

Lost at Sea: Navigating A Token Sale That Does Not Constitute the Sale of a Security

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CONDUCTING A TOKEN SALE THAT DOES NOT CONSTITUTE THE SALE OF A SECURITY

I. WHAT IS THE LEGAL TEST FOR WHETHER OR NOT THE TOKEN IS AN INVESTMENT CONTRACT?

- The Howey Test
 - *Does the token purchaser invest in a common enterprise and have an expectation of profits based primarily on the efforts of third parties/the promoter?*
- The Risk Capital Test
 - *Does the token purchaser have actual or practical control over the managerial decisions of the promoter/third-party?*

II. TOKEN DESIGN

- Creating the token to have characteristics of an asset—an instrument that provides inherent use and value—lessens the chance that it will be considered a security. The more functionality a token carries, the more likely it is to be deemed an asset, which also decreases the likelihood that the token was purchased with an expectation of profits derived solely from the efforts of others.
- The features and functionalities of blockchain tokens vary from token to token and are dependent on the project's purpose and the objectives of the token holder. To create a well-designed token for specific consumption and/or use, companies can build rights into the tokens. Indeed, companies can grant token holders the right to perform the following functions:
 - Participate in the creation, deployment, and operation of the foundational technology and anticipated updates that will help expand the Technology's utility;
 - Program, develop, or create various functionalities and features on the new protocol, platform, or dApp;
 - Access, sell and/or license various features of the technology;
 - Contribute labor or effort to the network;
 - Use the technology and its outputs;
 - Sell or acquire products/services on the network; and
 - Vote on additions to or deletions from the technology in terms of features and functionality.¹
- A token with any one or a combination of the above features has/or will have, a utility which enables the owner/buyer to use the token for a particular purpose or purposes. One of the critical legal issues is whether or not the token "utility" must be functional or fully functional at the time of the sale/purchase of the token and, if the token has little to no functionality at the time of sale/purchase, is the token an investment contract, and therefore, a security?

¹ A Securities Law Framework for Blockchain Tokens, <http://www.coinbase.com/legal/securities-law-framework.pdf>

III. WHAT IS NOT THE LEGAL TEST FOR WHETHER THE TOKEN IS AN INVESTMENT CONTRACT?

- Does the token purchaser receive *any* **benefits** from the purchase of a token?
- Can the token purchaser **resell** the token for a **profit**?
- Is the token purchaser purchasing the token **before** the platform on which it will be deployed is fully functional?

IV. RECENT “SAFE HARBOR” PROPOSAL:

- It has been proposed that the characteristics of a token can evolve from a security (if no utility at the time of sale/purchase) to a utility token that is “fully functional”. The assumption is that, once the token is “fully functional”, investors/purchasers are not purchasing the token with expectation of benefits from the efforts of the issuer. Nonetheless, the utility/functionality of the asset at the time of the token sale is irrelevant if the design, development and deployment (of the token and related business model) is designed, developed and deployed by the purchaser/participants—not third parties. It is incumbent upon the purchaser/participants, therefore, to organize a vehicle that will simultaneously enable the purchaser/participants to (1) “occupy” (create a membership-based ecosystem), enable, and organize/create the business opportunity and (2) “develop [the business opportunity] themselves”². One vehicle through which this can be effected is a Cooperative.

V. WHAT IS A COOPERATIVE?

- “Co-operatives are people-centered enterprises **owned and run by and for their members** to realize their common dreams. Profits generated are either reinvested in the enterprise or returned to the members.”³

VI. PRINCIPLES OF A COOPERATIVE⁴

- Voluntary and open membership
 - Purchasers become Sponsors/Issuers: membership is required of initial market, private-sale token purchasers;
 - The Cooperative puts in place measures to discourage the sale of the token on secondary markets by providing “bounty” opportunities through Cooperative governance/ participation;
 - Duty to contribute to platform or protocol;
 - Value driven by membership. Technology identification, research, development, “bounty” programs, launch of dApps and blockchain related solutions.
- Democratic member control
 - Member-controlled – expectations of profits are not from the efforts of others (*Howey*)
 - Voting mechanism built into token ownership (Satisfies Risk Capital Test)
 - Voting power on operations and tech deployment such as deciding which dApps to feature blockchain launch
 - Ability to establish and stake transaction validating nodes
 - To discuss the Cooperative’s self-governance and member-empowering processes
 - Organization of committees to influence token protocol, like a governance forum.
- Member economic participation

² *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 853 (1975) (emphasis added).

³ <https://ica.coop/en/what-co-operative-0>

⁴ <https://ica.coop/en/whats-co-op/co-operative-identity-values-principles>

- Purchase of token asset with built-in utility
- Autonomy and independence
 - No preset re-sale value
 - Avoiding token lock-up
 - Allowing the provision of a way out of project: secondary market placement is discouraged by value of token utility; however, purchasers have autonomy to resell tokens back to Cooperative if the purchasers want to leave project
- Education, training, information
 - Provision of “essential services” as described in *United Housing*.
 - “The short of the matter is that the stores and services in question were established not as a means of returning profits to tenants, but for the purpose of making essential services available for the residents of this enormous complex”.²
 - Example of essential services within the Cooperative structure:
 - Member onboarding
 - dApp development
 - Technology optimization
- Cooperation among Cooperatives
 - Development of token interpolation/interoperability technology
- Concern for community
 - Vibrant asset market place created by the creation of a new asset class (token) that provides:
 - Robust currency use/consumption
 - Does token serve a currency function?
 - Store of value
 - Means of payment
 - Unit of account
 - “Open source” projects seek to incorporate/compensate the community of developers, testers, validators, logo creators, PR/marketing specialists, strategic partners, and advisors in connection with producing “essential services” to those participants.

VII. CURRENT LEGAL FRAMEWORK

(i) Howey Test

- Howey Test⁵
 - Investment of money
 - In a common enterprise
 - With the expectation of profits
 - Solely derived from the efforts of the promoter or third party.
- The three main questions at issue within the context of a token sale are:
 - What is motivating the purchaser of the token? (Why is the producer buying the token?)
 - What constitutes expectation of profits?
 - What level of effort satisfies “efforts of a promoter or third party”?
- Expectation/Realization of Profits – Can arise in three main scenarios

⁵ *SEC v. Howey*, 328 U.S. 293 (1946) (reaffirmed by the Supreme Court in *SEC v. Edwards*, 540 U.S. 398 (2004).

- Traditional Equity/Debt Offering: **passively holding** an investment while waiting for the promoter to do the work and increase the value of the investment.
 - “They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. **Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment.**”⁶
- Market Forces: expectations of increase in value/capital appreciation due to market fluctuations.⁷
 - No further undertakings by promoter to ensure purchaser secures an ROI
- Creation/Realization of Benefits: expectation of benefits to be realized by a [unit/token] purchaser associated with the **use, consumption, occupation, or development** of the purchased item. (*Howey, United Housing*).
 - “By contrast, when a purchaser is motivated by a desire to use or consume the item purchased— ‘to occupy the land or to develop it themselves,’ as the Howey Court put it—the securities laws do not apply.”⁸
- Efforts of the Promoter or Third Party
 - Who is the promoter?
 - Within the context of a **Cooperative**, the token purchaser must also become a Cooperative member at the time of purchase and, therefore, the purchaser is also the issuer/promoter.
 - What “essential services”/benefits can be provided by the promoter to token purchasers without triggering a violation of securities laws?
 - “The short of the matter is that the stores and services in question were established not as a means of returning profits to tenants, but for the purpose of making essential services available for the residents of this enormous complex. By statute these facilities can only be ‘incidental and appurtenant’ to the housing project. Undoubtedly, they make Co-op City a more attractive housing opportunity, but the possibility of some rental reduction is not an ‘expectation of profit’ in the sense found necessary in *Howey*.”⁹
 - Solicitation/Promotion: It’s critical that the issuer identify purchasers who are interested in the Cooperative’s stated objectives and are likely to commit to building out the Cooperative’s ecosystem and/or have an interest in consuming/using the product/services to be purchased with the token. Marketing, therefore, should be devoted to potential participants who commit to helping design, develop and deploy the ecosystem via their execution of the Cooperative Partnership Agreement and/or are potential consumers or users of the product or service:
 - The SEC looks at the types of purchasers the issuer solicits/secures in determining whether there was an expectation of profits derived from the efforts of the promoter.

⁶ *Howey*, 328 U.S. at 299-300 (emphasis added).

⁷ *Noa v. Key Futures, Inc.*, 638 F.2d77 (1980) (holding that sales contracts for the purchase of silver bars are not investment contracts when the profits to the purchaser depended upon the fluctuations of the silver market, not the managerial efforts of the promoter.)

⁸ *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 853 (1975) (emphasis added).

⁹ *United Housing*, 421 U.S. at 857 (emphasis added).

- “They are offering this opportunity to persons who ...lack the ...experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment.”¹⁰
- In the Matter of Munchee Inc.,¹¹ the SEC issued a cease and desist order to Munchee Inc. (“**Munchee**”), a blockchain-based food review service company holding a token sale. In *Munchee*, the SEC found that Munchee’s sale of its MUN Token constituted the sale of securities, due in part to (1) Munchee’s marketing of the MUN and (2) the fact that, based on Munchee’s white paper, MUN purchasers reasonably believed they could profit from holding or trading the MUN Tokens regardless of whether the purchasers participated in the Munchee ecosystem (i.e., using MUN to pay for meals or receiving MUN in exchange for reviewing restaurants). Even if MUN had immediate utility that allowed MUN holders to pay for meals and to leave reviews at the time purchasers received MUN, the SEC will still look to the “economic realities” of the purchase transaction to determine whether purchasers bought MUN as an investment to hold and wait for MUN to build value as opposed to realizing the value of the MUN by deploying it within the Munchee ecosystem. The SEC also noted that Munchee’s marketing efforts primarily targeted those in the investment communities, rather than those in the food and dining industry—the industry Munchee claimed MUN would benefit.

(ii) Risk Capital

- Differs slightly from state to state –*Silver Hills Country Club v. Sobieski* sets forth **the California Risk Capital Test**:¹²
 - an attempt by an issuer to raise funds for a business venture or enterprise;
 - an indiscriminate offering to the public at large where the persons solicited are selected at random;
 - a passive position on the part of the investor; and
 - the conduct of the enterprise by the issuer with other people’s money.
- **WA Risk Capital Test:** RCW 21.20.005(17): “investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture.”
- The ability to **resell** one’s purchase for at least the purchase price actually helps to satisfy the Risk Capital test as the buyer can be made whole via a more liquid market.

VIII. A TOKEN ENTITLING THE BUYER TO ESSENTIAL SERVICES IS NOT A SECURITY

- In 1975, the U.S. Supreme Court in *United Housing Foundation, Inc. v. Forman* established that so long as the benefits realized by the purchaser of “shares” were for the “essential services”

¹⁰ *Howey*, 328 U.S. at 299-300.

¹¹ In the Matter of Munchee Inc., Securities Act release No. 10455, Administrative Proceeding File No. 3-18304, <http://www.sec.gov/litigation/admin/2017/33-10445.pdf>

¹² *Silver Hills Country Club v. Sobieski*, 55 Cal.2d 811, 815, 361 P.2d 906 (1961).

sought by the purchaser, even if the purchaser had the ability to sell such “shares” for a profit, the sale of such “shares” did not constitute the sale of securities.

IX. WHAT IS NOT THE LEGAL TEST

- The existence/realization of monetary benefits;
- The ability to resell for a profit; or
- The ability/willingness/commitment to build and develop the platform on which the token will be deployed.

(i) United Housing

- (Why (1) the ability to resell or (2) the expectation/receipt of benefits (from the efforts of third parties) cannot be the legal test)
- In *United Housing*, the Supreme Court held that shares of stock which entitled purchasers to lease an apartment in a state subsidized and supervised nonprofit housing cooperative were not securities per the '33 Act and the '34 Act even when (i) the tenant stock purchasers received benefits as a result of owning the shares unrelated to the tenants own efforts¹³ and (2) the tenant stock purchasers had the ability to resell the stock for a profit¹⁴.

(ii) Benefits Received by the *United Housing* Tenants

- **Reduced Housing Costs**
 - The spread between the market price of housing and subsidized housing;
 - *“This benefit cannot be liquidated into cash; nor does it result from the managerial efforts of others. In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps, or other government subsidies.”*¹⁵
- **Additional Housing Discounts**
 - Realized as a result of Cooperative City renting out retail space to non-tenant stock purchaser businesses
 - *“... the stores and services in question were established not as a means of returning profits to tenants, but for the purpose of making **essential services** available for the residents of this enormous complex. By statute these facilities can only be ‘incidental and appurtenant’ to the housing project. Undoubtedly, they make Co-op City a more attractive housing opportunity, but the possibility of some rental reduction is not an ‘expectation of profit’ in the sense found necessary in *Howey*.”*¹⁶
- **Community Atmosphere**¹⁷

(iii) In *United Housing*, the Tenant Can Resell Shares at a Profit and this is not a Security

- *“In the extremely unlikely event that Riverbay declines to repurchase the stock, **the tenant cannot sell it for more than the initial purchase price plus a fraction of the portion of the mortgage that he has paid off...**”*¹⁸

¹³ *United Housing*, 421 U.S. at 856-858.

¹⁴ *Id.* at 842-843.

¹⁵ *Id.* at 855.

¹⁶ *Id.* at 856-857.

¹⁷ *Id.* at 854.

¹⁸ *Id.* at 842-843.

United Housing Resale Example

In *United Housing*, a prospective purchaser must buy 18 Riverbay shares per room.¹⁹ The cost per share is \$25, making the total cost \$450 per room (\$25x18) - \$1800 for a four-room apartment (\$25x18x4).

Let's assume that an unhappy tenant has:

- A four-room apartment
- Lived in the apartment for 5 years
- Approximately \$92/month in rent/mortgage²⁰
- The ability to resell the stock for the initial price *plus* [10%] of the portion of the mortgage already paid off²¹

Based on these facts, the *United Housing* court held that the tenant/purchaser could receive a profit by passively owning the shares associated with the apartment it occupied and used without the shares being deemed securities.

Unhappy Tenant Can Sell Shares for: \$2,352 = \$1,800 initial share price + [(\$92x12x5) rent/mortgage paid over 5 years x 10% rent/mortgage paid].

Unhappy Tenant Can Realize a Monetary Profit from the Sale of Shares in the Amount of: \$552 = \$2,352 - \$1,800.

X. UTILITY DOES NOT NEED TO EXIST AT THE TIME OF THE TOKEN SALE UNDER EITHER HOWEY OR UNITED HOUSING

- Howey does not address the concept of “utility”. The focus of the token issuer, and the benefit of the Cooperative structure, must be able to ensure that any economic benefit to members/token purchasers is created by the efforts and contributions of the membership—that the members “occupy/take responsibility for and develop” the protocol/platform/dApp or “use and consume” the products or services derived from the protocol/platform/dApp.
- A token sale that provides the purchaser with the ability to use the ecosystem/platform in the future, but also enables the purchaser to secure the token at a specific price at the time of purchase, enables the purchaser to establish a fixed price for future expenses to be incurred (e.g. “gas”) in connection with the deployment of the token in the ecosystem.
- This fixed price, which may be lower than the token price at the time the platform is launched, provides a monetary benefit to the token holder for the “essential services” (protocol deployment/dApp functionality) sought by the investor/participant, which “essential services” were also designed and deployed by the investor/participant. In *United Housing*, the shareholders received an economic benefit by receiving housing at a subsidized price lower than they would have paid in the open market. Similarly, token purchasers may receive a monetary benefit at the time of their purchase by paying less for the token, at the time of sale, than they might later pay in the open market.
- Further, while the completed platform where the token will be deployed might not be finalized at the time of purchase, the token holder—as a member of the Cooperative—has the right, ability and obligation via the Membership Agreement, to help build out a protocol or platform that will best serve the needs of the membership.

¹⁹ *Id.* at 842.

²⁰ *Id.*

²¹ *See Id.*

XI. OVERVIEW REGARDING CREATING AND SELLING A TOKEN WITHOUT IT BEING AN INVESTMENT CONTRACT

(i) The Steps

- Set up a **Cooperative** with specific objectives to build a certain ecosystem that furthers the Cooperative's objectives and which ecosystem is developed and "occupied" by the Cooperative membership.
- Create a **token** with utility that can be used or consumed within the ecosystem to benefit the token holder.
- **Identify** and **solicit** purchasers who will (1) help develop the ecosystem/platform and (2) deploy the token in order to enrich the ecosystem and further the Cooperative's objectives.
- Require that token purchasers currently are, or as part of their purchase become, Cooperative **members**.
- Have the members **vote**, build out, design, and develop the ecosystem.
- **Deploy** the token within the member-developed ecosystem/platform and enjoy the benefits!

(ii) What is a Cooperative?

- "Co-operatives are people-centered enterprises **owned and run by and for their members** to realize their common dreams. Profits generated are either reinvested in the enterprise or returned to the members."²²

(iii) Key Features of a Cooperative

- "Co-operatives bring people together in a democratic and equal way. Whether the members are the customers, employees, users or residents, co-operatives are **democratically managed** by the '*one member, one vote*' rule. Members share equal voting rights regardless of the amount of capital they put into the enterprise. They allow people to take control of their economic future and, because **they are not owned by shareholders**, the economic and social benefits of their activity stay in the communities where they are established."²³

(iv) Why this Cooperative Model Works

- *While the Cooperative membership is separate from the token, the Cooperative is the actualization of the project, which is realized by the participation of its members.*
- In other words, without the Cooperative, there is no one planting or harvesting the *Howey* citrus groves or otherwise bringing value to the land/project.
 - The Cooperative resolves some issues related to solicitation—those purchasing the token are primarily the people intending to build the membership and business model.
 - There is no claim to or expectation of net profits because a member's expectation of benefits is related to the member's level of work provided in building the business or using the token in the ecosystem.
 - The entity structure is designed to incentivize token holders to *use* and *deploy* the token rather than engage in price speculation. While the token may be available for purchase and sale on a decentralized exchange, the token holders realize greater

²² <https://ica.coop/en/what-co-operative-0>

²³ <https://ica.coop/en/what-co-operative-0>

value from the token by deploying it in the platform and receiving services and/or rebates based on the holder's use of the token.