

The Framework of a Token Sale

BY DAVID M. OTTO

MANAGING PARTNER

MARTIN DAVIS PLLC

Investment Contract Legal Test

The Howey Test

Does the token purchaser effect:

1. an invest of money;
2. in a common enterprise
3. with an expectation of profits
4. solely from the efforts of others.
5. Also, is timing of benefit/profit an issue?

The Risk Capital Test

Does the token purchaser have:

1. actual or practical control
2. over the managerial decisions of the promoter/third-party?
3. Timing of “benefit” to investor matters

Token Design

Asset-like Characteristics

- provides inherent use and value
- Which lessens the chance that it will be considered a security.
- The more functionality, the more likely a token is to be deemed an asset.
- Also decreasing the likelihood that the token was purchased with an expectation of profits, derived solely from the efforts of others.

Functionality

Tokens created for specific use, will have rights built into them. Examples include the right to:

- Create, deploy, and operate on foundational technology
- Program, develop, or create functionalities on the new protocol, platform, or dApp;
- Access to sell and/or license the technology;
- Use the technology and its outputs;
- Sell or acquire products/services on the network; and
- Vote on additions to or deletions from technology features and functionality.

Asset-like Characteristics & Functionality Combined

- These features provide 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?

What is not a legal test for whether a token is an investment contract?

1. DOES THE TOKEN PURCHASER RECEIVE ANY **BENEFITS** FROM THE PURCHASE OF A TOKEN? (UNITED HOUSING— PURCHASER RECEIVED BENEFITS AND THE SALE OF “STOCK” WAS NOT DEEMED TO BE THE SALE OF A SECURITY)
2. CAN THE TOKEN PURCHASER **RESELL** THE TOKEN FOR A **PROFIT**? (GARY PLASTIC— DOES THE ISSUER OF TOKENS ASSIST IN SECONDARY MARKET MAKING)
3. IS THE TOKEN PURCHASER PURCHASING THE TOKEN **BEFORE** THE PLATFORM ON WHICH IT WILL BE DEPLOYED IS FULLY FUNCTIONAL?

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”.
- ▶ 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 token is designed, developed and deployed by the purchaser/participants—not third parties.
- ▶ It is incumbent upon the purchaser/participants 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”. One vehicle through which this can be effected is a Cooperative.

What is a cooperative?

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

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

Principles of Cooperative

- Voluntary and open membership
- Democratic member control
- Member economic participation
- Autonomy and independence
- Education, training, information
- Cooperation among Cooperatives
- Development of token interpolation/interoperability technology

Legal Focus of Howey Test

Four main questions at issue

Why is the purchaser buying the token?

What constitutes expectation of profits?

What level of effort satisfies “efforts of a promoter or third party”?

Is the purchaser expected to use or consume the token?

Legal Focus of Howey Test (continued)

Expectation of Profits

Can arise in 3 main scenarios:

1. Traditional equity/debt offering
2. Market Forces
3. Creation/realization of benefits

Efforts of Promoter/Third Party

- ▶ Within a Coop, token purchasers must also become a Coop member at the time of purchase, and therefore, the purchaser is also the issuer/promoter.
- ▶ Marketing is devoted to potential participants who commit to helping design, develop, and deploy ecosystem

Legal Focus of Risk Capital Test

In California

- 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.

In Washington

- 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. (But is at odds with the Gary Plastic case).

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" 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.

What is not a legal test for whether a token is an investment contract?

1. DOES THE TOKEN PURCHASER RECEIVE ANY **BENEFITS** FROM THE PURCHASE OF A TOKEN? (UNITED HOUSING— PURCHASER RECEIVED BENEFITS AND THE SALE OF “STOCK” WAS NOT DEEMED TO BE THE SALE OF A SECURITY)
2. CAN THE TOKEN PURCHASER **RESELL** THE TOKEN FOR A **PROFIT**? (GARY PLASTIC— DOES THE ISSUER OF TOKENS ASSIST IN SECONDARY MARKET MAKING)
3. IS THE TOKEN PURCHASER PURCHASING THE TOKEN **BEFORE** THE PLATFORM ON WHICH IT WILL BE DEPLOYED IS FULLY FUNCTIONAL?

United Housing & Legal Test

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 efforts and (2) the tenant stock purchasers had the ability to resell the stock for a profit *United Housing*, 421 U.S. at 856-858.

United Housing & Legal Test (continued)

Benefit Received by *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.”*
- **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.”*
- **Community Atmosphere**
- **Can resell shares at a profit and it 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...**”*

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”

- Coop must be able to ensure that any economic benefit to members/token purchasers is created by the efforts and contributions of the membership

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

If 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 Coop—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.

Steps to create & sell a non-security token

1. 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.
2. Create a **token** with utility that can be used or consumed within the ecosystem to benefit the token holder.
3. **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.
4. Require that token purchasers currently are, or as part of their purchase become, Cooperative **members**.
5. Have the members **vote**, build out, design, and develop the ecosystem.
6. **Deploy** the token within the member-developed ecosystem/platform and enjoy the benefits!

Why the 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.
- 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 own level of work.
- The entity structure is designed to incentivize token holders to *use* and *deploy* the token rather than engage in price speculation.



CONTACT : DOtto@martindavislaw.com



LINKEDIN: David M. Otto



WEBSITE : martindavislaw.com



PHONE NUMBER : 206-906-9346 ext.1

THANK YOU!