The Law and Guidance Behind Cryptographic Tokens

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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

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The Seminal Security Cases

- The four-part Howey Test:
  1. The United Housing Foundation, Inc. v. Forman
  2. Noa v. Key Futures, Inc.
  3. SEC v. Edwards
  4. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc./Marine Bank v. Weaver

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United Housing Foundation, Inc. v. Forman

- Tenants of a low-income, cooperative housing project brought suit and alleged violations of federal securities laws.
- Purchasing an apartment in the Co-op City housing cooperative, a prospective purchaser had to buy 18 shares of stock in an associated nonprofit, cooperative housing corporation.
- The Court Found
  1. The income received by the cooperative in these external leases was "far too speculative and insubstantial to bring the entire transaction within the Securities Act."12
  2. When the instrument sold is deemed a security, the investor is "attracted solely by the prospects of the return" on his investment.
  3. By contrast, when a purchaser is motivated by 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." 13
  4. Dollar value "spent" between subsidized housing and market rate housing not deemed to be "substantial" enough for the purchase/sale transaction to be deemed an "investment contract" and, therefore, a security.

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Noa v. Key Futures, Inc.

- Key Futures sold silver bars; the buyers brought action against Key Futures.
- The Court held that the agreements to sell the silver bars were not investment contracts
- The Ninth Circuit found no expectation of profits from the efforts of others [once the purchase occurred the investors' profits depended on the fluctuations of the silver market— or market forces— and not the managerial efforts of Key Futures.]

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SEC v. Edwards

- Edwards, founded a company that sold pay telephones and leased the pay phones back from the purchasers for a fixed monthly fee.
- The SEC sued Edwards after filing for bankruptcy for the for selling unregistered securities, among other securities law violations asserting the buyers purchased the telephones as an investment as defined in the Exchange Act and clarified in Howey.
- The question at issue was whether the Exchange Act definition of "investment contract" included an investment opportunity where the promoter promised a fixed rate of return.
- In a unanimous opinion, the Supreme Court held that an investment scheme promising a fixed rate of return can be an "investment contract," and thereby a "security" subject to U.S. federal securities laws.
- The Court stated that the Howey Test's expectation of profits prong does not distinguish between fixed or variable rates of return, but that the expectation of profits derived from the efforts of others

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Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.

- Gary Plastic brought a securities fraud action against Merrill Lynch alleging that certificates of deposit Gary Plastic bought were "securities." Gary Plastic alleged that Merrill Lynch told prospective customers that it held negotiable, insured and liquid $100,000 CDs, for which it would maintain a secondary market.
- Merrill Lynch also advertised that it screened daily a large group of banks to provide its customers with CDs with "competitive" yields from a variety of issuers.
- The SEC has interpreted Gary Plastic to stand for the proposition that, where an issuer provides and maintains a secondary market for a financial instrument, the purchaser's expectation of profits is derived from the issuer's work in maintaining a secondary market, thereby enabling the purchaser to realize a profit on its purchase, and thereby making the instrument an investment contract.[14]

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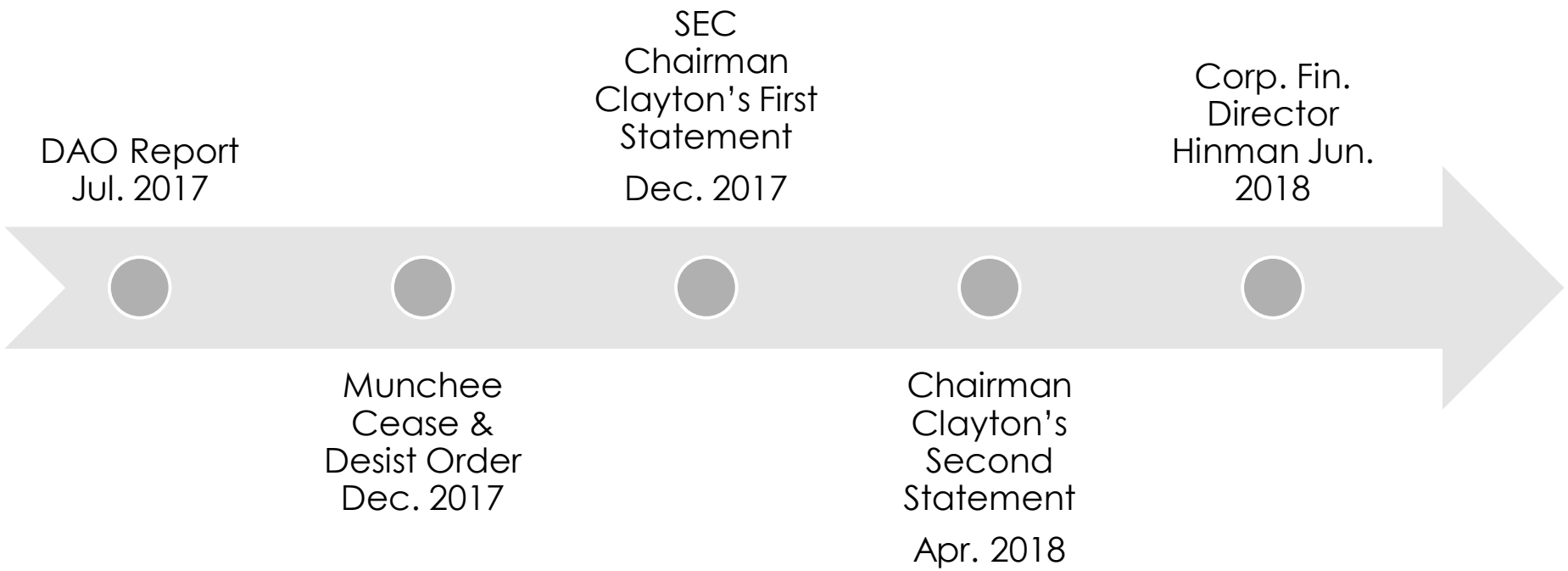
Guidance from the SEC



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The DAO Report

- In August 2017, the SEC published an investigative report on the DAO ICO, designating the DAO tokens as securities based on the agency's analysis of the Howey Test.[16]
- The SEC's report focused on who — between the issuing entity and the token purchasers — had "meaningful control" over
  1. The operation of the business operation;
  2. and the use and deployment of the asset, when determining whether investors' expectations of profit were derived from the efforts of others. In discussing whether the token holders' expectations of profits were "derived from the managerial efforts of others," the SEC looked to the lack of meaningful management opportunities, voting decisions, and communications capabilities given to the DAO token holders.
- The SEC determined that the DAO token purchasers had invested in investment contracts and, therefore, the DAO tokens were securities.
- The SEC pointed to the fact that Slock.it and its cofounders had significant control over the enterprise and that DAO token holders had limited voting rights. Slock.it selected "Curators," individuals who had substantial power within the enterprise, to confirm that:
  1. proposals for funding originated from an identifiable person or organization;
  2. and the smart contracts associated with any such proposal properly reflected the code a contractor (someone who submitted proposals to the DAO entity) claimed to have deployed on the Ethereum Blockchain.
- Importantly, the curators — not the token holders — determined the criteria used to select proposals for a vote by the token holders.
- The SEC concluded that the token holders' voting power was not meaningful because their ability to vote was a perfunctory one and the use of pseudonymous identities inhibited token holders' ability to communicate and coordinate with other token holders.

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The Munchee Cease & Desist Order

- The SEC found that Munchee's sale of its MUN token constituted the sale of securities, due in part to:
  1. Munchee's marketing/selling 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.[18]
- Munchee published marketing material promoting the MUN token as an investment by telling MUN purchasers that the company would place the MUN in secondary markets as a way for the MUN to generate more value.
- The SEC found that, even if MUN had immediate utility that allowed MUN holders to pay for meals and to leave reviews when they received tokens, the SEC would still look to the "economic realities" of the purchase transaction.
- This would determine whether purchasers bought MUN as an investment to hold and wait for MUN to build value or to realize 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.

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Chairman Clayton's First Statement

- In a public statement on cryptocurrencies and initial coin offerings (ICOs) on December 11, 2017,[19] SEC Chairman Jay Clayton gave an example of an ICO that would likely NOT implicate securities laws.
  - This example describes a book-of-the-month club ICO where the club operators create an efficient way to fund the future acquisition of books and to facilitate the distribution of books to token holders.
- Clayton went on to say that one hallmark of a security and a securities offering exists when token purchasers are promised a secondary market for which to immediately trade their tokens; thereby implying the tokens' value is derived from holding or trading the token, not by deploying the token in the issuer's ecosystem. Clayton's statement was the first time that the SEC openly articulated that there is a way for a token to be issued that doesn't implicate securities laws.

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Chairman Clayton's Second Statement

- In a second public statement, in April 2018 by Clayton at a talk at Princeton University on "Cryptocurrency and Initial Coin Offerings,"
- Clayton used an analogy to describe the difference between a utility token and a security token:
  - If I have a laundry token for washing my clothes, that's not a security. But if I have a set of 10 laundry tokens and the laundromats are to be developed and those are offered to me as something I can use for the future and I'm buying them because I can sell them to next year's incoming class, that's a security.
- Clayton also suggested that a token's classification as a security or as an asset can change over time. "What we find in the regulatory world [is that] the use of a laundry token evolves over time," he continued, "[t]he use can evolve toward or away from a security."

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SEC Director of Corp. Finance Hinman's Statement

- At a Yahoo Finance conference in June, William Hinman, the SEC's director of corporate finance, gave a statement that further demonstrated the SEC's evolving views on cryptocurrency.20 Hinman stated that offers and sales of Bitcoin ("BTC") and Ether ("ETH"), in their current states, are no longer securities transactions.
- Such transactions are no longer securities transactions because the ecosystems in which both tokens transact are "sufficiently decentralized," which he defined as an ecosystem "where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts." Accordingly, the SEC's position is that, with large enough network usage, a token that is initially deemed to be a security can morph into a non-security.
- Hinman's statements regarding the fact that a purchase or sale of a token may not implicate federal securities laws are in line with Clayton's statements, where a token dedicated for use within a certain ecosystem and sold to a reasonably narrow group of people interested in using the token within that ecosystem will likely not implicate securities laws.
- The notion that a token formerly deemed to be a security may have its securities designation changed if the ecosystem in which it transacts becomes sufficiently decentralized is a novel concept set forth by the SEC, and one that elicits many questions as to the process or mechanisms required to enable the designation change.
- Additionally, Hinman provided the factors in the table below to assist an analysis as to whether a token is a security.

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Factors Likely to Indicate That a Token Is an Investment Contract	Factors to Analyze Whether the Digital Asset Functions As a Consumer Item v. a Security
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?	1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
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?	2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
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?	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 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?	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. 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?	5. Is the asset marketed and distributed to potential users or the general public?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?	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?

Differing Standards

Case or Guidance:	Required Analysis to Determine Whether a Token is an Investment Contract
Howey	Contribution; Self-Determination; Own and Occupy the Project
United Housing	Use and Consumption; Primary Purpose of Investment
Noa	Market Forces; Need for "Third Parties" to Participate
Gary Plastic	Promise to Create Secondary Market; Issuer-Maintained Secondary Market
The DAO Report	Participation; Voting Rights
Munchee	Marketing; Targeting Purchasers and Narrow Group of Potential Users
Clayton's Statements	Immediate/ Existing Utility; Timing
Hinman's Statement	Tokens that are Sufficiently Decentralized constitute digital currency – not securities

The table above summarizes the general "requirements" for which each SEC enforcement action or SEC guidance stands.

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To What Extent Can Potential Issuers Rely on the SEC's Contemporary Orders & Statements?

For various economic, geopolitical and social reasons, SEC regulation must not unduly stifle blockchain innovation. At present, indecisiveness and incomplete or conflicting guidance are creating uncertainty among many viable blockchain/tokenization projects. Until the SEC, or any other regulator, clarifies and creates an official process for token issuers to issue tokens that are not deemed to be securities, current and prospective token issuers are left balancing on the high wire.

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THANK YOU!

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