obligations under Rule 144 become stricter to the extent a seller is an affiliate of the organization issuing the token, since, as an ''affiliate,'' the seller is likely to have significantly greater knowledge about the token and its prospects as an investment than the buyer.

Regulations, guidance, and case law around what constitutes ''material non-public information'' and what disclosures would be meaningful to investors generally contemplate traditional equity or debt securities, where the inherent value of the security ties to the inherent value of the issuer and its business. It is not necessarily the case that the same is true of all tokens. However, when tokens are issued to investors in transactions intended to finance the development of the issuer and its services, it is more likely that their value will in fact be tied to the value of the issuer and its business, since the utility of the token depends on the growth of the issuer.

Accordingly, when considering what information would be material to investors in connection with a resale transaction, analogies to typical disclosures in the stock sale context are informative, as purchasers would likely find the following types of information highly relevant to evaluating an investment:

- total number of outstanding tokens (analogous to total number of outstanding shares of stock), which a buyer would need to determine the token's ''market cap;''
- total number tokens issuable in the future (analogous to stock ''overhang''), which a buyer would need to calculate potential dilution to the token's market cap;
- total number of tokens mined in and spent in recent periods (analogous to disclosures of recent sales of unregistered securities and stock repurchases and redemptions), so investors can understand the impact of such transactions on the token's market cap;
- timing and size of lock-up period expirations (analogous to ''stock available for future sale'' disclosures), which would help a buyer to predict when to expect increases in market supply that will drive down price;
- known holders of 5 percent of outstanding tokens and organization insiders (analogous to beneficial

owner and management disclosures), so purchasers can understand the market drivers and their interests; and

- basic business and financial information regarding the organization that has issued the tokens, so investors can understand whether the company will have the resources available to render the services for which the tokens are to be used.

The true challenge lies in identifying what other disclosure would be material to investors in the unique context of tokens and where there is no good analogy to traditional securities. In this, resellers wishing to fully comply with U.S. securities laws—and insiders wishing to avoid insider trading claims by disappointed buyers—will be breaking new ground. For example, one can imagine an investor being interested in understanding the dollar value of services provided each year in exchange for tokens, so as to understand how much value the organization is providing—effectively for free—to holders surrendering tokens as payment. Such information, together with the organization's financial statements, could help an investor evaluate whether the organization may continue to have the financial health necessary to both stay in business and ensure the tokens have utility and, thereby, value.

At some point, however, a token may be sufficiently distributed so that there are no holders of 5 percent of its outstanding tokens, its network and operations may become so decentralized that there are no inside managers with access to the kinds of information discussed above, and the token platform may be so self-supported by market participants themselves that the financial health of the organization that originally issued the tokens is more or less irrelevant to the continued value of the token. In that case, it very well may be that the token is no longer considered a security by the SEC, in which case the disclosure and other obligations associated with secondary sales under the U.S. federal securities laws will have become moot.

However, token sellers should continue to remember that even if a token ceases to be treated as a security by the SEC, token resale transactions may still be subject to laws and regulations related to commodities, money transmission, consumer protection, and potentially state securities laws, and subject to oversight by the Department of Justice, the Commodity Futures Trading Commission, the Financial Crimes Enforcement Network, the Federal Trade Commission, the Treasury Department and state regulators.

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Howey Got Here: SEC Issues Guidance on Token Offerings

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07/26/2017

Banking + Financial Services, Corporate Finance | Capital Markets, Emerging Companies + Venture Capital, Financial Institutions + Financial Services, Financial Technology, Private Funds, Technology Transactions, and Investment Management

Client Alert

Also published in *Banking Exchange* (07/27/2017).

The *Howey* test lives on—now in a lesson in what not to do when it comes to token offerings.

Token offerings, also known as “initial token offerings,” “token launches,” “token sales,” “initial coin offerings,” or “ICOs,” represent a new capital-raising method being explored by many emerging companies; venture, hedge, and private equity funds; large and well-established corporations; and others hoping to raise significant amounts of money quickly and from a broad base of potential participants. Token launches provide issuers with an alternative to more traditional forms of fundraising, such as obtaining venture capital investments, which often involve significant due diligence by investors and dilute founders’ equity and rights.

To date, many issuers have launched ICOs from non-U.S. jurisdictions, with some taking the position that, so long as the token being offered was not a security under the laws of the jurisdiction of its issuance, there was no need to consider whether the token constituted a security in the jurisdictions in which such token may have been purchased. Critics of The Decentralized Autonomous Organization—more commonly referred to as The DAO and which used a Swiss foundation in connection with its ICO—have long held the view that, while The DAO was successful in raising a precedent-setting amount of capital from purchasers located across the globe, it likely ran afoul of myriad securities regulations and regimes around the world, including in the United States.

Yesterday, the U.S. Securities and Exchange Commission (the “SEC”) spoke formally on the topic for the first time, disappointing some individuals and issuers that had hoped tokens might fall outside of the definition of “securities.” [1] The SEC also issued an investor bulletin on initial coin offerings as part of its investor-education and investor protection mission. [2]

Section 2(a)(1) of the Securities Act of 1933 (the “Securities Act”) and Section 3(a)(10) of the Securities Exchange Act of 1934 (the “Exchange Act”) both include an “investment contract” among the list of instruments that are considered a “security.” In *SEC v. W.J. Howey Co.*, [3] the United States Supreme Court articulated a facts-and-circumstances test for determining whether a particular instrument should be considered an “investment contract,” and, therefore, a “security” subject to the Securities Act. That test has evolved over the years, but the core factors considered are: whether purchasers of the instrument contributed money or valuable goods or services; [4] whether purchasers were investing in a common enterprise and reasonably expected to earn profits through that enterprise; [5] and whether the expected profits are to be derived from the efforts of others. [6]

In applying the *Howey* test to determine whether tokens are “investment contracts,” the SEC did not declare that tokens are all necessarily securities, but provided cautionary advice to market participants, observing that “the federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology.” This guidance was issued in the context of the SEC’s Report of Investigation regarding the 2016 initial token offering by The DAO. The SEC determined that “The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was ‘crucial’ to the DAO Token holders’ investment decision . . . . The DAO was ‘responsible for the success or failure of the enterprise,’ and accordingly was the entity about which the investors needed information material to their investment decision.”

In addition, after having previously declined to approve proposed rule changes to facilitate the listing and trading of shares of the Winklevoss Bitcoin Trust, [7] the SEC followed the path of the U.S. Commodity Futures Trading Commission on July 24, 2017, [8] and affirmed the SEC’s role in regulating platforms like those on which blockchain-based instruments are traded. In its Report, the SEC noted that the platforms that traded The DAO’s tokens “provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.” As such, these trading platforms appear to fall within the definition of a securities exchange and should have registered as a national securities exchange pursuant to Sections 5 and 6 of the Exchange Act or operated pursuant to an appropriate exemption (such as an alternative trading system that complies with Regulation ATS, which requires, among other things, registration as a broker-dealer and filing of a Form ATS with the SEC to give notice of the alternative trading system’s operations).

Although the SEC’s guidance is important, its analysis is limited to The DAO’s token, which, for several reasons, serves as a near-perfect example of a token that should have been treated as a security based on the *Howey* test: participants in The DAO’s token offering made a contribution of value to the project, had a reasonable expectation of profits to be derived from the efforts of others, and had limited management capability. So while the SEC’s Report does confirm that *some* tokens are securities, it does not mean that *all* tokens are securities. Until the SEC has issued guidance on whether certain types of tokens, such as “app tokens,” will be considered securities, issuers whose offerings have a U.S. nexus should consider taking a conservative approach, issuing tokens as securities and complying with the securities laws by registering the offering or relying on a well-established exemption from Securities Act registration, such as Regulation D or Regulation S.

Issuers that propose to offer interests in tokens must also be mindful of the requirements of the Investment Company Act of 1940 (the “1940 Act”), which requires “investment companies” to register with the SEC unless they qualify for one of several exclusions from the definition. Generally, an investment company is an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire “investment securities” having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. For this purpose, “securities” and “investment securities” are broadly defined, and in some cases include instruments that may not be securities under the *Howey* test.

An issuer that is required to register as an investment company but fails to register is subject to many potential penalties, including criminal sanctions. Notably, the SEC’s Report did not address whether The DAO would be an investment company under the 1940 Act, leaving that analysis for another day and another issuer. Even if an issuer can avoid having its tokens classified as securities for purposes of the Securities Act, it still must determine whether it falls within the definition of an investment company under the 1940 Act or within the scope of myriad other federal or state regulatory regimes, including those applicable to money transmitters and financial institutions.

The SEC's next steps remain to be seen, as no enforcement action was sought with regard to The DAO. However, the level of coordination demonstrated by this cross-divisional effort, managed by the SEC's Distributed Ledger Technology Working Group, signals that the SEC is taking issues regarding token markets seriously. We expect enforcement actions may follow if the SEC becomes aware of future token sales that violate U.S. securities laws.

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[1] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017) (the "Report"), *available at* http://www.sec.gov/litigation/investreport/34-81207.pdf.

[2] Investor Bulletin: Initial Coin Offerings (July 25, 2017), *available at* https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings.

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

[4] *See Howey*, 328 U.S. at 301; *see also Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991).

[5] *See SEC v. Edwards*, 540 U.S. 389, 394 (2004).

[6] *See Howey*, 328 U.S. at 299.

[7] Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust, Exchange Act Release No. 34-80206 (Mar. 10, 2017), *available at* https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf.

[8] Press Release: CFTC Grants DCO Registration to LedgerX LLC (July 24, 2017), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7592-17.

Speech

Digital Asset Transactions: When Howey Met Gary (Plastic)

William Hinman
Director, Division of Corporation Finance

San Francisco, CA

June 14, 2018

Remarks at the Yahoo Finance All Markets Summit: Crypto

Thank you Andy. I am pleased to be here today.[1] This event provides a great opportunity to address a topic that is the subject of considerable debate in the press and in the crypto-community – whether a digital asset offered as a security can, over time, become something other than a security.[2]

To start, we should frame the question differently and focus not on the digital asset itself, but on the circumstances surrounding the digital asset and the manner in which it is sold. To that end, a better line of inquiry is: "Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security?" In cases where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise, the answer is likely "no." In these cases, calling the transaction an initial coin offering, or "ICO," or a sale of a "token," will not take it out of the purview of the U.S. securities laws.

But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created? I believe in these cases the answer is a qualified "yes." I would like to share my thinking with you today about the circumstances under which that could occur.

Before I turn to the securities law analysis, let me share what I believe may be most exciting about distributed ledger technology – that is, the potential to share information, transfer value, and record transactions in a decentralized digital environment. Potential applications include supply chain management, intellectual property rights licensing, stock ownership transfers and countless others. There is real value in creating applications that can be accessed and executed electronically with a public, immutable record and without the need for a trusted third party to verify transactions. Some people believe that this technology will transform e-commerce as we know it. There is excitement and a great deal of speculative interest around this new technology. Unfortunately, there also are cases of fraud. In many regards, it is still "early days."

But I am not here to discuss the promise of technology – there are many in attendance and speaking here today that can do a much better job of that. I would like to focus on the application of the federal securities laws to digital asset transactions – that is how tokens and coins are being issued, distributed and sold. While perhaps a bit dryer than the promise of the blockchain, this topic is critical to the broader acceptance and use of these novel instruments.

I will begin by describing what I often see. Promoters,[3] in order to raise money to develop networks on which digital assets will operate, often sell the tokens or coins rather than sell shares, issue notes or obtain bank financing. But, in many cases, the economic substance is the same as a conventional securities offering. Funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument – usually by selling their tokens in the secondary market once the promoters create something of value with the proceeds and the value of the digital enterprise increases.

When we see that kind of economic transaction, it is easy to apply the Supreme Court's "investment contract" test first announced in *SEC v. Howey*.[4] That test requires an investment of money in a common enterprise with an expectation of profit derived from the efforts of others. And it is important to reflect on the facts of *Howey*. A hotel operator sold interests in a citrus grove to its guests and claimed it was selling real estate, not securities. While the transaction was recorded as a real estate sale, it also included a service contract to cultivate and harvest the oranges. The purchasers could have arranged to service the grove themselves but, in fact, most were passive, relying on the efforts of Howey-in-the-Hills Service, Inc. for a return. In articulating the test for an investment contract, the Supreme Court stressed: "Form [is] disregarded for substance and the emphasis [is] placed upon economic reality."[5] So the purported real estate purchase was found to be an investment contract – an investment in orange groves was in these circumstances an investment in a security.

Just as in the *Howey* case, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit. And, as in *Howey* – where interests in the groves were sold to hotel guests, not farmers – tokens and coins typically are sold to a wide audience rather than to persons who are likely to use them on the network.

In the ICOs I have seen, overwhelmingly, promoters tout their ability to create an innovative application of blockchain technology. Like in *Howey*, the investors are passive. Marketing efforts are rarely narrowly targeted to token users. And typically at the outset, the business model and very viability of the application is still uncertain. The purchaser usually has no choice but to rely on the efforts of the promoter to build the network and make the enterprise a success. At that stage, the purchase of a token looks a lot like a bet on the success of the enterprise and not the purchase of something used to exchange for goods or services on the network.

As an aside, you might ask, given that these token sales often look like securities offerings, why are the promoters choosing to package the investment as a coin or token offering? This is an especially good question if the network on which the token or coin will function is not yet operational. I think there can be a number of reasons. For a while, some believed such labeling might, by itself, remove the transaction from the securities laws. I think people now realize labeling an investment opportunity as a coin or token does not achieve that result. Second, this labeling might have been used to bring some marketing "sizzle" to the enterprise. That might still work to some extent, but the track record of ICOs is still being sorted out and some of that sizzle may now be more of a potential warning flare for investors.

Some may be attracted to a blockchain-mediated crowdfunding process. Digital assets can represent an efficient way to reach a global audience where initial purchasers have a stake in the success of the network and become part of a network where their participation adds value beyond their investment contributions. The digital assets are then exchanged – for some, to help find the market price for the new application; for others, to speculate on the venture. As I will discuss, whether a transaction in a coin or token on the secondary market amounts to an offer or sale of a security requires a careful and fact-sensitive legal analysis.

I believe some industry participants are beginning to realize that, in some circumstances, it might be easier to start a blockchain-based enterprise in a more conventional way. In other words, conduct the initial funding through a registered or exempt equity or debt offering and, once the network is up and running, distribute or offer blockchain-based tokens or coins to participants who need the functionality the network and the digital assets offer. This allows the tokens or coins to be structured and offered in a way where it is evident that purchasers are not making an investment in the development of the enterprise.

Returning to the ICOs I am seeing, strictly speaking, the token – or coin or whatever the digital information packet is called – all by itself is not a security, just as the orange groves in *Howey* were not. Central to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers. When someone buys a housing unit to live in, it is probably not a security.[6] But under certain circumstances, the same asset can be offered and sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others. For example, if the housing unit is offered with a management contract or other services, it can be a security.[7] Similarly, when a CD, exempt from being treated as a security under Section 3 of the Securities Act, is sold as a part of a program organized by a broker who offers retail investors promises of liquidity and the potential to profit from changes in interest rates, the *Gary Plastic* case teaches us that the instrument can be part of an investment contract that is a security.[8]

The same reasoning applies to digital assets. The digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract. And regulating these transactions as securities transactions makes sense. The impetus of the Securities Act is to remove the information asymmetry between promoters and investors. In a public distribution, the Securities Act prescribes the information investors need to make an informed investment decision, and the promoter is liable for material misstatements in the offering materials. These are important safeguards, and they are appropriate for most ICOs. The disclosures required under the federal securities laws nicely complement the *Howey* investment contract element about the efforts of others. As an investor, the success of the enterprise – and the ability to realize a profit on the investment – turns on the efforts of the third party. So learning material information about the third party – its background, financing, plans, financial stake and so forth – is a prerequisite to making an informed investment decision. Without a regulatory framework that promotes disclosure of what the third party alone knows of these topics and the risks associated with the venture, investors will be uninformed and are at risk.

But this also points the way to when a digital asset transaction may no longer represent a security offering. If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

And so, when I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value.[9] And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value. Over time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required. And of course there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise. In those cases, application of the securities laws protects the investors who purchase the tokens or coins.

I would like to emphasize that the analysis of whether something is a security is not static and does not strictly inhere to the instrument.[10] Even digital assets with utility that function solely as a means of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security. If a promoter were to place Bitcoin in a fund or trust and sell interests, it would create a new security. Similarly, investment contracts can be made out of virtually any asset (including virtual assets), provided the investor is reasonably expecting profits from the promoter's efforts.

Let me emphasize an earlier point: simply labeling a digital asset a "utility token" does not turn the asset into something that is not a security.[11] I recognize that the Supreme Court has acknowledged that if someone is purchasing an asset for consumption only, it is likely not a security.[12] But, the economic substance of the transaction always determines the legal analysis, not the labels.[13] The oranges in *Howey* had utility. Or in my favorite example, the Commission warned in the late 1960s about investment contracts sold in the form of whisky warehouse receipts.[14] Promoters sold the receipts to U.S. investors to finance the aging and blending processes of Scotch whisky. The whisky was real – and, for some, had exquisite utility. But Howey was not selling oranges and the warehouse receipts promoters were not selling whisky for consumption. They were selling investments, and the purchasers were expecting a return from the promoters' efforts.

Promoters and other market participants need to understand whether transactions in a particular digital asset involve the sale of a security. We are happy to help promoters and their counsel work through these issues. We stand prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use.[15] In addition, we recognize that there are numerous implications under the federal securities laws of a particular asset being considered a security. For example, our Divisions of Trading and Markets and Investment Management are focused on such issues as broker-dealer, exchange and fund registration, as well as matters of market manipulation, custody and valuation. We understand that market participants are working to make their services compliant with the existing regulatory framework, and we are happy to continue our engagement in this process.

What are some of the factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security? Primarily, consider whether a third party – be it a person, entity or coordinated group of actors – drives the expectation of a return. That question will always depend on the particular facts and circumstances, and this list is illustrative, not exhaustive:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
4. Are purchasers "investing," that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
5. Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

While these factors are important in analyzing the role of any third party, there are contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security. Again, we would look to the economic substance of the transaction, but promoters and their counsels should consider these, and other, possible features. This list is not intended to be exhaustive and by no means do I believe each and every one of these factors needs to be present to establish a case that a token is not being offered as a security. This list is meant to prompt thinking by promoters and their counsel, and start the dialogue with the staff – it is not meant to be a list of all necessary factors in a legal analysis.

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

These are exciting legal times and I am pleased to be part of a process that can help promoters of this new technology and their counsel navigate and comply with the federal securities laws.

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[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners or other members of the staff.

[2] Section 2(a)(1) of the Securities Act of 1933 (Securities Act) [15 U.S.C. § 77b(a)(1)] and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act) [15 U.S.C. § 78c(a)(10)] define "security." These definitions contain "slightly different formulations" of the term "security," but the U.S. Supreme Court has "treated [them] as essentially identical in meaning." *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

[3] I am using the term "promoters" in a broad, generic sense. The important factor in the legal analysis is that there is a person or coordinated group (including "any unincorporated organization" see 5 U.S.C. § 77n(a)(4)) that is working actively to develop or guide the development of the infrastructure of the network. This person or group could be founders, sponsors, developers or "promoters" in the traditional sense. The presence of promoters in this context is important to distinguish from the circumstance where multiple, independent actors work on the network but no individual actor's or coordinated group of actors' efforts are essential efforts that affect the failure or success of the enterprise.

[4] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Depending on the features of any given instrument and the surrounding facts, it may also need to be evaluated as a possible security under the general definition of security – see footnote 2 – and the case law interpreting it.

[5] *Id*. at 298.

[6] *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975).

[7] *Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development*, SEC Rel. No. 33-5347 (Jan. 4, 1973).

[8] *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985).

[9] Secondary trading in digital assets by regulated entities may otherwise implicate the federal securities laws, as well as the Commodity Exchange Act. In addition, as SEC Chairman Jay Clayton has stated, regulated financial entities that allow for payment in cryptocurrencies, allow customers to purchase cryptocurrencies on margin or otherwise use cryptocurrencies to facilitate securities transactions should exercise caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations. *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017). In addition, other laws and regulations, such as IRS regulations and state money servicing laws, may be implicated.

[10] The Supreme Court's investment contract test "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299.

[11] "[T]he name given to an instrument is not dispositive." *Forman*, 421 U.S. at 850.

[12] *Forman*, 421 U.S. at 853.

[13] *See* footnotes 10 and 11.

[14] SEC Rel. No. 33-5018 (Nov. 4, 1969); *Investment in Interests in Whisky*, SEC Rel. No. 33-5451 (Jan 7, 1974).

[15] For example, some have raised questions about the offering structure commonly referred to as a Simple Agreement for Future Tokens, or "SAFT." Because the legal analysis must follow the economic realities of the particular facts of an offering, it may not be fruitful to debate a hypothetical structure in the abstract and nothing in these remarks is meant to opine on the legality or appropriateness of a SAFT. From the discussion in this speech, however, it is clear I believe a token once offered in a security offering can, depending on the circumstances, later be offered in a non-securities transaction. I expect that some, perhaps many, may not. I encourage anyone that has questions on a particular SAFT structure to consult with knowledgeable securities counsel or the staff.

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The Journey from Security to Non-Security: SEC Director Comments on Mutability of Token Treatment

F. Dario de Martino, Susan I. Gault-Brown, Daniel R. Kahan, Spencer D. Klein, Alfredo B. D. Silva, and Mark S. Wojciechowski

06/19/2018

Emerging Companies + Venture Capital, Financial Institutions + Financial Services, Financial Technology, Financial Transactions, Investment Management, Mergers + Acquisitions, and Corporate Finance | Capital Markets

Client Alert

Many in the blockchain and cryptocurrency community were in a celebratory mood on June 14, 2018, following a landmark speech given by William Hinman, Director for the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "SEC"). [1]

Director Hinman's remarks addressed, head on, a key question that has long been vexing market participants and their lawyers—namely, whether present-day sales of Ether ("ETH"), the native token of the Ethereum blockchain, are sales of investment contracts and, hence, securities. Perhaps even more significant, however, was the analysis behind Director Hinman's views on ETH—that the characteristics that cause a token to be classified as a security can change so that the same token or, one issued at a later time, may be reclassified as a non-security. While Director Hinman's comments do not have the force of law, his speech provided much-needed direction for a market that has been hungry for regulatory guidance.

Background on the Howey Investment Contract Analysis

As the SEC previously has made clear, "[w]hether or not a particular transaction involves the offer and sale of a security —regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction," [2] and the SEC will apply the facts-and-circumstances test outlined in *SEC v. W.J. Howey Co*. [3] to determine whether a sale of tokens is a sale of securities.

The so-called *Howey* test, developed by the U.S. Supreme Court, is a four-pronged test to evaluate whether a particular instrument or scheme constitutes an "investment contract," which is a type of security. Under *Howey*, an "investment contract" is said to exist where all of the following four factors are satisfied: (a) an investment of money; (b) is made in a common enterprise; (c) with an expectation of profits; (d) to be derived from the efforts of others.

Alluding to *Howey*, Director Hinman distinguished between digital assets representing a set of rights that grant a financial interest in a common enterprise—which are securities—and those digital assets sold only for purposes of acquiring a good or service from an operational and decentralized platform "where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts" [4]—which, in his view, likely are not securities.

Director Hinman reconfirmed that, irrespective of whether a token is labeled as a "utility token," "[f]orm should be disregarded for substance" [5] and "the emphasis should be on economic realities underlying a transaction." [6]

Current Offers and Sales of ETH Are Not Securities Transactions

Director Hinman's remarks were notable not just for their content, but also for their directness and clarity. Until Director Hinman's remarks, many in the blockchain community had been concerned about whether the SEC and its staff viewed ETH to be a security. This question was especially significant in light of the fact that many tokens and decentralized applications (dApps) run, or are intended to run, on Ethereum. If ETH were deemed to be a security issued, sold, or traded in violation of securities laws, many feared that this would threaten the viability and legality of all Ethereum-based projects.

Are present-day sales of ETH securities transactions? Director Hinman answered that question with a resounding no, stating, in pertinent part, that "putting aside the fundraising that accompanied the creation of Ether, . . . current offers and sales of Ether are not securities transactions." [7]

Director Hinman also emphasized the importance of decentralization in determining whether ETH, or any other token, should be considered a security, stating "[i]f the network on which the token or coin is to function is sufficiently decentralized—where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts—the assets may not represent an investment contract." [8]

Securities Can Become Non-Securities

Notably, Director Hinman's statements indicated that the analysis of whether a token is a security is "not static and does not strictly inhere to the instrument," [9] and that decentralization could develop over time, even after an initial token sale launch. This means that, unlike records stored on a blockchain, a token's treatment under U.S. federal securities laws is potentially mutable.

This clarification was welcomed by some in the token sale space who had been concerned that initial token sales launched for capital raising purposes might result in future sales (including secondary market sales) of such tokens that would continue to be treated as sales of securities and, hence, be subject to continued regulation under U.S. federal securities laws.

For example, while Director Hinman suggested that, though initial sales of ETH in fundraising transactions for the Ethereum network may have been securities offerings, at this time, because the characteristics involving ETH have changed, offers and sales of ETH are no longer securities transactions in his view.

Similarly, certain tokens initially issued by blockchain startups pursuant to Simple Agreements for Future Tokens (or "SAFT") transactions conducted as private placements under U.S. securities laws may have the potential to ultimately become part of a decentralized token economy and no longer bear the hallmarks of securities.

Factual Examination

In his speech, Director Hinman emphasized two key areas for practitioners to examine when evaluating the treatment of a particular token as a security or non-security under U.S. federal securities laws. First, who are the parties involved? Second, what is the nature of the digital asset?

Who Are the Parties Involved?

When assessing whether a digital asset is offered as an investment contract, Hinman advised practitioners to "consider whether a third party—be it a person, entity or coordinated group of actors—drives the expectation of a return." [10]

He noted that this question "will always depend on the particular facts and circumstances," including several factors that Director Hinman included in an illustrative, although expressly "not exhaustive," list:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
4. Are purchasers "investing," that is, seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
5. Does application of the Securities Act of 1933's protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

What Is the Nature of the Digital Asset?

In addition, Director Hinman emphasized the relevance of "contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security." [11] Director Hinman further emphasized that the SEC staff "would look to the economic substance of the transaction, but then urged "promoters and their counsels [to] consider these, and other, possible features" [12]:

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

Director Hinman noted that the list was not intended to be exhaustive and was "meant to prompt thinking by promoters and their counsel, and start the dialogue with the [SEC] staff—it is not meant to be a list of all necessary factors in a legal analysis." [13]

Disclosure

Director Hinman also reminded market participants that the "impetus of the Securities Act is to remove the information asymmetry between promoters and investors" [14] by prescribing adequate disclosure to address that asymmetry. A token seller's disclosure, therefore, becomes particularly important when a token purchaser relies on a token seller's efforts to develop an enterprise and, eventually, generate a return on investment for the token purchaser.

But, related to the mutability analysis described above, Director Hinman also noted that "[w]hen the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful." [15] Accordingly, as disclosure becomes less important later in the lifecycle of certain tokens, it becomes less important for purchasers to be afforded the protections of the federal securities laws.

Key Takeaways

Director Hinman's speech is significant in many ways.

First, using Bitcoin and Ether as its primary examples, Director Hinman clarified that tokens that are initially classified as securities can later be viewed as non-securities under certain circumstances. In particular, Director Hinman's speech indicated that subsequent sales (and resales) of certain tokens that were investment contracts and, therefore, "securities" when sold intitially for capital raising purposes may later be sold in transactions that are not classified as sales of "securities" if (a) the tokens would be used to purchase goods and services from a sufficiently decentralized platform and (b) purchasers would no longer reasonably expect a centralized person or group to carry out essential managerial or entrepreneurial efforts.

Second, it emphasized the importance of decentralization as a factor that is relevant not just to the federal securities law analysis, but also to the degree and necessity of ongoing disclosure requirements.

Third, as the SEC staff has stated before, an issuer cannot simply label a token as a "utility token" in an attempt to avoid the applicability of U.S. federal securities laws.

Fourth, consistent with prior guidance, sales of tokens for capital raising purposes will likely continue to be deemed securities offerings.

Fifth, there is certainly no one-size-fits-all structure or bright-line test for determining when a token is, is not, or ceases to be a security. Rather, token sellers, together with their legal counsel, will need to consider numerous factors to determine whether a token sale qualifies as a securities sale, including issues related to the manner of sale, purchaser intent, decentralization, and other relevant factors as articulated in *Howey* and subsequent U.S. federal securities law guidance.

Sixth, and likely welcomed by many token sellers and their legal counsel, Director Hinman signaled that the SEC staff intends to provide assistance and guidance to token sellers on the proper characterization of the sale of digital assets.

Finally, it is important to note that, although Director Hinman offered clarity on long-standing questions, there remain other pivotal issues that his speech did not address. First, the speech did not articulate whether and how the SEC might come to identify any practical distinctions between tokens classified as securities and non-security “utility” tokens, despite recent petitions to the SEC to establish safe harbors or otherwise promulgate guidance on this point. Second, it is not clear how an issuer whose token was initially offered as a security might, as a practical matter, exit such a framework, including whether purchasers who initially acquired digital tokens under the auspices of a securities offering may continue to demand the protections thereof even if at some point, sales of the token cease to constitute sales of securities. In addition to leaving these and other securities law-related questions open, Director Hinman’s speech of course did not address, and should not distract market participants from the need to understand and comply with, other federal, state, and non-U.S. laws and regulations, including those related to money transmission, banking (including KYC/AML), commodities, and tax.

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[1] *See* Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.

[2] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

[3] 328 U.S. 293 (1946).

[4] *See supra* note 1.

[5] *See Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

[6] *See United Housing Found., Inc. v. Forman*,421 U.S. 837, 852-53 (1975).; *see also* Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order (Dec. 11, 2017), *available at* https://www.sec.gov/litigation/admin/2017/33-10445.pdf.

[7] *See supra* note 1.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.*