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Securities Regulation and Initial Coin Offerings: A Legal Primer

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SUMMARY

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Securities Regulation and Initial Coin Offerings: A Legal Primer

Initial coin offerings (ICOs)—a method of raising capital in exchange for digital coins or tokens that entitle their holders to certain rights—are a hot topic among legislators, regulators, and financial market professionals. In response to a surge in the popularity of ICOs over the past 18 months, regulators in a number of countries have banned ICOs. Other foreign regulators have cautioned that unregistered ICOs may violate their securities laws, issued guidance clarifying the application of their securities laws to ICOs, or proposed new rules or legislation directed at regulating ICOs. ICOs have also attracted the attention of U.S. securities regulators. The Securities and Exchange Commission (SEC) has cautioned that depending on their specific features, ICOs may qualify as offerings of "securities" subject to federal regulation.

Whether an ICO involves an offering of "securities" has important legal consequences. Section 5 of the Securities Act of 1933 (Securities Act) requires issuers of securities to register their offerings with the SEC or conduct them pursuant to a specific exemption from registration. Issuers and sellers of securities also face anti-fraud liability under the Securities Act and the Securities Exchange Act of 1934 (Exchange Act). The SEC has the authority to investigate and punish violations of the securities laws, and has indicated that it will "vigorously" police the burgeoning ICO market for such violations.

To determine whether a transaction involves an offering of "securities," courts employ a four-part test outlined by the Supreme Court's 1946 decision in *SEC v. W.J. Howey Co*. Under that test, a transaction qualifies as an offering of "securities" if it involves (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profit, (4) to be derived from the efforts of others. In applying the *Howey* test, the Court has emphasized the importance of analyzing "the economic realities" of a transaction, as opposed to its form or the label that its promoters give it.

Because ICOs are incredibly diverse, it is impossible to draw broad conclusions about their status under the securities laws, which will depend on fact-intensive inquiries into details that vary among different ICOs. As a general matter, though, ICOs are more likely to qualify as offerings of "securities" when token purchasers (1) are motivated primarily by a desire for financial returns (as opposed to a desire to use or consume some good or service for which tokens can be exchanged), and (2) lack a meaningful ability to control the activities on which their profits will depend. In light of these principles, attorneys have developed a method for structuring ICOs—the Simple Agreement for Future Tokens (SAFT)—that attempts to avoid classification of the tokens issued pursuant to certain ICOs as "securities." However, whether the SAFT achieves its intended goal remains subject to significant debate.

The SEC has pursued a number of enforcement actions related to unregistered ICOs. In July 2017, the SEC issued a report of investigation concluding that tokens issued by an unincorporated organization called "The DAO" qualified as "securities" under the *Howey* test. And in December 2017, the agency reached the same conclusion about tokens issued by Munchee, Inc., the creator of an iPhone application involving restaurant reviews. These enforcement actions, and a prominent speech given by an agency official in June 2018, offer some guidance on the SEC's views on when ICOs will qualify as offerings of "securities."

The Securities Act and related regulations offer a number of exemptions from the Act's registration requirements for offerings that meet certain conditions. However, some commentators have doubted the attractiveness of the relevant exemptions for ICOs. Commentators have also proposed a number of policies to improve the regulation of ICOs, ranging from a specific registration exemption for ICOs to a "safe harbor" for certain token exchanges.

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Initial coin offerings (ICOs) are a hot topic among federal legislators,[1] regulators,[2] financial market professionals,[3] and even athletes[4] and celebrities.[5] An ICO is a method of raising capital in exchange for digital "coins" or "tokens" that entitle their holders to certain rights.[6] The promoter of an ICO may raise capital to develop a digital platform, software, or other projects, and the tokens issued pursuant to the ICO may entitle their holders to access the platform, use the software, or share in any profits generated by the projects.[7] In many cases, these tokens may be resold to others in a secondary market via virtual currency exchanges or other platforms.[8] ICOs have been described as "a new form of crowdfunding" that startups and other online businesses can use to raise money without issuing stock or obtaining venture capital funding.[9]

The popularity of ICOs has surged over the past 18 months. According to one report, total ICO fundraising in 2017 has been estimated as ranging between $5.6 billion and $6.5 billion,[10] up

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[1] *See* Kia Kokalitcheva, *Congress Holds First Hearing on Initial Coin Offerings*, AXIOS (Mar. 14, 2018), https://www.axios.com/crypto-ico-congress-1521059028-8807c852-22de-461a-8c9e-8a8a9f85d452.html.

[2] *See* Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, SEC. AND EXCH. COMM'N (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 [hereinafter "Clayton Statement"].

[3] *See* Yuji Nakamura, *Startups Are Raising Billions Using Initial Coin Offerings*, BLOOMBERG (Jan. 22, 2018), https://www.bloomberg.com/news/articles/2018-01-22/startups-are-raising-billions-using-initial-coin-offerings; Paul Vigna, *Forget an IPO, Coin Offerings Are New Road to Startup Riches*, WALL ST. J. (July 7, 2017), https://www.wsj.com/articles/forget-an-ipo-coin-offerings-are-new-road-to-startup-riches-1499425200; Nathaniel Popper, *Easiest Path to Riches on the Web? An Initial Coin Offering*, N.Y. TIMES DEALBOOK (June 23, 2017), https://www.nytimes.com/2017/06/23/business/dealbook/coin-digital-currency.html.

[4] *See* Arjun Kharpal, *Founders of Cryptocurrency Backed by Floyd Mayweather Charged with Fraud by SEC*, CNBC (Apr. 3, 2018), https://www.cnbc.com/2018/04/03/floyd-mayweather-backed-cryptocurrency-ico-fraud-sec-says.html; Josiah Wilmoth, *Boxing Legend Manny Pacquiao Latest Celebrity to Turn ICO Promoter*, YAHOO! FINANCE (Mar. 20, 2018), https://finance.yahoo.com/news/boxing-legend-manny-pacquiao-latest-153935042.html.

[5] *See* Frank Chaparro, *A Crypto Company Touted by Rapper The Game Just Got Hit with a Lawsuit from Investors Who Want Their Money Back*, BUS. INSIDER (Jan. 31, 2018), http://www.businessinsider.com/crypto-company-paragon-faces-lawsuit-from-investors-who-want-their-money-back-2018-1; Robert Hackett, *DJ Khaled Is the Latest Celebrity to Endorse an Ethereum ICO*, FORTUNE (Sept. 28, 2017), http://fortune.com/2017/09/28/ethereum-bitcoin-cryptocurrency-ico-dj-khaled/; Rachel Rose O'Leary, *Hotel Heiress Paris Hilton Is the Latest Celebrity to Promote an ICO*, COINDESK (Sept. 4, 2017), https://www.coindesk.com/hotel-heiress-paris-hilton-is-the-latest-celebrity-to-promote-an-ico/. *See also SEC Statement Urging Caution Around Celebrity Backed ICOs*, SEC. AND EXCH. COMM'N (Nov. 1, 2017), https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos.

[6] *See Investor Bulletin: Initial Coin Offerings*, SEC. AND EXCH. COMM'N (July 25, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings [hereinafter "Investor Bulletin"].

[7] *Id*. Often, the promoters of an ICO will describe the projects they intend to pursue in a "white paper" that is distributed to prospective token purchasers. *See* Chris Brummer, *What Should Be in an ICO White Paper? Expert Take*, COIN TELEGRAPH (Mar. 14, 2018), https://cointelegraph.com/news/what-should-be-in-an-ico-white-paper-expert-take.

Given their relative novelty, there is not an extensive body of literature analyzing the types of projects that ICOs fund. According to a taxonomy offered in an analysis of 253 ICOs conducted between 2014 and August 2017, "financial services" or "fintech" projects accounted for the largest share of ICOs, followed by projects concerning "smart contracts," "high tech services," and "marketplaces and exchanges." *See* Saman Adhami, Giancarlo Giudici & Stefano Martinazzi, *Why Do Businesses Go Crypto? An Empirical Analysis of Initial Coin Offerings*, J. OF ECON. AND BUS. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3046209. However, no single category of projects exceeded 15.4 percent of all of the ICOs analyzed, suggesting that ICOs have been used to fund a diverse array of activities. *Id*.

[8] Investor Bulletin, *supra* note 6.

[9] Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html.

[10] *See* Gerelyn Terzo, *SEC Targets ICOs in Broad Cryptocurrency Markets Investigation*, CRYPTO COINS NEWS (Mar. 1, 2018), https://www.ccn.com/sec-targets-icos-in-broad-investigation/.

from $225 million in 2016.[11] According to an estimate from Goldman Sachs, ICO funding of Internet companies during certain periods in 2017 exceeded early-stage venture capital funding of such businesses.[12] This general trend has continued in 2018. One estimate puts the total proceeds generated by ICOs in 2018 at over $14 billion as of the publication of this report.[13] Commentators have attributed this surge in popularity to, among other things: (1) large increases in the value of virtual currencies like Bitcoin, which investors can often exchange for new virtual currencies issued pursuant to an ICO and thereby diversify their holdings;[14] (2) enthusiasm about the blockchain technology involved in the projects funded by certain ICOs;[15] and (3) large returns that certain ICOs have provided to early token purchasers.[16]

Some commentators have expressed enthusiasm about the rise of ICOs, noting their potential to "energize and democratize start-up funding" by offering retail investors the opportunity to participate in the early-stage funding of new businesses.[17] Other observers have expressed

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[11] *See* Steven Russolillo, *Initial Coin Offerings Surge Past $4 Billion—and Regulators Are Worried*, WALL ST. J. (Dec. 14, 2017), https://www.wsj.com/articles/initial-coin-offerings-surge-past-4-billionand-regulators-are-worried-1513235196.

Two ICOs conducted in 2017—by the blockchain companies Filecoin and Tezos, which raised $257 million and $232 million, respectively—each individually exceeded the total amount of money raised in all ICOs conducted the previous year. *See* Oscar Williams-Grut, *The 11 Biggest ICO Fundraises of 2017*, BUS. INSIDER (Jan. 1, 2018), http://www.businessinsider.com/the-10-biggest-ico-fundraises-of-2017-2017-12/?r=UK&IR=T/#11-salt-48-million-1.

While ICO proceeds have increased rapidly, they are still considerably smaller than the proceeds generated from initial public offerings (IPOs) of stock. For purposes of comparison, IPOs generated $33.5 billion in the U.S. and $188.8 billion globally in 2017. *Value of IPOs in the United States from 2000 to 2017*, STATISTA, https://www.statista.com/statistics/264607/ipo-volume-in-the-us/; *Global IPO trends: Q4 2017*, EY, http://www.ey.com/Publication/vwLUAssets/ey-global-ipo-trends-q4-2017/%24FILE/ey-global-ipo-trends-q4-2017.pdf.

[12] Arjun Kharpal, *Initial Coin Offerings Have Raised $1.2 Billion and Now Surpass Early Stage VC Funding*, CNBC (Aug. 9, 2017), https://www.cnbc.com/2017/08/09/initial-coin-offerings-surpass-early-stage-venture-capital-funding.html.

[13] *ICO Tracker, Summary Stats*, COINDESK, https://www.coindesk.com/ico-tracker/ (last accessed Aug. 20, 2018).

[14] Chance Barnett, *Inside the Meteoric Rise of ICOs*, FORBES (Sept. 23, 2017), https://www.forbes.com/sites/chancebarnett/2017/09/23/inside-the-meteoric-rise-of-icos/#1bfb08c5670c.

Bitcoin was created in 2008 by an unidentified programmer (or group of programmers) as the world's first decentralized virtual currency, and is the largest virtual currency by market capitalization. *See* JERRY BRITO & ANDREA CASTILLO, BITCOIN: A PRIMER FOR POLICYMAKERS 1, 3 (2013); *All Cryptocurrencies*, COINMARKETCAP (last accessed Aug. 20, 2018), https://coinmarketcap.com/all/views/all/. The price of Bitcoin skyrocketed in 2017 from a low of roughly $750 in January to a high of $17,900 in December. *See* Jonathan Garber, *Bitcoin is Having Trouble Getting Through $900*, BUS. INSIDER (Jan. 19, 2017), http://www.businessinsider.com/bitcoin-price-january-19-2017-2017-1; Jemima Kelly, *Bitcoin Hits New Record High as Warnings Grow Louder*, REUTERS (Dec. 15, 2017), https://www.reuters.com/article/us-global-markets-bitcoin/bitcoin-hits-new-record-high-as-warnings-grow-louder-idUSKBN1E919T.

[15] For a general overview of blockchain technology, *see* CRS Report R45116, *Blockchain: Background and Policy Issues*, by Chris Jaikaran.

[16] *See* Barnett, *supra* note 14 (noting returns on investment of 84,720 percent, 54,038 percent, and 2,720 percent as of September 2017 for ICOs conducted by Ethereum, Stratis, and Augur, respectively). *See also ROI Since ICO*, ICO STATS, https://icostats.com/roi-since-ico (identifying 13 ICOs with returns on investment exceeding 500 percent as of August 20, 2018, with the highest return at 598,054 percent).

[17] Jay Preston, *Initial Coin Offerings: Innovation, Democratization and the SEC*, 16 DUKE L. & TECH. REV. 318, 331 (2018). *See also* Saheli Roy Choudhury, *Billionaire CEO Taizo Son Predicts that ICOs will Come to Dominate Fundraising*, CNBC (Sept. 20, 2017), https://www.cnbc.com/2017/09/20/ico-cryptocurrency-will-become-major-funding-source-billionaire-taizo-son-says.html.

skepticism, raising concerns about fraud,[18] market manipulation,[19] and cybersecurity.[20] Regulators are likewise divided in their approaches to ICOs. China and South Korea have banned ICOs altogether,[21] and policymakers in a number of other countries have warned that certain unregistered ICOs may run afoul of their securities laws.[22] Other countries have developed proposed rules or legislation specifically directed at regulating ICOs,[23] while still others have released guidance clarifying the application of existing laws to ICOs.[24]

U.S. securities regulators have also actively monitored the rise of ICOs. The Securities and Exchange Commission (SEC) has cautioned that depending on their features, ICOs may qualify as offerings of "securities" subject to federal regulation under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act).[25] The Chairman of the SEC has indicated that the agency's Division of Enforcement will "vigorously" police ICOs for violations of the Acts' registration and anti-fraud provisions.[26] Consistent with this representation, the SEC has brought a number of enforcement actions related to unregistered and fraudulent

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[18] *See* Shane Shifflett & Coulter Jones, *Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud*, WALL ST. J. (May 17, 2018), https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115; Arjun Kharpal, *Cryptocurrency Scammers Run Off with More than $2 Million After Ditching their Investors*, CNBC (Mar. 12, 2018), https://www.cnbc.com/2018/03/09/cryptocurrency-scammers-of-giza-make-off-with-2-million-after-ico.html; John Wasik, *Why Millenials Are At High Risk for Bitcoin & ICO Fraud*, FORBES (Mar. 5, 2018), https://www.forbes.com/sites/johnwasik/2018/03/05/why-millennials-are-at-high-risk-for-bitcoin-ico-fraud/#269381e985ea; David Z. Morris, *The Rise of Cryptocurrency Ponzi Schemes*, THE ATLANTIC (May 31, 2017), https://www.theatlantic.com/technology/archive/2017/05/cryptocurrency-ponzi-schemes/528624/.

[19] Jay Clayton, *Governance and Transparency at the Commission and in Our Markets*, Remarks at the PLI 49th Annual Inst. on Sec. Reg., SEC. AND EXCH. COMM'N (Nov. 8, 2017), https://www.sec.gov/news/speech/speech-clayton-2017-11-08.

[20] *See EY Research: Initial Coin Offerings (ICOs)*, EY (Dec. 2017), http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/$File/ey-research-initial-coin-offerings-icos.pdf (estimating that more than 10 percent of ICO proceeds have been lost as a result of hacking).

[21] *See* Oscar Williams-Grut, *South Korea Bans ICOs*, BUS. INSIDER (Sept. 29, 2017), http://www.businessinsider.com/ico-south-korea-bans-icos-2017-9; Jon Russell, *China Has Banned ICOs*, TECHCRUNCH (Sept. 4, 2017), https://techcrunch.com/2017/09/04/chinas-central-bank-has-banned-icos/.

[22] *See* Media Statement on Initial Coin Offerings, SEC. COMM'N MALAYSIA (Jan. 5, 2018), https://www.sc.com.my/post_archive/statement-on-initial-coin-offerings/; *Mexican authorities warn cryptocurrency offerings could be a crime*, REUTERS (Dec. 13, 2017), https://www.reuters.com/article/us-markets-bitcoin-mexico/mexican-authorities-warn-cryptocurrency-offerings-could-be-a-crime-idUSKBN1E72GV; Initial Coin Offerings, U.K. FIN. CONDUCT AUTH. (Dec. 9, 2017), https://www.fca.org.uk/news/statements/initial-coin-offerings; Jeff John Roberts, *Canada Pours Cold Water on "Initial Coin Offerings,"* FORTUNE (Aug. 28, 2017), *MAS Clarifies Regulatory Position on the Offer of Digital Tokens in Singapore*, MONETARY AUTH. OF SINGAPORE (Aug. 1, 2017), http://www.mas.gov.sg/News-and-Publications/Media-Releases/2017/MAS-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-Singapore.aspx.

[23] Ryan Browne, *Japan is Planning New Rules for Legalizing Controversial Cryptocurrency Fundraising*, CNBC (Apr. 5, 2018), https://www.cnbc.com/2018/04/05/japan-proposes-guidelines-to-legalize-icos.html; Hannah Murphy & David Keohane, *France Plans Rules to Lure Cryptocurrency Business*, FIN. TIMES (Mar. 22, 2018), https://www.ft.com/content/2e7b2778-2d22-11e8-9b4b-bc4b9f08f381; Wolfie Zhao, *Russian Finance Ministry Proposes Draft Law on ICO Regulation*, COINDESK (Jan. 26, 2018), https://www.coindesk.com/russian-finance-ministry-proposes-draft-law-on-ico-regulation/.

[24] *See Initial Coin Offerings: BaFin Publishes Advisory Letter on the Classification of Tokens as Financial Instruments*, FED. FIN. SUP. AUTH. (Mar. 28, 2018), https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2018/meldung_180213_ICOs_Hinweisschreiben_en.html;jsessionid=D4CFFA2088304431A9DB4D91E711B581.1_cid381; Ralph Atkins, *Switzerland Sets Out Guidelines to Support Initial Coin Offerings*, FIN. TIMES (Feb. 16, 2018), https://www.ft.com/content/52820f90-1307-11e8-940e-08320fc2a277.

[25] *Initial Coin Offerings*, SEC. AND EXCH. COMM'N, https://www.sec.gov/ICO; Clayton Statement, *supra* note 2.

[26] Clayton Statement, *supra* note 2.

ICOs,[27] and has reportedly issued a number of subpoenas to other token issuers.[28] While the SEC's enforcement efforts do not present a complete picture of the agency's views on when ICOs will qualify as offerings of "securities," they provide insight into the agency's general approach to these transactions.

This report discusses the principles that the SEC and courts[29] use to determine whether a transaction qualifies as an offering of "securities" under the Securities Act and the Exchange Act, and the application of those principles to ICOs. First, the report discusses the four-part test guiding that inquiry that the Supreme Court adopted in the 1946 case *SEC v. W.J. Howey Co*.[30] The report provides an overview of each of the four *Howey* requirements and discusses their application to ICOs. Second, the report reviews a popular method for structuring ICOs—the Simple Agreement for Future Tokens (SAFT)—that has been developed with the goal of allowing the tokens issued pursuant to certain ICOs to trade free from SEC oversight. Third, the report provides an overview of two prominent SEC enforcement actions concerning ICOs and a recent speech given by the Director of the SEC's Division of Corporation Finance that offer some guidance as to how the agency will apply the *Howey* test to ICOs. Fourth, the report examines a number of exemptions from the Securities Act's registration requirements and discusses their possible application to ICOs. Finally, the report reviews a number of legal changes that Congress could consider concerning the regulation of ICOs.[31]

The Securities Act and the Exchange Act

Whether an ICO involves an offering of "securities" has important legal implications. Under Section 5 of the Securities Act, an issuer of "securities" must either (1) file a registration statement with the SEC containing a variety of information about the issuer and its business, or (2) conduct the offering pursuant to a specific exemption from registration.[32] Commentators have noted that many businesses regard the detailed and complex disclosures required in registration statements, and the large fees charged by securities lawyers, as burdensome.[33] Federal law also imposes anti-fraud liability on certain securities transactions, as issuers and sellers of securities are liable to buyers for false statements and misleading omissions in prospectuses and registration statements.[34]

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[27] SEC Release No. 3-18304, *In the Matter of Munchee, Inc.*, (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf [hereinafter the "Munchee Order"]; SEC Release No. 81207, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf [hereinafter the "DAO Report"].

[28] *See* Jean Eaglesham & Paul Vigna, *Cryptocurrency Firms Targeted in SEC Probe*, WALL ST. J. (Feb. 28, 2018), https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266?mod=searchresults&page=1&pos=1.

[29] As of the publication of this report, few courts have evaluated the application of the federal securities laws to ICOs. *See* Rensel v. Centra Tech, Inc., No. 17-cv-24500, 2018 U.S. Dist. LEXIS 106642 (S.D. Fla. June 25, 2018). However, courts are likely to be called upon to apply the Securities Act and the Exchange Act to ICOs in SEC enforcement actions and private litigation in the coming years.

[30] 328 U.S. 293 (1946).

[31] This report is limited to a discussion of federal securities law and does not address the application of state securities laws to ICOs. While the report does not extensively discuss the application of commodity and derivatives regulations to ICOs, the role of the Commodity Futures Trading Commission in regulating virtual currencies is addressed briefly in "Regulatory Structure" *infra*.

[32] 15 U.S.C. §§ 77e-77f.

[33] *See* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 56 (6th ed. 2014).

[34] 15 U.S.C. §§ 77k-77l. By contrast, contract law ordinarily adopts the "buyer beware" principle, according to which

On top of the requirements imposed by the Securities Act, the Exchange Act imposes certain continuous disclosure obligations on securities issuers and anti-fraud liability on securities issuers and sellers.[35] Moreover, the platforms on which securities trade must register with the SEC as "securities exchanges" in certain circumstances.[36] The SEC has the authority to investigate violations of the Securities Act and the Exchange Act and to impose civil monetary penalties and certain other remedies against persons who violate either Act.[37]

These disclosure and anti-fraud requirements are widely viewed as protecting investors and promoting the accurate pricing of securities, which in turn facilitates the efficient allocation of capital.[38]

The *Howey* Test

As discussed, in order for the registration and anti-fraud requirements of the Securities Act and the Exchange Act to apply, a transaction must involve the offer or sale of "securities." The Securities Act defines the term "security" broadly as encompassing a range of specified financial products, including "investment contract[s],"[39] a "[c]atchall phrase[] . . . included to cover unique instruments not easily classified."[40] The Act does not define the term "investment contract," and its legislative history does not significantly clarify the term's meaning.[41] In 1946, the Supreme Court outlined a four-part test (shown in **Figure 1**) for determining whether a transaction qualifies as an "investment contract" within the meaning of the Act. In *SEC v. W.J. Howey Co.*, the Court explained that a transaction is an "investment contract" when it involves (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profit, (4) to be derived solely from the efforts of others.[42]

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sellers generally do not have affirmative disclosure obligations. *See* RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. a; 28 CORBIN ON CONTRACTS § 28:35; NICHOLAS L. GEORGAKOPOULOS, THE LOGIC OF SECURITIES LAW 21-22 (2017). *See also* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (explaining that one purpose of the federal securities laws is to "substitute a philosophy of full disclosure for the philosophy of *caveat emptor*").

[35] *See* 15 U.S.C. §§ 78o(d), 78j(b); 17 C.F.R. § 240.10b-5.

[36] 15 U.S.C. § 78f.

[37] *Id*. §§ 77h-1, 78u.

[38] *See The Role of the SEC*, SEC. AND EXCH. COMM'N, https://www.investor.gov/introduction-investing/basics/role-sec (identifying investor protection as part of the SEC's mission); H.R. REP. NO. 73-1383, pt. 2, at 5 (1934) ("As a complex society so diffuses . . . the financial interests of the ordinary citizen that he . . . cannot personally watch the managers of all his interests . . . it becomes a condition of the very stability of that society that its rules of law . . . protect that ordinary citizen's dependent position."); GEORGAKOPOULOS, *supra* note 34 at 143-46; Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L. J. 711, 714 (2006).

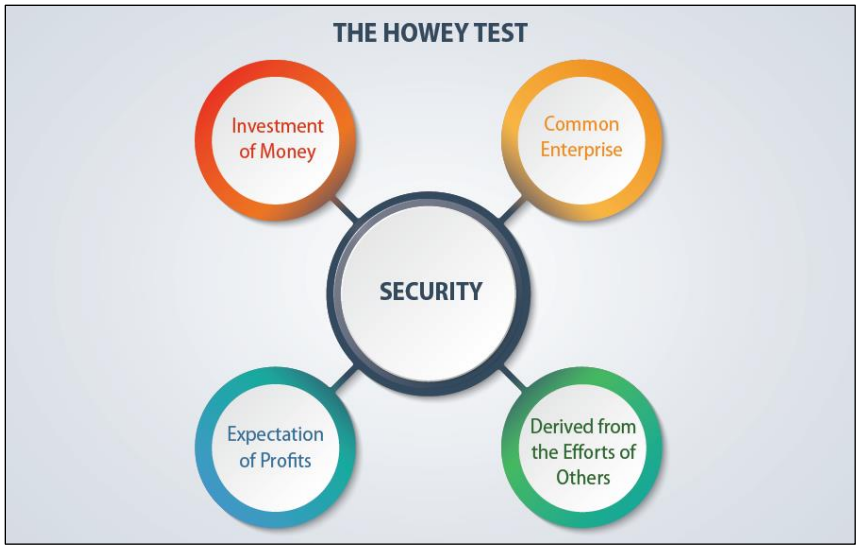
[39] The Securities Act defines "security" to mean "any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit, or group or index of securities . . . or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." 15 U.S.C. § 77b(a)(1) (emphasis added).

[40] Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982).

[41] *See* Steinhardt Grp. Inc. v. Citigroup, 126 F.3d 144, 150-51 (3d Cir. 1997) (explaining that the Securities Act's legislative history does not "illuminate what Congress intended by the term investment contract").

[42] *Howey*, 328 U.S. at 299. The Exchange Act contains a definition of the term "security" that is "virtually identical" to the term's definition in the Securities Act, including the use of the undefined term "investment contract." *See* 15 U.S.C. § 78c(a)(10); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). The Supreme Court has explained that for purposes of

Figure 1. The *Howey* Test



Source: CRS.

In *Howey*, a company sold investors tracts of land in a citrus grove coupled with ten-year service contracts pursuant to which the company agreed to cultivate the groves, harvest and market the fruit, and remit any profits to the investors.[43] The SEC brought an action to enjoin the company from offering the land sale and service contracts on the grounds that they qualified as unregistered "securities."[44] The Supreme Court agreed with the SEC and held that the scheme qualified as an offering of "securities" based upon the four-part test noted above.[45] The Court explained that because purchasers of the land and service contracts (1) invested money in citrus groves that "gain[ed] . . . utility only when cultivated and developed as component parts of a larger area," and (2) expected profits based on the management expertise and labor of others, the contracts qualified as "investment contracts" (and, by extension, "securities") within the meaning of the Securities Act.[46]

The Court has made clear that the *Howey* 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."[47] Accordingly, in applying the test, the Court has emphasized the importance of the "economic realities underlying a transaction,"[48] as opposed to a transaction's form or the name that its promoters give it.[49] Commentators have

evaluating whether a transaction qualifies as an "investment contract," the "coverage of the two Acts may be considered the same." United Hous. Found. v. Forman, 421 U.S. 837, 847 n.12 (1975). *See also* SEC v. Edwards, 540 U.S. 389, 393 (2004) (noting that the Court has treated the two definitions "as essentially identical in meaning").

[43] *Howey*, 328 U.S. at 294-95.

[44] *Id*.

[45] *Id*. at 301.

[46] *Id*.

[47] *Id.* at 299.

[48] *United Hous. Found.*, 421 U.S. at 849.

[49] Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) ("Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called."); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (explaining that "in searching for the meaning and scope of the word 'security' . . . form should be disregarded for substance and the emphasis should be on economic reality").

noted that "[t]he intentional breadth and adaptability" of the test "necessarily leads to complex and fact-intensive judicial inquiries" into a transaction's granular details.[50] Perhaps unsurprisingly, courts have concluded that a wide variety of financial arrangements qualify as "investment contracts" under the *Howey* test, ranging from pyramid schemes[51] and ice machine leases[52] to interests in earthworm farms[53] and chinchilla ranches.[54] Whether an ICO involves an offering of "securities" will accordingly depend primarily on its "economic realities" and not on its formal characteristics or the name given to the relevant coins or tokens.

Because the coins or tokens issued pursuant to ICOs are incredibly diverse,[55] and the *Howey* test's application depends upon highly fact-intensive evaluations of a transaction's specific features,[56] it is impossible to draw broad conclusions concerning the application of the *Howey* test to all ICOs. With that caveat in mind, the following subsections discuss the four parts of the *Howey* test and examine how possible features of specific ICOs may affect the test's application.

Investment of Money

Case Law

Under the first part of the *Howey* test, an agreement can qualify as an "investment contract"—and, by extension, a "security"—only if it involves an "investment of money."[57] One commentator has observed that parties "rarely litigate[]" this element of the *Howey* test,[58] and the Supreme Court's case law offers only limited guidance on the types of transactions that will satisfy it. The Court's decisions make clear that investments of cash will qualify as investments of "money" for purposes of this part of the *Howey* test.[59] At least one court has also held that an investment of virtual currency qualifies as an investment of "money."[60] In *SEC v. Shavers*, the U.S. District Court for the Eastern District of Texas held that a scheme pursuant to which individuals transferred Bitcoin to a promoter for use in a variety of "investment opportunities" involved an investment of "money" under *Howey*.[61] The court explained that based upon existing case law, "the primary consideration" under *Howey*'s "investment of money" requirement "is whether the purchaser was required to give up something of value in exchange for the promised consideration," rejecting the argument that *Howey*'s first prong is limited to the investment of

[50] Miriam R. Albert, *The* Howey *Test Turns 64: Are the Courts Grading This Test on a Curve?*, 2 WM. & MARY BUS. L. REV. 1, 8 (2011).

[51] SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 480 (9th Cir. 1973).

[52] Albanese v. Fla. Nat'l Bank of Orlando, 823 F.2d 408, 410 (11th Cir. 1987).

[53] Smith v. Gross, 604 F.2d 639, 642-43 (9th Cir. 1979).

[54] Miller v. Cent. Chinchilla Grp., Inc., 494 F.2d 414, 417 (8th Cir. 1974).

[55] *See generally* Peter Van Valkenburgh, *Framework for Securities Regulation of Cryptocurrencies*, COIN CENTER (Jan. 2016), https://coincenter.org/wp-content/uploads/2016/01/SECFramework2.5.pdf.

[56] *See* Investor Bulletin, *supra* note 6 (noting that *"[d]epending on the facts and circumstances of each individual ICO*, the virtual coins that are offered or sold may be securities") (emphasis added).

[57] *Howey*, 328 U.S. at 301.

[58] Albert, *supra* note 50 at 16.

[59] *See Tcherepnin*, 389 U.S. at 339 (holding that the exchange of cash for bank capital stock involved an investment of "money"); *Howey*, 328 U.S. at 299-300 (holding that the exchange of cash for land sale and service agreements involved an investment of "money").

[60] SEC v. Shavers, No. 4:13-cv-416, 2014 WL 12622292, at *6 (E.D. Tex. Aug. 26, 2014).

[61] *Id*.

cash or currency that amounts to legal tender.[62] Because the defendant in *Shavers* conceded that Bitcoin had value, the Court held that the scheme satisfied the first element of the *Howey* test.[63]

However, it is less clear whether an individual's provision of labor or services can involve an investment of "money"—a question that, as discussed below, may be relevant to some ICOs. While the Supreme Court has not squarely answered this question, it addressed a related issue in *International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel*.[64] In that case, the Court held that an employee's interest in a compulsory, noncontributory pension did not involve an "investment of money" under the *Howey* test.[65] In arriving at this conclusion, the Court rejected the argument that the plaintiff's labor qualified as the required "investment of money" in the pension plan on the grounds that the plan was "a relatively insignificant part" of his "total and indivisible compensation package."[66] Because the employee in *Daniel* "surrender[ed] his labor as a whole, and in return receive[d] a compensation package . . . substantially devoid of" other benefits that resembled a "security," the Court concluded that he exchanged his labor "primarily to obtain a livelihood" rather than to "mak[e] an investment."[67] While the Court accordingly concluded that the employee's interest in the pension plan did not involve an "investment of money" (and, therefore, was not a "security"), the Court noted in dicta that it declined to hold "that a person's 'investment' . . . must take the form of cash only, rather than of goods and services" in order to satisfy this element of the *Howey* test.[68] Instead, the Court's holding appeared to rest on the fact that the primary motivation behind the employee's provision of labor was to obtain a salary and other benefits that were not "securities," rather than to make an "investment," leaving open the question of whether exchanging labor for pension benefits that represented a more significant component of an employee's compensation—or for pension benefits alone—would have involved an "investment of money."

Lower courts have arrived at different conclusions as to whether the provision of labor or services qualifies as an "investment of money" under the *Howey* test. In *Peyton v. Morrow Electronics, Inc.*, the Ninth Circuit[69] rejected the argument that labor qualified as an "investment of money," holding that a contract pursuant to which an employee was entitled to receive a cash salary and a percentage of his employer's gross sales did not satisfy that element of the *Howey* test.[70] By contrast, in *Uselton v. Commercial Lovelace Motor Freight*, the Tenth Circuit endorsed the broad proposition that an "investment of money" under *Howey* "may take the form of goods and services . . . or some other exchange of value."[71] In that case, the court held that transactions pursuant to which employees forfeited their legal rights to a portion of their wages under a collective bargaining agreement in exchange for the right to participate in a profit-sharing plan qualified as "investment contracts" under *Howey*.[72] At least two district courts have also held that

[62] *Id*.

[63] *Id*.

[64] 439 U.S. 551 (1979).

[65] *Id*. at 560.

[66] *Id*.

[67] *Id*.

[68] *Id*. at 560 n.12.

[69] This report references a significant number of decisions by federal appellate courts of various regional circuits. For purposes of brevity, references to a particular circuit in the body of this report (e.g., the Ninth Circuit) refer to the U.S. Court of Appeals for that particular circuit.

[70] 587 F.2d 413, 414 (9th Cir. 1978).

[71] 940 F.2d 564, 574 (10th Cir. 1991).

[72] *Id*.

performing services or labor can qualify as an "investment of money" for purposes of the *Howey* test.[73]

Application to ICOs

Some ICOs involve a sale of tokens for cash.[74] Such ICOs will almost certainly involve "investments of money" under the *Howey* test based upon the Court's case law.[75] Other ICOs involve sales of tokens for other digital currencies.[76] Commentators have generally agreed that such offerings will also involve "investments of money,"[77] and the district court in *Shavers* agreed that the exchange of a valuable virtual currency qualifies as an "investment of money,"[78] suggesting that ICOs in which purchasers exchange Bitcoin or other valuable virtual currencies for newly created tokens will satisfy the first element of the *Howey* test.

While most ICOs involve the sale of tokens for cash or other digital currencies, some tokens are distributed in other ways. Tokens can be offered as rewards for "mining," a process whereby transactions on a blockchain are verified via the solution of cryptographically difficult problems.[79] An issuer may also offer tokens as rewards for the contribution of other valuable services or resources to an enterprise.[80] For example, Filecoin—the creator of a major virtual currency issued to develop a distributed file storage system—sold tokens to investors in an ICO in 2017, but also offers tokens as rewards for individuals who offer storage services or retrieve data for the enterprise.[81] Distributions of this sort raise the question of whether distributing tokens *only* as rewards for the provision of services (and not in exchange for cash or other virtual currencies) would involve an "investment of money" under *Howey*.[82]

The answer to this question is unclear. As discussed, in *Daniel*, the Supreme Court suggested in dicta that the provision of "goods and services" may satisfy this element of the *Howey* test.[83] In *Uselton*, the Tenth Circuit went further and held that the forfeiture of legal rights to agreed-upon

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[73] Frazier v. Manson, 484 F. Supp. 449, 452 n.5 (N.D. Tex. 1980) (holding that the performance of managerial services in exchange for limited partnership interests satisfied the "investment of money" element of the *Howey* test); SEC v. Addison, 194 F. Supp. 709, 722 (N.D. Tex. 1961) (holding that an agreement pursuant to which non-salaried workers exchanged their services for a share in their employer's profits qualified as an "investment contract.").

[74] Juan Batiz-Benet, Jesse Clayburgh & Marco Santori, *The SAFT Project: Toward a Compliant Token Sale Framework*, COOLEY LLP at 7 (Oct. 2, 2017), https://saftproject.com/static/SAFT-Project-Whitepaper.pdf. [hereinafter "SAFT White Paper"].

[75] *See* note 59 *supra*.

[76] *See* SAFT White Paper, *supra* note 74 at 7.

[77] *Id*.

[78] *Shavers*, 2014 WL 12622292 at *6.

[79] BRITO & CASTILLO, *supra* note 14 at 8.

[80] *See* Valkenburgh, *supra* note 55 at 27-29 (raising the possibility of an enterprise issuing tokens in exchange for the provision of video hosting capacity that the enterprise could use to develop a user-owned and controlled video sharing website).

[81] *See Filecoin: A Decentralized Storage Network*, PROTOCOL LABS (Jan. 2, 2018), https://filecoin.io/filecoin.pdf.; Fitz Tepper, *Filecoin's ICO Opens Today for Accredited Investors after Raising $52M from Advisers*, TECHCRUNCH (Aug. 10, 2017). The Filecoin white paper refers to individuals who provide these services as "miners"—a term that should not be conflated with Bitcoin miners, who verify transactions on the Bitcoin blockchain. BRITO & CASTILLO, *supra* note 14 at 8.

[82] Whether the term "initial coin offering" would be the best description of token distributions of this sort is unclear. This report discusses this issue under the "investment of money" part of the *Howey* test because of its general relevance for virtual currencies, but brackets the semantic question of how to characterize such token distributions.

[83] *Daniel*, 439 U.S. at 560 n.12.

wages qualified as an "investment of money" on the grounds that it involved an "exchange of value"—a broad standard that would arguably include the provision of labor or services.[84] The district court in *Shavers* adopted a similar rule, concluding that this element of the *Howey* test is satisfied whenever a purchaser exchanges "something of value . . . for the promised consideration."[85] At least two other district courts have also held that performing services or labor can satisfy this requirement.[86] By contrast, in *Peyton*, the Ninth Circuit held that the provision of services does not qualify as an "investment of money."[87]

If a court were to adopt *Peyton*'s rule that providing services cannot qualify as an "investment of money," the distribution of tokens in exchange for valuable services like mining or data storage would be unlikely to satisfy this element of the *Howey* test. However, token distributions of this sort are factually distinguishable from *Peyton*, which involved a contract pursuant to which an employee was entitled to receive a percentage of his employer's gross sales *and a cash salary* in return for his services.[88] By contrast, miners and others who provide valuable services to a token issuer generally do not receive a cash salary, arguably making such arrangements more analogous to the facts in *SEC v. Addison*.[89] In that case, a district court held that an agreement pursuant to which *non-salaried* workers exchanged their services for a share in their employer's profits qualified as a "security."[90]

If a court were to adopt *Uselton*'s broad rule that any "exchange of value" involves an "investment of money," the distribution of tokens in exchange for valuable services like mining or data storage would appear to satisfy this element of the *Howey* test, because these services likely have at least some value to token issuers. However, *Uselton*—which involved employees' forfeiture of contractually established rights to certain salaries in exchange for the right to participate in a profit-sharing plan—is distinguishable from offerings of this sort.[91] Specifically, the value of "mining" and other services provided to a token issuer is likely more difficult to establish than the value of the salary rights at issue in *Uselton*. Along these lines, one commentator has argued that the uncertain value of such services makes it unlikely that their provision qualifies as an "investment of money" under *Howey*.[92]

But the contention that labor cannot qualify as an "investment of money" because it is difficult to value is debatable. There does not appear to be support in the case law for the proposition that difficulties in valuing a certain type of consideration remove transactions involving that consideration from the ambit of federal securities law. Such a categorical rule is arguably inconsistent with the Supreme Court's instruction that the *Howey* test embodies "a flexible . . . principle" that is "capable of adaptation" to encompass a wide variety of schemes,[93] and with the

[84] *Uselton*, 940 F.2d at 574.

[85] *Shavers*, 2014 WL 12622292, at *6.

[86] *Frazier*, 484 F. Supp. at 452 n.5; *Addison*, 194 F. Supp. at 722.

[87] *Peyton*, 587 F.2d at 414.

[88] *Id*.

[89] *Addison*, 194 F. Supp. at 722.

[90] *Id*.

[91] *Uselton*, 940 F.2d at 574.

[92] Valkenburgh, *supra* note 55 at 48 ("In the case of mining or the provision of resources, money is not provided in return for the interest—there is no purchase per se; instead, there is participation in the enterprise, effectively labor, in return for rewards. And though we may not always believe we've been compensated for the fair market value of the work we've contributed to an employer or common cause, this disappointed expectation is less calculable than contributing a known sum of money to a formal enterprise with some sort of disclosable risk profile.").

[93] *Howey*, 328 U.S. at 299.

Court's "repeated[] recogni[tion]" that the securities laws "should be construed not technically and restrictively, but flexibly to effectuate [their] remedial purposes."[94]

A rule that the exchange of difficult-to-value consideration cannot constitute an "investment of money" may also have odd implications. Closely held businesses,[95] life insurance,[96] collectibles,[97] and certain derivatives[98] can be difficult to value. But, while the case law is limited, it seems unlikely that a court would hold that exchanging interests in any of these assets for newly created tokens would not involve an "investment of money" under *Howey*'s "flexible" test. Indeed, courts are routinely called upon to perform complex valuations,[99] so it is unclear why the difficulty of valuing any of these assets—or an individual's services—would disqualify them from satisfying the "investment of money" requirement.

The difficulty of valuing contributions to a token issuer's enterprise may also be overstated. Even if the labor of virtual currency "miners" or other service providers may be difficult to value, their *costs* may be more readily identifiable. Certain Bitcoin miners have set up extensive mining operations involving hundreds of computer servers,[100] and a research organization has published estimates of the cost of mining Bitcoin in various countries based on their respective average electricity rates.[101] Arguably, quantifiable expenditures on "mining" or other services could provide a court with sufficient information to calculate the value of contributions to a token issuer's enterprise within reasonable boundaries.[102]

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[94] Herman & MacLean v. Huddleston, 459 U.S. 375, 386-87 (1983). *See also* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) ("[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a 'security.'")

[95] *See* Comptroller's Handbook, Asset Management (AM), Unique and Hard-to-Value Assets, OFFICE OF THE COMPTROLLER OF THE CURRENCY (Aug. 2012), https://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/unique-hard-to-value-assets/pub-ch-unique.pdf.

[96] *See id*.

[97] *See id*.

[98] *See* Sarah Sharer Curley & Elizabeth Fella, *Where to Hide? How Valuation of Derivatives Haunts the Courts—Even After BAPCPA*, 83 AM. BANKR. L. J. 297, 300 (2009) ("A derivative may be illiquid, or not traded very often, in which case it becomes difficult, if not impossible, to place a value on it.").

[99] *See generally* Anthony J. Casey & Julia Simon-Kerr, *A Simple Theory of Complex Valuation*, 113 MICH. L. REV. 1175 (2015).

[100] *See What It Looks Like Inside an Actual Bitcoin Mining Operation*, CNBC (Jan. 12, 2018), https://www.cnbc.com/2018/01/12/what-it-looks-like-inside-an-actual-bitcoin-mining-operation.html.

[101] *See* Aaron Hankin, *Here's How Much it Costs to Mine a Single Bitcoin in Your Country*, MARKETWATCH (May 11, 2018), https://www.marketwatch.com/story/heres-how-much-it-costs-to-mine-a-single-bitcoin-in-your-country-2018-03-06.

[102] Commentators generally agree that Bitcoin does not qualify as a "security" because of the other *Howey* factors. *See* Joseph Young, *Brian Kelly: Three Reasons Why Bitcoin Will Continue to Surge in Short-Term*, YAHOO! FINANCE (May 5, 2018), https://finance.yahoo.com/news/brian-kelly-three-reasons-why-155648038.html (noting SEC Chairman Jay Clayton's testimony before the House Appropriations Committee that "[a]s a replacement for currency, [Bitcoin] has been determined by most people to not be a security"); Jeffrey E. Alberts & Bertrand Fry, *Is Bitcoin a Security?*, 21 B.U. J. SCI. & TECH. L. 1, 21 (2015) (concluding that Bitcoin is not a security, without addressing the question of whether mining Bitcoin qualifies as an "investment of money" under the *Howey* test). However, some commentators have argued that *mining* Bitcoin qualifies as an "investment of money" under the *Howey* test. *See* Benjamin Akins, Jennifer L. Chapman & Jason Gordon, *The Case for the Regulation of Bitcoin Mining as a Security*, 19 VA. J. L. & TECH. 669, 698 (2015). If this view is correct, and a different token were to satisfy the other elements of the *Howey* test, that token would arguably qualify as a "security" if issued as a reward to miners who perform tasks analogous to those performed by Bitcoin miners.

Indeed, if a virtual currency "miner" were to expend money in connection with his mining activities or other contributions to an enterprise based upon representations as to the enterprise's likely profitability, it seems as though a "flexible" application of the *Howey* test directed at effectuating the remedial purposes of the securities laws would militate in favor of the view that the miner's provision of those services qualified as an "investment of money" in the enterprise.

Common Enterprise

Case Law

Under the *Howey* test, a transaction must involve an investment in a "common enterprise" in order to qualify as an offering of "securities." The *Howey* decision did not explain the concept of a "common enterprise," and subsequent Supreme Court decisions have not elaborated upon its rationale. According to one commentator, the existence of a "common enterprise" is necessary for an agreement to qualify as a "security" because investors in such an enterprise "tend to have difficulty assessing the greater enterprise and have no control of its management," thereby requiring special protection.[103] According to this reasoning, the "buyer beware" regime applicable to ordinary contracts in which buyers are able to inspect and administer the relevant consideration for themselves is inadequate for sales of fractional participation in collective projects in which "each buyer cannot appropriately inspect and will not have the control necessary to administer the common enterprise."[104]

Lower courts have disagreed about the proper test for assessing the "common enterprise" element of the *Howey* test, and have adopted three basic approaches to this requirement: (1) "horizontal commonality," (2) "broad vertical commonality," and (3) "narrow vertical commonality."[105] Under the horizontal commonality approach, a "common enterprise" exists where investors pool assets and "share in the profits and risks of the enterprise."[106] By contrast, vertical commonality emphasizes the relationship between an investor and the promoter of an enterprise. Under the broad vertical commonality approach, a "common enterprise" exists where an investor's fortunes are dependent on the *efforts* or *expertise* of the promoter or his agents.[107] Under the narrow vertical commonality approach, a "common enterprise" exists where an investor's fortunes are dependent not only on a promoter's efforts or expertise, but also on a promoter's *profits*.[108]

One commentator has offered the following illustration of the differences between the three approaches to commonality. If a condominium developer sells individual condominium units coupled with management agreements under which the developer will rent the units to vacationers, pay each owner a percentage of the rental proceeds from their individual units, and pocket the remaining proceeds, that arrangement likely lacks horizontal commonality because each purchaser owns a separate asset, the investment funds are not pooled, and there is no sharing of profits (because each purchaser's return is based on the rental use of his individual unit).[109] By

[103] GEORGAKOPOULOS, *supra* note 34 at 26.

[104] *Id*.

[105] *See* SEC v. SG Ltd., 265 F.3d 42, 49-50 (1st Cir. 2001) (discussing different approaches to *Howey*'s "common enterprise" requirement, and noting that "[c]ourts are in some disarray as to the legal rules associated with the ascertainment of a common enterprise.").

[106] *Id*. at 49.

[107] *See* Villeneuve v. Advanced Bus. Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983).

[108] *See* SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 n.7 (9th Cir. 1973).

[109] James D. Gordon III, *Defining a Common Enterprise in Investment Contracts*, 72 OHIO ST. L. J. 59, 69-70 (2011).

contrast, an arrangement under which investors' funds are pooled to buy *an entire condominium project* and each investor receives a share of the enterprise's profits would involve horizontal commonality.[110]

While the arrangement in which investors purchase individual condominium units and share in the manager's profits lacks horizontal commonality, it would involve vertical commonality under both the broad and narrow approaches.[111] The arrangement would involve broad vertical commonality because the investors' fortunes depend on the manager's efforts and expertise in renting the units and managing the condominiums.[112] And the arrangement would involve narrow vertical commonality because investors are entitled to a percentage of the rental proceeds generated by the manager's activities, meaning that the investors' fortunes depend on the manager's profits in addition to his expertise and efforts.[113] By contrast, if the investors paid the manager a fixed fee, the arrangement would lack narrow vertical commonality because investors' fortunes would depend only on the manager's efforts, but not on his profits.[114]

The federal circuit courts have adopted a range of positions concerning these three constructions of *Howey*'s "common enterprise" requirement. The Third, Sixth, and Seventh Circuits require horizontal commonality for a "common enterprise."[115] The Fifth and Eleventh Circuits have held that broad vertical commonality is sufficient.[116] The First, Fourth, and D.C. Circuits have held that horizontal commonality is sufficient, but have not addressed the issue of vertical commonality.[117] The Ninth Circuit has held that either horizontal or narrow vertical commonality is sufficient.[118] The Second Circuit has held that horizontal commonality is sufficient and that broad vertical commonality is insufficient, but has not addressed narrow vertical commonality.[119]

Application to ICOs

Whether an ICO involves a "common enterprise" depends on its specific features and the test for evaluating that requirement adopted by the federal circuit in which litigation is brought. Some commentators have argued that horizontal commonality exists for token sales in which (1) tokens are fungible, (2) the issuer pools the money raised from selling the tokens, and (3) the issuer uses the pooled funds to build a network or develop other projects.[120] According to these

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[110] *Id*.

[111] *Id*. at 70.

[112] *Id*.

[113] *Id*.

[114] *Id*.

[115] *See* Newmyer v. Philatelic Leasing, Ltd., 888 F.2d 385, 394 (6th Cir. 1989); Salcer v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100-01 (7th Cir. 1977).

[116] *See* SEC v. ETS Payphones, Inc., 408 F.3d 727, 732 (11th Cir. 2005); Long v. Shultz Cattle Co., Inc., 881 F.2d 129, 140-41 (5th Cir. 1989).

[117] *See* SEC v. SG Ltd., 265 F.3d 42, 50 n.2 (1st Cir. 2001); SEC v. Banner Fund Intern., 211 F.3d 602, 614 (D.C. Cir. 2000); Teague v. Bakker, 35 F.3d 978, 986 n.8 (4th Cir. 1994).

[118] *See* Hocking v. Dubois, 885 F.2d 1449, 1459 (9th Cir. 1989).

[119] *See* Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994).

[120] SAFT White Paper, *supra* note 74 at 7. *See also* Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, Cardozo Legal Studies Research Paper No. 527; Univ. of Tenn. Legal Studies Research Paper No. 338 at 48-49 (Oct. 4, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3048104 (arguing that tokens will involve horizontal commonality when they are "sold to more than one purchaser, and the received funds are pooled to finance the project"); Valkenburgh, *supra* note 55 at 46-48

commentators, many tokens issued pursuant to ICOs satisfy these requirements and therefore involve horizontal commonality.[121]

By contrast, broad vertical commonality will exist where the fortunes of token purchasers are dependent on the expertise or efforts of an issuer.[122] If the value of tokens issued pursuant to an ICO depends on the issuer's ability to develop a business or certain valuable products or services, the ICO may involve broad vertical commonality.[123] For example, in early 2018, a company called ChronoBank issued tokens in exchange for Bitcoin that it indicated it would use to develop a platform on which users could manage digital assets.[124] Such tokens appeared to involve an investment in a "common enterprise" under the broad vertical commonality test because tokenholders depended on ChronoBank's efforts and expertise in developing the platform.[125] When the fortunes of token purchasers also depend on an issuer's *profits*—for example, where tokenholders are entitled to dividends or returns based on the profitability of the enterprise issuing the tokens—the tokens will also involve narrow vertical commonality.[126] While certain ICOs likely satisfy the narrow vertical commonality requirement,[127] one commentator has noted that such tokens are "rare," and concluded that most ICOs will accordingly not involve narrow vertical commonality.[128]

Reasonable Expectation of Profit

Case Law

The *Howey* test requires that a transaction involve a "reasonable expectation of profit" in order to qualify as an offering of "securities." In elaborating upon this element of the *Howey* test, the Supreme Court has distinguished between transactions in which purchasers are motivated primarily by financial returns (which will satisfy this requirement) and those in which purchasers are motivated primarily by a desire to use or consume a product or service (which will not). This distinction was critical to the Court's decision in *United Housing Foundation, Inc. v. Forman*, where the Court held that shares of stock entitling their purchasers to lease an apartment in a housing cooperative were not "securities" because the purchasers lacked the required "expectation of profit."[129]

The shares at issue in *Forman* allowed their purchasers to occupy an apartment in the cooperative, but could not be transferred to a non-tenant, pledged or encumbered, or willed to

(identifying the scarcity and fungibility of tokens as factors that are indicative of horizontal commonality).

[121] *See* Rohr & Wright, *supra* note 120 at 48-49; Valkenburgh, *supra* note 55 at 46-48.

[122] *See SG Ltd.*, 265 F.3d at 49-50.

[123] *See* Julian Zegelman, *Re: Analysis of the NVB Tokens Under the Howey Test* at 5 VELTON ZEGELMAN PC (Dec. 23, 2017), https://nvb.digital/howey_letter.pdf (concluding that an ICO involving the development of a digital video platform involved broad vertical commonality).

[124] *See* Julian Zegelman, *Re: Analysis of the TIME Tokens Under the Howey Test* at 2 VELTON ZEGELMAN PC (Jan. 5, 2018).

[125] *Id*. at 4.

[126] *Id*. at 4-5 (concluding that the relevant ICO also involved narrow vertical commonality because token purchasers were entitled to receive a percentage of the issuer's profits).

[127] *See id*.

[128] SAFT White Paper, *supra* note 74 at 7.

[129] 421 U.S. 837, 858 (1975).

anyone other than a surviving spouse.[130] Tenants who wanted to terminate their occupancy of an apartment in the cooperative were required to offer their shares to the cooperative for their initial purchase price and could not sell the shares to third parties for more than that price plus their mortgage equity if the cooperative declined to repurchase them.[131] The cooperative also leased commercial facilities and professional offices in the apartment building and used the net income from these leases to reduce tenant rental costs.[132] After the cooperative increased rental charges, purchasers of its shares brought federal securities law claims against it under the anti-fraud provisions of the Securities Act and the Exchange Act.[133]

A lower court in the *Forman* litigation held that the purchasers of the shares had an "expectation of profit" because, while the various resale restrictions prevented them from realizing capital appreciation, the purchasers derived income from the shares based on the cooperative's leasing activities—income that could be used to reduce their rental fees.[134] The Supreme Court rejected this reasoning and overturned the lower court's decision. The Court concluded that although income derived from the cooperative's leasing activities was "the kind of profit traditionally associated with a security investment," the income at issue in *Forman* was "far too speculative and insubstantial" to bring the transactions within the ambit of the securities laws.[135] Specifically, the Court noted that the prospect of such income was not mentioned in an information bulletin promoting the shares, and that nothing in the factual record suggested that the leased facilities actually generated income that exceeded the facilities' costs to the cooperative.[136] Based on these considerations, the Court concluded that purchasers of the shares "were attracted solely by the prospect of acquiring a place to live" and not by an expectation of profit.[137] While "the possibility of some rental reduction" from the cooperative's leasing activities made the shares "more attractive," the Court explained that such a possibility did not mean that purchasers had "an 'expectation of profit' in the sense found necessary in *Howey*."[138]

Lower courts have followed *Forman* in distinguishing between transactions motivated primarily by financial returns and transactions motivated primarily by a desire to use or consume a product or service. In *Rice v. Branigar Organization, Inc.*, for example, the Eleventh Circuit relied on this distinction in holding that the sale of lots in a housing development and equity memberships in a nearby country club did not involve an "expectation of profit" for purposes of the *Howey* test.[139]

Rice involved a residential planned-unit development on a barrier island off the coast of Georgia.[140] A developer sold purchasers lots in a housing development on the island and equity and non-equity memberships in a nearby country club.[141] After the developer transferred ownership and management of the country club to a non-profit corporation and revoked club usage rights for non-equity members, purchasers of lots on the island sued the developer on the

[130] *Id*. at 842.

[131] *Id*. at 842-43.

[132] *Id*. at 855-56.

[133] *Id*. at 844.

[134] *Id*.

[135] *Id*. at 856.

[136] *Id*.

[137] *Id*. at 853.

[138] *Id*. at 857.

[139] 922 F.2d 788, 789 (11th Cir. 1991).

[140] *Id*.

[141] *Id*.

grounds that (1) the sales of the lots and equity memberships in the country club represented unregistered sales of "securities," and (2) the developer's failure to disclose that non-equity club members would lose access to the club violated the Exchange Act's principal anti-fraud provision.[142]

The Eleventh Circuit affirmed a lower court order granting summary judgment for the developer, concluding that the lots and equity club memberships were not "securities" under the *Howey* test because they did not involve the required "expectation of profit."[143] The court reasoned that purchasers of the lots were motivated "primarily" by a desire to "use" the lots, and "not to derive profits from the entrepreneurial efforts of the developers."[144] Like the Supreme Court in *Forman*, the Eleventh Circuit relied in part upon promotional materials for the lots, which "d[id] not emphasize the[ir] investment value" and instead focused on "the beauty of the island and the amenities of the club and community."[145]

Similarly, the court concluded that equity memberships in the country club were not "securities" because purchasers "bought the memberships to use the club's facilities."[146] While the memberships represented equity interests in the club, the court rejected the argument that purchasers were motivated primarily by financial returns, noting that "there is normally little reason to invest in the equity of a non-profit company."[147] The Court again relied upon promotional materials related to the transactions, which it concluded were "clearly aimed at selling the memberships to give the purchasers access to the club's facilities."[148]

In *Teague v. Bakker*, by contrast, the Fourth Circuit held that a jury could have concluded that transactions involving both consumptive and profit-related motivations involved an "expectation of profit" under the *Howey* test.[149] *Teague* involved a non-profit organization's sale of "lifetime partnerships" entitling purchasers to short annual stays at a hotel and vacation retreat.[150] After the organization oversold the "partnerships" and its president diverted funds for personal use, a class of purchasers brought federal securities fraud claims against the organization and its president.[151] A district court granted the defendants' motion for a directed verdict against the plaintiffs on the grounds that the "lifetime partnerships" did not qualify as "securities."[152] The district court reasoned that because the plaintiffs purchased "lifetime partnerships" primarily in order to stay at the hotel and vacation retreat once a year (and not to obtain financial returns), they did not have an "expectation of profit" for purposes of the *Howey* test.[153]

The Fourth Circuit rejected this reasoning and reversed the district court's order granting the directed verdict.[154] The court explained that based upon *Forman*, the "expectation of profit"

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[142] *Id*. at 790.

[143] *Id*. at 791.

[144] *Id*. at 790-91.

[145] *Id*. at 791.

[146] *Id*.

[147] *Id*.

[148] *Id*.

[149] 35 F.3d 978, 990 (4th Cir. 1994).

[150] *Id*. at 982.

[151] *Id*. at 984.

[152] *Id*. at 987.

[153] *Id*. at 985-86.

[154] *Id*. at 986.

element of the *Howey* test requires proof that "the opportunity provided to offerees tended to induce purchases by emphasizing the possibility of profits," and that "the profits are offered in the form of capital appreciation or participation in earnings."[155] The court concluded that a jury could have reasonably concluded that the sale of the "lifetime partnerships" satisfied these requirements.[156] Specifically, the court reasoned that a jury could have reasonably concluded that promotional materials circulated by the non-profit organization "emphasiz[ed] the possibility of profits" in light of representations that the value of the "lifetime partnerships" "far exceeded" their purchase price.[157] The court also noted that portions of the materials explicitly touted the partnerships as an "investment opportunity" that could increase in value.[158] The court explained that by emphasizing the partnerships' investment value, the promotional materials could "be read to suggest that [partnership] purchasers would receive an economic benefit in the form of discounted lodging privileges"—a benefit that the non-profit organization could offer "by virtue of its operation, at regular prices, of the facilities not occupied by lifetime partners."[159] Because the court concluded that a jury could have reasonably found that these representations created an "expectation of profit," it reversed the district court's order granting a directed verdict for the defendants.[160]

Application to ICOs

As with the other *Howey* factors, whether an ICO involves an "expectation of profit" depends on its specific features. Where purchasers of a token are motivated primarily by a desire to use or consume a product or service for which the tokens can be exchanged, an ICO likely will not satisfy this element of the *Howey* test despite any incidental profit opportunity the tokens might offer.[161] By contrast, where purchasers of a token are motivated primarily by the prospect of financial returns, an ICO will satisfy this element of the test.[162] The promotional materials that accompany an ICO will likely play a "central" role in assessing whether token purchasers have an "expectation of profit."[163] If promotional materials "tend[] to induce purchases by emphasizing the possibility of profits," that fact will militate in favor of the conclusion that tokens qualify as

[155] *Id*. at 987.

[156] *Id*. at 990.

[157] *Id*.

[158] *Id*.

[159] *Id*. at 988.

[160] *Id*. at 990. The Tenth Circuit reached a similar conclusion regarding certain real estate transactions in *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036 (10th Cir. 1980). In that case, purchasers of lots in a real estate development brought federal securities fraud claims against the seller of the lots. *Id*. at 1038. A district court had dismissed the claims on the grounds that the lots did not qualify as "securities," despite the fact that the plaintiffs had alleged that they purchased the lots "with investment intent, that defendants encouraged investment purchases by promising the lots would increase in value because of defendants' activities in developing and providing amenities, and that defendants led purchasers to believe a trust would be established to construct and operate facilities for their common benefit." *Id*. at 1038. The Tenth Circuit reversed the district court's order as to the federal securities fraud claims. *Id*. at 1044. The court explained that "the promotional emphasis of the developer" was "central" to the "reasonable expectation of profit" element of the *Howey* test, and that "[a]n action should not be dismissed without an exploration of these materials where . . . the plaintiffs reasonably allege the existence of investment intent . . . and where nothing in the complaint precludes the finding of a security." *Id*. at 1039-40. Because the district court had not evaluated the promotional materials that accompanied the sales of the lots, the Tenth Circuit reversed the order dismissing the federal securities fraud claims. *Id*. at 1044.

[161] *See Forman*, 421 U.S. at 853; *Rice*, 922 F.2d at 790-91.

[162] *See Teague*, 35 F.3d at 988-90.

[163] *See Aldrich*, 627 F.2d at 1039-40.

"securities."[164] By contrast, promotional materials that emphasize only the goods and services for which tokens may be exchanged will support the opposite conclusion.[165]

In evaluating the application of this part of the *Howey* test to ICOs, commentators have distinguished between (1) "investment" or "securities" tokens, and (2) "utility" tokens.[166] Commentators have used the former terms to refer to tokens that are meant to serve as substitutes for traditional securities like corporate stock, the primary purpose of which is to offer purchasers the opportunity for capital appreciation or income in the form of dividends or interest payments.[167] Such tokens will likely satisfy the third prong of the *Howey* test because their purchasers are motivated primarily by a desire for financial returns.[168] Utility tokens, by contrast, are "designed to offer intrinsic utility" by allowing purchasers to use or access "a consumptive good or service."[169] Utility tokens can "act as staking or betting mechanisms, membership rights, or loan collateral," or as "cryptographic 'coupons' redeemable for mundane goods and services like bags of ground coffee or boxes of razor blades."[170] Filecoin, Storj, and Siacoin, for example, are tokens that allow their holders to access cloud storage platforms.[171] Likewise, Basic Attention Tokens can be used to purchase Internet advertising and compensate publishers and Internet users who view ads within the Brave web browser.[172]

Whether utility tokens involve the required "expectation of profit" under the *Howey* test is a difficult question, because such tokens can appreciate in value and present opportunities for speculation in addition to entitling their holders to use certain goods or services.[173] Some commentators have addressed this problem of dual motivation by suggesting that utility tokens will not satisfy the "expectation of profit" requirement unless purchasers' desire for financial returns "predominate[s]" over their desire to use or consume a product or service for which the tokens can be exchanged.[174] This "predominance" interpretation of the "expectation of profit" element of the *Howey* test has some support in the case law. In *Rice*, the Eleventh Circuit concluded that the relevant housing lots did not qualify as "securities" because purchasers bought them "*primarily* to use them," rather than to derive profits.[175] However, the Fourth Circuit appeared to endorse a weaker interpretation of the "expectation of profit" element in *Teague*, where it concluded that this requirement is satisfied where "the opportunity provided to . . .

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[164] *See Teague*, 35 F.3d at 987.

[165] *See Rice*, 922 F.2d at 791.

[166] *See* SAFT White Paper, *supra* note 74 at 3; Rohr & Wright, *supra* note 120 at 22-24.

[167] *See* Rohr & Wright, *supra* note 120 at 22-24.

[168] *See id*.

[169] SAFT White Paper, *supra* note 74 at 3.

[170] *Id*. at 3-4.

[171] *See* Bennett Garner, *Off to the Races: Best Decentralized Storage Solutions (Storj, Sia, Filecoin, Maidsafe)*, COIN CENTRAL (Feb. 19, 2018), https://coincentral.com/off-races-best-decentralized-storage-solutions-storj-sia-filecoin-maidsafe/.

[172] *See* Carlos Eduardo Dallacqua Freitas, *Basic Attention Token (BAT) has a Visionary Purpose, but Powerful Nemeses*, GLOBAL COIN REPORT (Mar. 27, 2018), https://globalcoinreport.com/basic-attention-token-bat-has-a-visionary-purpose-but-powerful-nemeses/.

[173] Rohr & Wright, *supra* note 120 at 41.

[174] SAFT White Paper, *supra* note 74 at 8.

[175] *Rice*, 922 F.2d at 790 (emphasis added). *See also Aldrich*, 627 F.2d at 1040 (indicating that housing lots "are not securities if the purchasers were induced to obtain them *primarily* for residential purposes") (emphasis added).

offerees *tend[s]* to induce purchases by *emphasizing* the possibility of profits."[176] The appropriate test for evaluating such "dual motivation" purchases accordingly remains somewhat unclear.

However, it is clear that simply describing a token as a "utility token" is insufficient to prevent it from qualifying as a "security." In a recent enforcement action, the SEC concluded that tokens characterized as "utility tokens" in an ICO's promotional materials qualified as "securities" despite this label.[177] This conclusion is consistent with the Supreme Court's case law, which makes clear that a transaction's "economic realities," and not the label given to it, determine whether the transaction involves an offering of "securities."[178]

Derived from the Efforts of Others

Case Law

Under *Howey*, a transaction must involve an expectation of profits "derived from the efforts of others" in order to qualify as a sale of "securities." One commentator has argued that the basis for this requirement is that buyers are in need of special legal protection where they lack the ability to control the uses to which their money is put.[179]

While the Supreme Court indicated in *Howey* that a "security" exists only when profits are to be derived "*solely* from the efforts of others,"[180] lower courts have subsequently held that the term "solely" should not be interpreted literally,[181] and the Court has omitted that term from later articulations of the *Howey* test.[182] Instead of requiring that expected profits be derived "solely" from the efforts of others, courts have employed a variety of weaker formulations of this requirement. The D.C. Circuit has explained that the requirement is satisfied when profits depend "predominantly" on the efforts of others.[183] Similarly, the Ninth Circuit has indicated that it is sufficient that the efforts of others are "the undeniably significant ones . . . which affect the failure or success of the enterprise."[184]

In evaluating the "efforts of others" element of the *Howey* test, courts have emphasized the extent to which investors participate in and control an enterprise. In *Albanese v. Florida National Bank of Orlando*, for example, the Eleventh Circuit held that contracts involving the purchase and operation of ice machines satisfied the "efforts of others" requirement based on investors' lack of control over the machines.[185] *Albanese* involved a scheme in which investors purchased ice

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[176] *Teague*, 35 F.3d at 987 (emphasis added).

[177] Munchee Order, *supra* note 27 at 3, 9. For a more extensive discussion of this enforcement action, *see* "Munchee" *infra*.

[178] *United Hous. Found.*, 421 U.S. at 849.

[179] *See* GEORGAKOPOLOUS, *supra* note 34 at 28.

[180] *Howey*, 328 U.S. at 301 (emphasis added).

[181] Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240 n.4 (4th Cir. 1988) (collecting cases).

[182] *Forman*, 421 U.S. at 852 (characterizing the *Howey* test as involving an inquiry into whether "an investment in a common venture [is] premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.").

Some courts have collapsed the "expectation of profit" and "efforts of others" elements of the *Howey* test, and analyze those requirements together. *See* Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981).

[183] SEC. v. Life Partners, Inc., 87 F.3d 536, 545 (D.C. Cir. 1996).

[184] SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

[185] *Id.*

machines and contracts pursuant to which the seller of the machines agreed to place the machines in various hotels and other institutions, manage the machines, and collect money from the machines on behalf of the investors.[186] Under the agreements, investors retained the right to select an initial location for the machines from a list provided by the seller, and the seller could not relocate the machines without the consent of investors.[187] After investors discovered that many of the ice machines did not exist and that the seller was using proceeds from new investors to pay earlier investors, they sued a bank associated with the seller for aiding and abetting violations of the Exchange Act's principal anti-fraud provision.[188]

A district court granted summary judgment to the defendant-bank on the grounds that the contracts were not "securities" because the plaintiffs "retained the potential for ultimate control over their investments" and therefore did not expect profits derived "based on the efforts of third parties."[189] However, the Eleventh Circuit rejected this reasoning and reversed the district court's order.[190] The court concluded that under the agreements—which granted investors the right to select the initial placement of the machines from a list of locations offered by the seller—investors' control over the enterprise "was too insubstantial to disqualify the agreements as securities."[191] Because the seller had offered its expertise in finding locations for the ice machines and contracting with hotels and other venues, and because there was no evidence suggesting that investors could hire other companies to manage their machines, the court concluded that investors were largely dependent on the seller's efforts for their profits and that the contracts accordingly qualified as "securities."[192]

The Ninth Circuit has held that a scheme involving even greater investor participation than the arrangement at issue in *Albanese* satisfied the "efforts of others" element of the *Howey* test. In *SEC v. Glenn W. Turner Enterprises, Inc*., the Ninth Circuit considered whether a multi-level marketing network in which investors purchased "Adventures" or "Plans" consisting of the right to attend seminar sessions and receive tapes and other materials aimed at improving self-motivation and sales ability involved a sale of "securities."[193] Purchasers of "Adventures" and "Plans" were tasked with either re-selling those products or bringing others into the organization, for which the investors received a portion of the new investors' contributions.[194] The SEC sought and obtained a preliminary injunction against the sale of the "Adventures" and "Plans" on the grounds that they constituted unregistered "securities."[195]

In affirming the preliminary injunction, the Ninth Circuit explained that under *Howey*'s "efforts of others" requirement, courts should evaluate "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[196] The court explained that the marketing scheme satisfied this requirement because purchasers of the "Adventures" and "Plans" effectively purchased

[186] *Id*. at 409-410.

[187] *Id*. at 411.

[188] *Id*. at 410.

[189] *Id*.

[190] *Id*. at 412.

[191] *Id*. at 412.

[192] *Id*.

[193] 474 F.2d 476, 478 (9th Cir. 1973).

[194] *Id*. at 479.

[195] *Id*. at 478.

[196] *Id*. at 482.

"shares in the proceeds of the selling efforts of" the scheme's promoters.[197] While investors also needed to contribute "something besides [their] money" in order to derive a profit from the scheme, the court explained that "the essential managerial efforts which affect the failure or success of the enterprise" were those of the promoters, not those of the investors.[198]

The D.C. Circuit adopted a similar test for applying the "efforts of others" requirement in *SEC v. Life Partners, Inc*.[199] *Life Partners* involved the sale of viatical settlements—a type of contract pursuant to which an investor acquires an interest in the life insurance policy of a terminally ill person, typically at a discount that depends upon the insured's life expectancy.[200] In the *Life Partners* litigation, the SEC brought an enforcement action against a company that sold fractional interests in life insurance policies and performed certain post-transaction administrative services on the grounds that the interests qualified as unregistered "securities."[201] The pre-sale tasks performed by the viatical settlements company included evaluating the medical conditions of insured policyholders, reviewing their insurance policies, negotiating purchase prices, and preparing relevant legal documents.[202] The company also performed certain post-sale functions, ranging from appearing as the owner of record on the insurance policies, holding the policies, monitoring the health of the insureds, paying premiums, filing death claims, collecting and distributing death benefits, and assisting investors who wished to resell their interests.[203]

The D.C. Circuit vacated injunctions against the company, concluding that the viatical settlements it had sold did not qualify as "securities" because investors did not expect to derive profits based on the "efforts of others."[204] In arriving at this conclusion, the court employed a test similar to that adopted by the Ninth Circuit in *Glenn W. Turner Enterprises*, explaining that the "efforts of others" requirement is satisfied only where expected profits are derived "predominantly" from the efforts of others.[205] Applying this test, the court distinguished between "purely ministerial" activities performed by the promoter of an investment (which are insufficient to satisfy the "efforts of others" requirement), and "entrepreneurial" activities (which may be sufficient).[206] The court explained that the company's *post-sale* functions (for example, paying premiums, filing death claims, and distributing death benefits to investors) were merely "ministerial" and therefore did not establish that investors expected to derive profits "predominantly" from the "efforts of others."[207] The court further reasoned that although the company's *pre-sale* activities (for example, evaluating the medical conditions and insurance policies of terminally ill persons) could be characterized as "entrepreneurial," such pre-sale activities have limited relevance to the *Howey* test because their value was likely already reflected in the purchase price of the contracts.[208] Accordingly, the court held that such pre-sale activities "cannot by themselves suffice to make the

[197] *Id*.

[198] *Id*.

[199] 87 F.3d 536, 545 (D.C. Cir. 1996).

[200] *Id*. at 537.

[201] *Id*. at 537-38.

[202] *Id*. at 539.

[203] *Id*. at 545-46.

[204] *Id*. at 538.

[205] *Id*. at 545 (internal quotation marks and citation omitted).

[206] *Id*. at 545-46.

[207] *Id*.

[208] *Id*. at 547.

profits of an investment arise predominantly from the efforts of others."[209] While the court declined to adopt a categorical rule that a promoter's pre-sale efforts are never relevant to the "efforts of others" element of the *Howey* test, it noted in dicta that it "doubt[ed]" that pre-sale efforts "should ever count for much" in applying that requirement.[210]

The Eleventh Circuit came to the opposite conclusion concerning viatical settlements and the importance of the distinction between pre-sale and post-sale efforts in *SEC v. Mutual Benefits Corp.*[211] That case involved a company that performed tasks that were largely similar to those performed by the relevant company in *Life Partners*. Like the viatical settlements company at issue in *Life Partners*, the company involved in *Mutual Benefits Corp.* identified terminally ill insureds, bid on policies, obtained life expectancy evaluations from doctors, and created the legal documents needed to conclude the relevant transactions.[212] After investors purchased fractionalized interests in the relevant policies, the company paid the policy premiums, monitored the health of the insureds, and distributed the proceeds from the policies to investors.[213]

The Eleventh Circuit concluded that investors in the viatical settlements depended on the "efforts of others" and that the contracts accordingly qualified as "securities."[214] The court rejected *Life Partners*' distinction between a promoter's pre-sale and post-sale efforts, reasoning that while the "efforts of others" element of the *Howey* test "may be . . . more easily satisfied by post-purchase activities, there is no basis for excluding pre-purchase managerial activities from the analysis."[215] The court accordingly concluded that "both pre- and post-purchase managerial activities . . . should be taken into consideration in determining whether *Howey*'s test is satisfied."[216] The court reasoned that because the viatical settlements company had engaged in significant pre-purchase managerial activities and a number of important post-purchase efforts, the viatical settlements contracts involved the required dependence on the "efforts of others."[217]

Application to ICOs

Whether the purchasers of tokens issued pursuant to ICOs have the sort of dependence on the "efforts of others" necessary for the tokens to qualify as "securities" depends on the degree of control purchasers are given over the enterprise that they fund.[218] Applying this element of the *Howey* test to individual ICOs requires close examination of "the rights, powers (and, sometimes, obligations) attendant to the token in question."[219] Where tokenholders have robust powers to control the activities of the relevant enterprise, an ICO is unlikely to involve the type of dependence on others required for the tokens to qualify as "securities."[220] By contrast, where

[209] *Id*. at 548.

[210] *Id*.

[211] 408 F.3d 737 (11th Cir. 2005).

[212] *Id*. at 738.

[213] *Id*. at 738-39.

[214] *Id*. at 745.

[215] *Id*. at 743.

[216] *Id*. at 743-44.

[217] *Id*. at 744-45.

[218] *See Steinhardt Grp. Inc.*, 126 F.3d at 154-55; *Albanese*, 823 F.2d at 410; *Williamson v. Tucker*, 645 F.2d 404, 422-25 (5th Cir. 1981).

[219] SAFT White Paper, *supra* note 74 at 9.

[220] *Williamson*, 645 F.2d at 425.

tokenholders have limited power or ability to control the activities they fund, the "efforts of others" requirement will likely be satisfied.[221]

The case law applying this requirement makes clear that in assessing whether investors depend on the "efforts of others," courts look primarily to investors' expectations of control at the time they make their investments and not "at some later time after the expectations of control have developed or evolved."[222] Accordingly, the formal powers granted to tokenholders in an ICO's white paper or other relevant documents are likely to be the focus of a court's assessment of the "efforts of others" requirement. However, courts have also considered evidence concerning how businesses have operated in practice as probative "of how control was allocated at the outset" of an investment.[223] That token purchasers have or have not exercised management responsibilities over an enterprise in practice may therefore be relevant to a court's "efforts of others" analysis.

The timing of a token issuer's efforts to support the value of the tokens it issues may also be relevant in applying the "efforts of others" element of the *Howey* test. In *Life Partners*, the D.C. Circuit "doubt[ed]" that activities performed by an issuer before a transaction "should ever count for much" in determining whether the transaction involves the sale of a "security."[224] If that approach to the "efforts of others" requirement is correct, then tokens are less likely to qualify as "securities" when an issuer performs the "entrepreneurial" tasks that make the tokens valuable before the tokens are sold. However, it is important to bear in mind that the D.C. Circuit's distinction between pre-sale and post-sale efforts has been rejected by at least one other federal circuit court.[225] Whether the timing of a token issuer's efforts is a central part of applying the "efforts of others" requirement accordingly remains unsettled.

Simple Agreements for Future Tokens (SAFTs)

The complexities surrounding the *Howey* test's application to ICOs have prompted the development of a framework for token offerings called the "Simple Agreement for Future Tokens" (SAFT). The SAFT is a framework for certain token offerings developed by Protocol Labs, Inc. and attorneys at the law firm Cooley LLP.[226] The goal of the SAFT is to obtain certain advantages related to securities, money services, and tax laws for ICOs that would otherwise involve "pre-functional utility tokens."[227] As discussed, a "utility token" is a token purchased not for investment purposes but primarily to use or consume a good or service for which the token can be exchanged.[228] A "pre-functional utility token" is a token that lacks utility when it is sold, but will become useful (that is, exchangeable for some good or service) at some later date, perhaps after the construction of a platform or products on which the tokens will be used.[229] A "functional utility token," by contrast, is a utility token that is useful when it is delivered to

[221] *Id*.

[222] *Id*. at 424 n.14. *See also* SEC v. Merchant Capital, LLC, 483 F.3d 747, 756 (11th Cir. 2007).

[223] *Merchant Capital, LLC*, 483 F.3d at 756. *See also* Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 242 (4th Cir. 1988); *Albanese*, 823 F.2d at 412.

[224] SEC v. Life Partners, Inc., 87 F.3d 536, 545 (D.C. Cir. 1996).

[225] SEC v. Mutual Benefits Corp., 408 F.3d 737, 744-45 (11th Cir. 2005).

[226] SAFT White Paper, *supra* note 74.

[227] *Id*. at 11-15.

[228] *Id*. at 3-4.

[229] *Id*. at 11.

purchasers.[230] Because "pre-functional utility tokens" do not have utility when they are sold and become useful only after the development of some type of platform or service that the tokens can be used to access, some commentators have suggested that they are more likely to involve an "expectation of profit" and depend on the "efforts of others" (and therefore qualify as "securities" under the *Howey* test) than "functional utility tokens."[231]

The basic goal of the SAFT vis-à-vis federal securities laws is to allow companies to raise money through a token offering for the development of a platform or service that is not yet fully functional, but without offering "pre-functional utility tokens" (which are arguably more likely than "functional utility tokens" to qualify as "securities"). The SAFT framework attempts to accomplish this goal through a contract pursuant to which investors exchange money for *the right to receive functional utility tokens at some future date*, instead of receiving "pre-functional utility tokens."[232]

The developers of the SAFT concept have explained that the SAFT contract itself—that is, the agreement to exchange money for the right to receive functional utility tokens in the future—is "very likely a security" under the *Howey* test.[233] The SAFT's developers have accordingly proposed that promoters enter into SAFTs with investors pursuant to SEC Regulation D, which provides an exemption to registration for offerings that meet certain conditions.[234] However, the developers of the SAFT concept have argued that the functional utility tokens delivered pursuant to SAFT contracts may not themselves qualify as "securities." Specifically, the SAFT's developers argue that tokens issued pursuant to SAFTs may not involve the required "expectation of profit" derived from the "efforts of others" because (1) token purchasers are motivated primarily by a desire to use or consume products or services, and (2) the relevant "efforts" to make the tokens useful occur before the tokens are delivered to investors.[235] Accordingly, the SAFT framework attempts to allow organizations to raise capital for the construction of a platform or service that tokens can be used to access, while potentially avoiding classification of the tokens as "securities" so that they can trade in secondary markets largely free from SEC regulation.[236]

Notably, the SAFT's developers caution that use of the SAFT framework does not prevent all "functional utility tokens" from qualifying as "securities." Specifically, the SAFT's developers note that where utility tokens are genuinely useful only by members of a particular industry or other small group, purchases of such tokens by the public at large are likely to be motivated primarily by a desire for financial returns and not by a desire to use or consume goods or services.[237] In such cases, ICOs will likely involve the required "expectation of profit" under *Howey*. The SAFT's developers also note that where a token issuer promises to engage in significant post-delivery activities that will enhance the value of tokens, an ICO likely satisfies the "efforts of others" requirement despite the SAFT structure.[238] Finally, the SAFT's developers

[230] *Id*. at 9-10.

[231] *Id*.

[232] *Id*. at 15-19.

[233] *Id*. at 15.

[234] 17 C.F.R. § 230.501. For a more detailed discussion of various exemptions from the Securities Act's registration requirements, *see* "Possible Exemptions from Registration" *infra*.

[235] SAFT White paper, *supra* note 74 at 17.

[236] *Id*.

[237] *Id*. at 20.

[238] *Id*.

caution that where a token issuer maintains control over the "monetary policy" for tokens—that is, if an issuer promises to redeem tokens based on its revenue or to engage in other activities to support secondary trading or enhance a token's price—an ICO likely involves dependence on the "efforts of others" and therefore qualifies as an offering of "securities."[239]

The SAFT concept has emerged as a popular method of structuring ICOs. According to one estimate, over 60 companies had raised $564 million using SAFTs in the first four months of 2018.[240] However, courts and the SEC have not evaluated whether the SAFT framework in fact achieves its intended goal of avoiding regulation under the securities laws. Moreover, in February 2018, the Wall Street Journal reported that the SEC had issued subpoenas and information requests to a number of token issuers, including issuers who have relied upon the SAFT framework.[241] Some commentators have also criticized the legal analysis in the SAFT white paper. Indeed, in November 2017, the Cardozo Blockchain Project at the Benjamin N. Cardozo School of Law issued a research report raising four general concerns with the SAFT framework.[242]

First, the report argues that the SAFT white paper "wrongly suggest[s] that application of the . . . federal securities laws will turn on bright-line rules" by maintaining "that the question of whether a utility token will be deemed a security will generally turn on whether the token is 'functional.'"[243] The paper argues that this suggestion is in tension with the flexible, case-by-case analysis mandated by *Howey* and its progeny.[244]

Second, the report contends that following the SAFT framework could present token creators with *greater* risk under federal securities laws than they might otherwise face.[245] Specifically, the report argues that because token creators who use the SAFT will tend to emphasize the profit-generating potential of their tokens in offering SAFT contracts to accredited investors under Regulation D, use of the SAFT could have the unintended consequence of "transform[ing] an inherently consumptive digital good (the token itself) . . . into an investment contract."[246] The report argues further that a premise on which the SAFT concept relies—that the timing of a token creator's efforts makes a difference in assessing the "efforts of others" element of the *Howey* test—lacks meaningful support in the case law.[247] Specifically, the report notes that although the D.C. Circuit drew a distinction between a promoter's pre-purchase and post-purchase efforts in *Life Partners*, other courts (such as the Eleventh Circuit in *Mutual Benefits Corp.*) have come to the opposite conclusion and have held that pre-purchase entrepreneurial activities (such as developing a platform) are relevant to the "efforts of others" analysis.[248] The report also questioned whether the post-purchase activities performed by most developers using SAFTs in

[239] *Id*.

[240] *See* Dave Michaels, *Startups Love This Cryptocurrency Strategy. Regulators Say Not So Fast*, WALL ST. J. (Apr. 24, 2018), https://www.wsj.com/articles/startups-love-this-cryptocurrency-strategy-regulators-say-not-so-fast-1524562200.

[241] *See* Jean Eaglesham & Paul Vigna, *Cryptocurrency Firms Targeted in SEC Probe*, WALL ST. J. (Feb. 28, 2018), https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266?mod=searchresults&page=1&pos=1.

[242] *Not So Fast—Risks Related to the Use of a "SAFT" for Token Sales*, CARDOZO BLOCKCHAIN PROJECT (Nov. 21, 2017), https://cardozo.yu.edu/sites/default/files/Cardozo%20Blockchain%20Project%20-%20Not%20So%20Fast%20-%20SAFT%20Response_final.pdf.

[243] *Id*. at 3.

[244] *Id*. at 3-4.

[245] *Id*. at 4-9.

[246] *Id*. at 5.

[247] *Id*. at 6.

[248] *Id*. at 7.

fact qualify as insignificant "ministerial" efforts, noting that platform developers routinely release updated versions of their platforms with additional features after tokens are sold.[249]

Third, the report argues that one of the concerns motivating the SAFT concept—that "pre-functional utility tokens" are likely to be "securities" because they involve dependence on the "efforts of others"—is misplaced.[250] The report argues that because purchasers of "pre-functional utility tokens" are likely motivated primarily by a desire to use or consume the platform or products they are funding and not by a desire for financial returns, such tokens do not involve an "expectation of profit" under *Howey*, and accordingly do not qualify as "securities" even if they involve dependence on the "efforts of others" for their ultimate consumptive value.[251]

Fourth, the report argues that use of the SAFT could harm consumers.[252] Specifically, the report contends that unlike traditional equity offerings, which often involve "lockup periods" during which investors cannot sell their shares, SAFTs offer investors the ability to quickly "flip" their tokens for a profit, incentivizing token creators to focus on the profitability of such near-term sales at the expense of viable long-term projects.[253] The report also raises concerns about the ability of SAFT purchasers who hold large numbers of tokens to manipulate the market for those tokens to the detriment of other investors and the token issuer.[254]

In light of this ongoing debate over the SAFT framework and the lack of guidance from regulatory agencies and the courts, it remains unclear whether (and in what circumstances) tokens issued pursuant to SAFTs will qualify as "securities" under federal law.

The SEC's Views

The SEC has pursued a number of enforcement actions against token issuers and other actors in the virtual currency industry,[255] and SEC officials have testified before Congress and given other public statements on their general approach toward ICOs.[256] The subsections below review two prominent SEC enforcement actions concerning ICOs and a recent speech by the Director of the SEC's Division of Corporation Finance that has generated considerable discussion about the agency's views on ICOs.

The DAO Report

In July 2017, the SEC issued a report of investigation concerning an unregistered sale of digital tokens by an unincorporated entity organization called "The DAO."[257] The DAO was a

[249] *Id*. at 8-9.

[250] *Id*. at 9-11.

[251] *Id*.

[252] *Id*. at 11-12.

[253] *Id*. at 11.

[254] *Id*. at 12.

[255] *See Statement on Potentially Unlawful Online Platforms for Trading Digital Assets*, SEC. AND EXCH. COMM'N (Mar. 7, 2018), https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[256] *See* Clayton Statement, *supra* note 2; *See* Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC, SEC. AND EXCH. COMM'N (Feb. 6, 2018), https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission [hereinafter "Chairman's Testimony"].

[257] DAO Report, *supra* note 27.

"decentralized autonomous organization," a term used to describe virtual organizations embodied in computer code and executed on a distributed ledger or blockchain.[258] One of The DAO's promoters memorialized the concept behind the organization in a white paper proposing the creation of an entity that would use "smart contracts"[259] to allow individuals to "work[] together collaboratively outside of a traditional corporate form."[260] The white paper indicated that in order to raise money, The DAO would issue digital DAO Tokens to "investors" in exchange for units of the virtual currency Ether, which The DAO would then use "to fund 'projects'" that could generate financial returns for the enterprise.[261]

The DAO's white paper indicated that DAO Tokens granted their holders certain voting and ownership rights.[262] Specifically, holders of DAO Tokens could propose projects for The DAO to pursue, vote on whether The DAO should pursue particular projects, and share in any profits generated by these projects.[263] However, the white paper also contemplated a managerial role for certain employees of the organization responsible for The DAO. These employees—called "Curators"—were charged with reviewing proposed projects before they were put to a tokenholder vote. The Curators were also granted "ultimate discretion" as to whether proposals were submitted for a vote.[264] According to the SEC, one Curator commented publicly that he had "complete control" over the projects that would be submitted for votes, the order in which the projects were submitted, and the duration of the voting process.[265] The white paper also indicated that Curators would have the power to reduce voting quorum requirements in certain circumstances.[266] The DAO's promotional materials included representations that DAO Tokens could be traded in secondary markets via several platforms, and The DAO's promoters solicited at least one Internet platform to trade DAO Tokens on its system by the time the tokens were offered.[267] According to the SEC, in the months after the offering, one platform executed over 500,000 transactions in DAO Tokens by more than 15,000 customers, while another executed more than 22,000 such transactions by more than 700 customers.[268]

After DAO Tokens were sold to investors, but before The DAO began funding projects, a hacker utilized a flaw in The DAO's code to steal approximately one-third of The DAO's assets, prompting the SEC's investigation.[269] While the SEC did not pursue an enforcement action

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[258] *Id*. at 1.

[259] Although there is no universally agreed upon definition of the term "smart contract," it is generally understood to refer to self-executing contracts with the terms of the agreement directly written into lines of code. *Smart Contracts*, INVESTOPEDIA, https://www.investopedia.com/terms/s/smart-contracts.asp. The code and the agreement contained therein exist across a distributed, decentralized blockchain network, ostensibly allowing transactions to be carried out among disparate, anonymous parties without a central authority or external enforcement mechanism. *Id. See also* SHAWN AMUIAL, JOSIAS N. DEWEY & JEFF SEUL, THE BLOCKCHAIN: A GUIDE FOR LEGAL AND BUSINESS PROFESSIONALS 26 (2016).

[260] Christoph Jentzsch, *Decentralized Autonomous Organization to Automate Governance Final Draft – Under Review* at 1, https://download.slock.it/public/DAO/WhitePaper.pdf.

[261] *Id*. at 1-3. The DAO sold approximately 1.15 billion DAO Tokens in exchange for approximately 12 million Ether, which represented approximately $150 million at the time. *Id.* at 2-3.

[262] *Id*. at 2.

[263] *See* DAO Report, *supra* note 27 at 6-7.

[264] *Id*. at 7-8.

[265] *Id*. at 8.

[266] *Id*.

[267] *Id*.

[268] *Id*. at 8.

[269] *Id*. at 9.

against The DAO's creators, it concluded in its report of investigation that DAO Tokens were "securities" under the *Howey* test.[270]

In the report, the SEC reasoned that the exchange of Ether for DAO Tokens represented an "investment of money" for purposes of the first part of the *Howey* test.[271] The agency also concluded (without explanation) that "[i]nvestors who purchased DAO Tokens were investing in a common enterprise."[272] The SEC also determined that purchasers of DAO Tokens had an "expectation of profit" based on promotional materials indicating that The DAO was "a for-profit entity whose objective was to fund projects in exchange for a return on investment."[273] In applying the "expectation of profit" factor, the SEC explained that even if the projects pursued by The DAO could include "services and the creation of goods for use by DAO Token holders," that fact did "not change the core analysis that investors purchased DAO Tokens with the expectation of earning profits from the efforts of others."[274]

The bulk of the SEC's analysis focused on the "efforts of others" requirement.[275] In evaluating this element of the *Howey* test, the SEC concluded that investors expected profits derived primarily from the "efforts of others" because (1) the efforts of The DAO's promoters and Curators were "essential" to the relevant enterprise, and (2) investors had only limited voting rights.[276] The SEC concluded that investors relied on the efforts of The DAO's promoters and Curators "to manage The DAO and put forth project proposals that could generate profits," emphasizing that The DAO's promoters had held themselves out as experts in the relevant subject matter and selected Curators based on their expertise.[277] The SEC explained that investors were dependent on the Curators' expertise in light of their authority to (1) vet proposed projects, (2) determine when to submit proposed projects for a vote, (3) determine the order and frequency of proposals submitted for a vote, and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals.[278] The SEC also concluded that investors had only limited voting rights.[279] These voting rights did not "provide [tokenholders] with meaningful control over the enterprise," the SEC explained, because tokenholders' ability to vote for proposed projects was "largely perfunctory" in light of the Curators' authorities and the absence of concrete information available in project proposals.[280] The SEC also noted that tokenholders' power was further diminished by the fact that they "were widely dispersed and limited in their ability to communicate with one another."[281]

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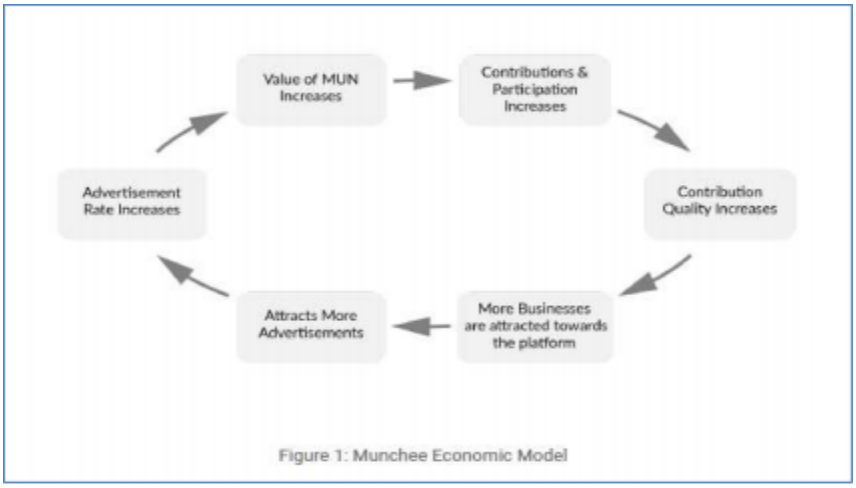
[270] *Id*. at 16.
[271] *Id*. at 11.
[272] *Id*.
[273] *Id*. at 12.
[274] *Id*. n.35. The exact test the SEC applied in assessing the various motivations of DAO Token purchasers is unclear. In one sentence in the report, the SEC appeared to indicate that because token purchasers were motivated "at least in part . . . by the prospect of profits," the tokens satisfied the "expectation of profit" requirement. *Id*. at 12.
[275] *Id*. at 12-15.
[276] *Id*. at 12-13.
[277] *Id*. at 12. In addition to touting their general expertise, The DAO's promoters had told investors that they "expected to put forth the first substantive profit-making contract proposal—a blockchain venture in [their] area of expertise." *Id*.
[278] *Id*. at 13.
[279] *Id*. at 13-14.
[280] *Id*. at 14.
[281] *Id*. at 14.

The SEC accordingly concluded that because DAO Tokens satisfied each of the four *Howey* factors, they qualified as "securities" that The DAO was legally required to register.[282]

Munchee

In December 2017, the SEC instituted cease-and-desist proceedings against Munchee, Inc., the creator of an iPhone application involving restaurant reviews.[283] In October 2017, Munchee had announced that it would conduct an ICO of "MUN tokens" to raise roughly $15 million to develop its business.[284] In a white paper describing the offering, Munchee explained that it would use the ICO's proceeds to hire employees for its development team, market and promote the Munchee App, pay for legal expenses, and maintain and "ensure the smooth operation of the MUN token ecosystem."[285] The white paper explained that within this "ecosystem" (shown in **Figure 2** below), users of the Munchee App could write restaurant reviews in exchange for MUN tokens, restaurants could purchase ads, and Munchee would offer "in-app" goods or services that could be purchased with MUN tokens.[286] Munchee also represented that it would work with restaurants so that users of the Munchee App could buy food with MUN tokens and restaurants could reward customers with MUN tokens.[287]

Figure 2. The Munchee "Ecosystem"



Source: Munchee Order, *supra* note 27 at 4.

The Munchee white paper described how increased participation in this "ecosystem" would lead to an increase in the value of MUN tokens.[288] Among other things, the white paper described how Munchee planned to take certain MUN tokens out of circulation when restaurants paid for advertising using the tokens, thereby increasing the price of MUN tokens by reducing their

[282] *Id*. at 16. Despite The DAO's failure to comply with its obligation to register DAO Tokens, the SEC did not pursue an enforcement action against The DAO's promoters.

[283] Munchee Order, *supra* note 27.

[284] *Id*. at 2-3.

[285] *Id*. at 3.

[286] *Id*. at 4.

[287] *Id*. at 5.

[288] *Id*.

supply.[289] The white paper also indicated that Munchee would ensure that holders of MUN tokens would be able to sell the tokens on secondary markets, and that Munchee would buy or sell tokens in order to ensure the existence of a liquid market.[290] In addition to touting MUN tokens' profit potential in its white paper, Munchee and its founders made a variety of other claims about prospective investment returns in blogs, podcasts, and on Facebook before the ICO.[291] The white paper also asserted that Munchee had performed a "*Howey* analysis" of the MUN tokens and concluded that "as currently designed, the sale of MUN utility tokens does not pose a significant risk of implicating federal securities laws."[292]

Munchee started selling MUN tokens in late October 2017.[293] After roughly 40 people purchased MUN tokens in exchange for approximately 200 Ether (the equivalent of roughly $60,000 at the time of the offering), SEC staff contacted Munchee, prompting it to stop the token sale and refund purchasers' money.[294]

The SEC imposed a formal cease-and-desist order against Munchee in December 2017.[295] In the order, the SEC concluded that MUN tokens qualified as "securities" under the *Howey* test.[296] The SEC reasoned that purchases of MUN tokens for Bitcoin or Ether qualified as "investments of money" under *Howey* because such sales involved "the type of contribution of value that can create an investment contract."[297] The SEC did not evaluate the "common enterprise" element of the *Howey* test, but concluded that MUN token purchasers had the required "expectation of profit" because of Munchee's representations about the MUN token ecosystem's capacity to generate capital appreciation and promises that MUN tokens could be traded on secondary markets.[298] Finally, the SEC concluded that purchasers of MUN tokens expected profits derived primarily from the "efforts of others" because Munchee had represented that it would revise the Munchee App and create the "ecosystem" that would increase the value of MUN tokens.[299]

Because Munchee had sold MUN tokens without filing a registration statement, the SEC concluded that it had violated the Securities Act and ordered it to cease and desist from future violations.[300] However, because Munchee had consented to the entry of the order and promptly ceased selling the tokens when contacted by the SEC, the agency did not impose a civil penalty.[301]

June 2018 Hinman Speech

In June 2018, William Hinman, the Director of the SEC's Division of Corporation Finance, delivered a speech on the application of the *Howey* test to virtual currencies.[302] Among other

[289] *Id*. at 4-5.

[290] *Id*. at 5.

[291] *Id*. at 5-6.

[292] *Id*. at 3-4.

[293] *Id*. at 7.

[294] *Id*. at 7-8.

[295] *Id*. at 1.

[296] *Id*. at 8.

[297] *Id*. at 8.

[298] *Id*. at 8-9.

[299] *Id*. at 9.

[300] *Id*. at 10.

[301] *Id*.

[302] William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All

things, the SEC's Division of Corporation Finance provides interpretive assistance to companies seeking clarification of SEC rules in the form of no-action, interpretive, and exemptive letters explaining the Commission's views.[303] While the speech does not represent a definitive statement of the law or a binding statement of the SEC's views, commentators have described it as "the SEC's most detailed guidance about digital tokens since" the DAO report.[304]

In the speech, Hinman addressed the question of "whether a digital asset offered as a security can, over time, become something other than a security."[305] Hinman explained that where a digital asset "represents a set of rights that gives the holder a financial interest in an enterprise, the answer is likely 'no'" based on a straightforward application of the *Howey* test.[306] However, Hinman clarified that where the centralized enterprise that issued a token no longer plays an active role in supporting the value of the token, and where the primary motivation of token purchasers is "to purchase a good or service," the token may not qualify as a "security" even if it qualified as a "security" when initially offered to investors.[307] In such cases, Hinman explained, "purchaser[s] . . . no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts," and "the efforts of the third party are no longer a key factor for determining the enterprise's success."[308] In light of these principles, Hinman concluded that based on his understanding, Bitcoin and Ether (the two largest virtual currencies by market capitalization) did not at that time qualify as "securities" because neither involved "a central third party whose efforts are a key determining factor in the enterprise."[309]

However, Hinman also emphasized the dynamic nature of the *Howey* test, cautioning that "[e]ven digital assets with utility that function solely as a means of exchange in a decentralized network" can qualify as "securities" based upon particular facts and circumstances surrounding their packaging and sale.[310] Along these lines, Hinman outlined more than a dozen factors that may be relevant to whether digital tokens qualify as "securities," ranging from the meaningfulness of investors' governance rights and influence over an enterprise to the characteristics of the groups to which tokens are marketed.[311]

Analysis

The DAO report, the Munchee enforcement action, and Hinman's June 2018 speech provide some insight into the SEC's views on ICOs. Because both The DAO and Munchee ICOs involved an exchange of Ether for the relevant tokens, the SEC's enforcement actions indicate that the agency believes that the exchange of virtual currency for newly issued tokens will qualify as an "investment of money" under the *Howey* test. Moreover, commentators have suggested that the

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Markets Summit: Crypto (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418 [hereinafter "Hinman Speech"].

[303] *See About the Division of Corporation Finance*, SEC. AND EXCH. COMM'N, https://www.sec.gov/divisions/corpfin/cfabout.shtml.

[304] Jeff John Roberts, *The SEC's Big Cryptocurrency Speech: 5 Things to Know*, FORTUNE (June 15, 2018), http://fortune.com/2018/06/15/sec-ethereum/.

[305] Hinman Speech, *supra* note 302.

[306] *Id*.

[307] *Id*.

[308] *Id*.

[309] *Id*.

[310] *Id*.

[311] *Id*.

SEC's lack of attention to the "common enterprise" element in both actions means that this part of the *Howey* test involves "a simple inquiry" under which that requirement will be satisfied whenever investors' funds are pooled together, establishing horizontal commonality.[312]

The Munchee report also makes clear that in assessing the "expectation of profit" requirement of the *Howey* test, the SEC will not simply accept a promoter's characterization of a token as a "utility token."[313] However, the Munchee order leaves a number of other questions concerning the "expectation of profit" requirement unanswered. Specifically, the SEC identified a number of factors that led to the conclusion that MUN tokens were "securities," including the tokens' lack of utility when they were delivered to investors, Munchee's representations about their potential for appreciation, its promise to take tokens out of circulation to maintain their value, and the company's promise to establish secondary markets for the tokens. As a consequence, it is unclear which (if any) of these factors the SEC regarded as necessary or sufficient to conclude that investors had the required "expectation of profit."

Some commentators have argued that the SEC's reasoning in the Munchee order appears to rest "on two key factors": (1) "the strong emphasis by Munchee and its agents on the potential profits of an investment in MUN tokens," and (2) "the inability to use the MUN tokens for any purpose for a substantial period of time."[314] If this analysis is correct, issuers of tokens intended to be "utility tokens" should take care to "avoid promoting the investment value of the tokens or the ability of purchasers to derive (or share in) profits from the purchase and sale of the tokens."[315] Moreover, while the SEC did not explicitly state "that tokens that have no function at the time of creation and distribution cannot be utility tokens (rather than securities)," commentators have suggested that "refrain[ing] from issuing tokens until they have meaningful functionality" may be a "reasonable approach" in light of the Munchee order.[316]

The DAO report also offers some guidance on how the SEC will apply *Howey*'s "efforts of others" requirement. The report makes clear that "giving [token] buyers some rudimentary role" in an enterprise is insufficient to insulate an ICO from the securities laws.[317] Instead, the SEC concluded that purchasers of DAO Tokens depended on the "efforts of others" because the significance of their voting powers was significantly diminished by (1) the authority of The DAO's "curators" to control key aspects of the voting process, (2) the limited information tokenholders were given about the projects that they voted on, and (3) the pseudonymity and

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[312] *See* Andrew D. Ledbetter & Trenton C. Dykes, *SEC Report on Tokens as Securities: Seven Takeaways*, DLA PIPER (July 31, 2017), https://www.dlapiper.com/en/us/insights/publications/2017/07/sec-report-on-tokens-as-securities/ (noting that the SEC did not discuss the various tests for commonality, and instead "observed in passing that investor funds were pooled to fund projects").

[313] *See* Munchee Order, *supra* note 27 at 9 ("Determining whether a transaction involves a security does not turn on labelling—such as characterizing an ICO as involving a 'utility token'—but instead requires an assessment of 'the economic realities underlying a transaction.'") (quoting *Forman*, 421 U.S. at 849). *See also* Peter Van Valkenburgh, *Munchee Settlement Puts Utility Token Argument to the Test*, COIN CENTER (Dec. 12, 2017), https://coincenter.org/entry/munchee-settlement-puts-the-utility-token-argument-to-the-test (arguing that "[t]he clearest takeaway [from the Munchee order] is that mere claims of 'utility!' in a white paper or other marketing materials will not suffice").

[314] Byungkwon Lim, Morgan J. Hayes & Gary E. Murphy, *Debevoise on Blockchain Tokens and Initial Coin Offerings: New Year, New Perspective*, THE CLS BLUE SKY BLOG (Feb. 15, 2018), http://clsbluesky.law.columbia.edu/2018/02/15/debevoise-on-blockchain-tokens-and-initial-coin-offerings-new-year-new-perspective/.

[315] *Id*.

[316] *Id*.

[317] Heather Cruz, Ryan J. Dzierniejko, David J. Goldschmidt, Kevin T. Hardy, Stuart D. Levi & Andrew J. Brady, *SEC Issues Guidance on Regulation of Initial Coin Offerings*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Aug. 1, 2017), https://www.skadden.com/insights/publications/2017/08/secissuesguidanceonregof-initialcoinofferings.

dispersion of tokenholders.[318] However, as with the Munchee order's assessment of the "expectation of profit" requirement, the weight the SEC placed on each of these factors in its "efforts of others" analysis is unclear. It is uncertain, for example, if the pseudonymity and dispersion of tokenholders are sufficient to establish the required dependence on the "efforts of others" in cases where tokenholders are better informed and a centralized entity has less authority to control the activities of the enterprise.[319]

Hinman's June 2018 speech has also generated a great deal of commentary. As discussed, in the speech, Hinman indicated that a token that initially qualifies as a "security" may "over time[] become something other than a security," concluding that based on his understanding, tokens such as Bitcoin or Ether are not "securities."[320] Ether originated in 2014 when the non-profit Ethereum Foundation conducted a token "pre-sale" in which it solicited contributions of Bitcoin that it promised to use to develop a blockchain-based computing platform (the Ethereum network).[321] After software developed by the Ethereum Foundation was run by "miners," participants in the "pre-sale" were awarded Ether, a newly invented scarce digital token that can be used in a variety of ways on the Ethereum network.[322]

Some commentators, including former Chairman of the Commodity Futures Trading Commission (CFTC) Gary Gensler, have suggested that Ether—which as of August 2018 was the second-largest virtual currency by market capitalization, clocking in at roughly $29.2 billion[323]—may qualify as a "security" because it was issued by a centralized entity before the Ethereum network was fully functional.[324] However, the Ethereum Foundation[325] and some commentators[326] have rejected this conclusion. Some commentators have argued that because Ether can now be exchanged for various services on the Ethereum network, the vitality of which now depends on the efforts of "hundreds of independent software developers" and "millions of users" (and not the small number of Ethereum Foundation programmers who originally developed the Ethereum network), Ether no longer qualifies as a "security," even if 2014 pre-sale contracts for Ether may have qualified as "securities."[327]

In his speech, Hinman appeared to side with this latter group of commentators, indicating that based on his understanding, Ether is not a "security" because the network on which it runs is "decentralized," meaning that purchasers of Ether do not depend primarily on the "efforts of

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[318] *See* DAO Report, *supra* note 27 at 13.

[319] *See* Alok Vasudev, *Three Takeaways From the SEC's Report on The DAO*, MEDIUM (July 25, 2017), https://medium.com/@alokvasudev/three-takeaways-from-the-secs-report-on-the-dao-91d92c849ae9.

[320] Hinman Speech, *supra* note 302.

[321] *See* Armand Tanzarian, *Ethereum Raises 3,700 BTC in First 12 Hours of Ether Presale*, COIN TELEGRAPH (July 23, 2014), https://cointelegraph.com/news/ethereum-raises-3700-btc-in-first-12-hours-of-ether-presale; Vitalik Buterin, *Launching the Ether Sale*, ETHEREUM BLOG (July 22, 2014), https://blog.ethereum.org/2014/07/22/launching-the-ether-sale/.

[322] *See* Linda Xie, *A Beginner's Guide to Ethereum*, THE COINBASE BLOG (Feb. 23, 2017), https://blog.coinbase.com/a-beginners-guide-to-ethereum-46dd486ceecf.

[323] *See Top 100 Cryptocurrencies by Market Capitalization*, COINMARKETCAP (last accessed Aug. 20, 2018), https://coinmarketcap.com/.

[324] *See* Nathaniel Popper, *A Former Top Wall Street Regulator Turns to the Blockchain*, N.Y. TIMES (Apr. 22, 2018), https://www.nytimes.com/2018/04/22/technology/gensler-mit-blockchain.html.

[325] *See id*.

[326] *See* Peter Van Valkenburgh, *No, Ether is Not a Security*, COIN CENTER (Apr. 23, 2018), https://coincenter.org/entry/no-ether-is-not-a-security.

[327] *Id*.

others" for their profits.[328] A network is sufficiently "decentralized" to preclude tokens from qualifying as "securities," Hinman explained, "where purchasers would no longer expect a person or group to carry out essential managerial or entrepreneurial efforts."[329] Hinman's suggestion that Ether is not a "security" was greeted with enthusiasm by investors[330] and virtual currency advocates, who have voiced concerns about the potential harms of applying federal securities laws to virtual currencies.[331]

Some commentators have also argued that Hinman's speech may have important implications for the viability of the SAFT framework. After the speech, one of the SAFT's developers argued that Hinman's emphasis on a network's "decentralization" is similar to (though not precisely the same as) the concept of "functional" utility tokens on which the SAFT white paper relied, because Hinman had explained that a network is "decentralized" when purchasers no longer expect a third party to carry out essential managerial efforts to support its value.[332] Other commentators have drawn similar conclusions, arguing that Hinman's endorsement of the proposition that a product that initially qualifies as a "security" may evolve into a non-security bodes well for the SAFT.[333]

Notably, the text of Hinman's speech contains a footnote indicating that because the *Howey* test depends upon the facts and circumstances of individual offerings, "nothing in" the speech was "meant to opine on the legality or appropriateness of a SAFT."[334] Accordingly, while Hinman's views are certainly relevant in assessing the viability of the SAFT, any firm legal conclusions about that framework remain premature.

Possible Exemptions from Registration

In light of the various uncertainties with the application of the *Howey* test to ICOs and the limited guidance offered by the SEC to date, commentators have discussed whether, assuming ICOs qualify as offerings of "securities," certain exemptions from the Securities Act's registration requirements may be available to token issuers. As a threshold matter, it is important to note that an issuer that relies upon an exemption from registration generally has the burden of proving that its offering falls within the exemption.[335] Moreover, such exemptions concern only an issuer's obligation to register securities with the SEC. The anti-fraud provisions of the Securities Act and the Exchange Act apply to securities even if they are exempt from registration.[336] Nevertheless,

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[328] Hinman Speech, *supra* note 302.

[329] *Id*.

[330] *See* Anna Irrera, *U.S. SEC Official Says Ether is Not a Security, Price Surges*, REUTERS (June 14, 2018), https://www.reuters.com/article/us-cryptocurrencies-ether/u-s-sec-official-says-ether-not-a-security-price-surges-idUSKBN1JA30Q.

[331] *See* Brian Fung, *Bitcoin and Ether Shouldn't be Regulated Like Stocks and Bonds, a Top SEC Official Says*, WASH. POST (June 14, 2018), https://www.washingtonpost.com/news/the-switch/wp/2018/06/14/bitcoin-and-ether-shouldnt-be-regulated-like-stocks-and-bonds-a-top-sec-official-says/?utm_term=.4b9b8d2cd584.

[332] *See* Santori, Marco (@msantoriESQ), June 14, 2018, 10:55 am, Tweet, https://twitter.com/msantoriESQ/status/1007320533397069825.

[333] Reginald Young, *Why a SEC Director Saying Ethereum Probably Isn't a Security Matters. A Lot*, MEDIUM (June 15, 2018), https://medium.com/@reginaldyoung/why-a-sec-director-saying-ethereum-probably-isnt-a-security-matters-a-lot-de504b9d4f72 ("If Ethereum ultimately is not a security, [SAFTs] are viable.").

[334] Hinman Speech, *supra* note 302 n.15.

[335] *See* SEC v. Ralston Purina, Co., 346 U.S. 119, 125 (1953).

[336] *See* 17 C.F.R. § 230.500(a); Daniel v. Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am., et al., 561 F.2d 1223, 1247-48 (7th Cir. 1977), *rev'd on other grounds* by Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel, 439 U.S. 551 (1979). *See also Frequently Asked Questions About Exempt*

registration exemptions may offer token issuers valuable benefits by allowing them to avoid the detailed and complex disclosures required in registration statements.[337] This section of the report reviews a number of exemptions from the Securities Act's registration requirements and discusses their possible application to ICOs. The features of the relevant exemptions are summarized in **Table 1** below.

Table 1. Exemptions from Registration

	Section 4(a)(2)	Regulation D	Regulation A	Regulation CF
Dollar Limit	None	$5 million for Rule 504 offerings; no limit for Rule 506 offerings	$20 million for Tier 1 offerings; $50 million for Tier 2 offerings	$1.07 million
Resale Restrictions	Yes	Rule 506 securities are subject to resale restrictions; Rule 504 securities are subject to resale restrictions in certain circumstances	No	Yes
State Law	State registration requirements apply	Rule 506 offerings are exempt from state registration requirements; Rule 504 offerings are not	Tier 2 offerings are subject to state filing requirements but are exempt from state laws concerning pre-offering review; Tier 1 offerings are not exempt from either category of state law	Exempt from state registration requirements
Other Relevant Features	Investors must be sufficiently sophisticated to be able to "fend for themselves"	General solicitation and advertising permitted for Rule 506(c) offerings, as long as all purchasers are accredited investors	Tier 2 offerings are subject to post-offering reporting requirements	Offering must be made through a platform registered with the SEC or operated by a registered broker-dealer

Source: CRS.

Section 4(a)(2) of the Securities Act

Section 4(a)(2) of the Securities Act offers an exemption to registration for transactions "not involving any public offering."[338] The Securities Act does not define the term "public offering." The provision's legislative history suggests that Congress intended it to exempt securities transactions from registration "where there is no practical need for [registration] . . . [or] where the public benefits [of registration] are too remote."[339] In interpreting the phrase "public

Offerings, SEC. & EXCH. COMM'N, https://www.sec.gov/smallbusiness/exemptofferings/faq?auHash=rh5WfJi9h3wRzP6X2anOmgYLdhPHNuo-3Vw0YNZyR_M#faq1 (explaining that "[a]ll securities transactions, even exempt transactions, are subject to the antifraud provisions of the federal securities laws.") (last accessed Aug. 27, 2018).

[337] *See* STEINBERG, *supra* note 33 at 56.

[338] 15 U.S.C. § 77d(a)(2).

[339] H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).

offering," the Supreme Court has held that the exemption is available for sales of securities to persons who are able to "fend for themselves" in evaluating an offering.[340] In *SEC v. Ralston Purina*, the Court considered whether a company's offering of stock to "key employees" fell within the Section 4(a)(2) exemption from registration.[341] In adopting and applying the "fend for themselves" standard, the Court explained that although "executive personnel who because of their position have access to the same kind of information" contained in a registration statement may qualify as persons able to "fend for themselves," many of the other employees who were offered the stock lacked that type of access, meaning that the exemption did not apply.[342]

Lower courts have considered a variety of factors in applying the "fend for themselves" standard. While "the principles emerging from these cases are," in the words of one commentator, "not crystal clear,"[343] courts have generally considered the number of offerees, the sophistication and experience of offerees, the nature and kind of information that has been provided or to which the offerees have access, the size of the offering, and the precautions taken to prevent the offerees from reselling their securities in determining whether the Section 4(a)(2) exemption applies to a securities transaction.[344] Importantly, securities sold pursuant to the Section 4(a)(2) exemption qualify as "restricted securities,"[345] meaning they cannot be resold within certain time periods unless certain conditions are met.[346]

Commentators have argued that Section 4(a)(2) is not an attractive option for most token issuers based on the limitations discussed above.[347] Specifically, observers have reasoned that because ICOs often involve offering a large number of tokens to a large number of prospective investors of varying levels of sophistication and generally do not involve resale restrictions, Section 4(a)(2)'s exemption will not appeal to the typical token issuer.[348] However, for token issuers who are comfortable with more limited offerings to smaller numbers of sophisticated investors, Section 4(a)(2) may offer an exemption from SEC registration.

Regulation D

In part because of the imprecision of the judicial decisions interpreting Section 4(a)(2), the SEC promulgated Regulation D to offer a more specific exemption.[349] Regulation D provides two more specific exemptions from the Act's registration requirements.

First, Rule 504 of Regulation D provides an exemption for certain issuers for offerings of up to $5 million.[350] The Rule 504 exemption is not limited to offerings of securities that involve sophisticated investors. However, as with securities sold pursuant to Section 4(a)(2), securities

[340] SEC v. Ralston Purina, Co., 346 U.S. 119, 125 (1953).

[341] *Id*. at 120.

[342] *Id*. at 125-27.

[343] STEINBERG, *supra* note 33 at 62.

[344] *See* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 900-08 (5th Cir. 1977); Barrett v. Triangle Mining Corp., 1976 WL 760, at *6 (S.D.N.Y. Feb. 2, 1976).

[345] 17 C.F.R. § 230.144(a)(3)(i).

[346] *Id*. § 230.144(b)-(h). If an issuer is not subject to the reporting requirements of the Exchange Act, purchasers of "restricted securities" must hold them for at least one year before selling them. *Id*. § 230.144(d)(1)(ii).

[347] *See* Rohr & Wright, *supra* note 120 at 74.

[348] *Id*.

[349] *Id*.

[350] 17 C.F.R. § 230.504.

sold pursuant to Rule 504 generally qualify as "restricted securities" subject to certain resale restrictions for certain time periods.[351]

Second, Rule 506 of Regulation D provides an exemption to registration for offerings that satisfy a variety of conditions.[352] Among other conditions, Rule 506 offerings must not involve general solicitation or advertising, and must be limited to accredited investors—a category that includes certain high net-worth individuals[353]—and up to 35 other purchasers.[354] The prohibition on general solicitation and advertising does not apply, however, to Rule 506(c) offerings, in which issuers must (among other things) take reasonable steps to ensure that only accredited investors purchase the relevant securities.[355] There is no limit on the amount of money that can be raised in Rule 506 offerings.[356] However, like securities sold in Section 4(a)(2) and Rule 504 offerings, securities sold in Rule 506 offerings are "restricted securities" subject to resale restrictions for certain time periods.[357]

A number of token issuers have relied upon Regulation D.[358] As discussed, the popular SAFT framework for token offerings involves offering SAFT contracts to accredited investors pursuant to Regulation D.[359] Over the past year, a number of SAFT issuers have filed Form Ds with the SEC providing notice of claimed exemptions from registration under Regulation D.[360] One issuer, the chat software company Telegram, filed a Form D with the SEC in February 2018 reporting that it had raised $850 million using the SAFT structure.[361] Likewise, in August and September 2017, the blockchain data storage company Filecoin raised over $257 million using the SAFT framework in an offering conducted pursuant to Rule 506.[362]

However, commentators have raised concerns about such offerings. Specifically, some analysts have noted that Rule 506's limitations on participation by non-accredited investors dramatically restrict the pool of investors eligible to participate in an ICO.[363] Other observers have argued that

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[351] *Id*. §§ 230.502(d), 504(b).

[352] *Id*. §§ 230.501-02, 506.

[353] *Id*. § 230.501(a).

[354] *Id*. §§ 230.501-02, 506.

[355] *Id*. § 230.506(c).

[356] *Id*.

[357] *Id*. §§ 230.502(d), 506(b).

[358] Andy Bromberg, Georgia Quinn & Regan Bozman, *What's Next for the ICO? Reflections on Securities Law and the Future of Initial Coin Offerings*, CROWFUND INSIDER (Apr. 2, 2018), https://www.crowdfundinsider.com/2018/04/131282-whats-next-for-the-ico-reflections-on-securities-law-and-the-future-of-initial-coin-offerings/; Ash Bennington, *Reg D on the Rise? Investor-Grade ICO Products Are Coming – and Soon*, COINDESK (Sept. 7, 2017), https://www.coindesk.com/reg-d-on-the-rise-investor-grade-ico-products-are-coming-and-soon/.

[359] As discussed, the developers of the SAFT concept argue that while SAFT contracts are likely "securities" under the *Howey* test, the tokens delivered pursuant to the contracts are not.

[360] *See* Francine McKenna & Katie Marriner, *Here's the Blueprint for how ICOs are Getting off the Ground without SEC Vetting*, MARKETWATCH (Feb. 22, 2018), https://www.marketwatch.com/story/number-of-icos-getting-regulation-lite-treatment-is-growing-2018-02-21.

[361] *See id*.; Brady Dale, *Telegram's $1.2 Billion ICO Could Be the Most Ambitious Token Sale Yet*, COINDESK (Jan. 10, 2018), https://www.coindesk.com/telegrams-1-2-billion-ico-ambitious-token-sale-yet/.

[362] *See Stan Higgins, $257 Million: Filecoin Breaks All-Time Record for ICO Funding*, COINDESK (Sept. 7, 2017), https://www.coindesk.com/257-million-filecoin-breaks-time-record-ico-funding/; JD Alois, *Protocol Labs Files Two Form D's with SEC Regarding Enormous Filecoin ICO*, CROWDFUND INSIDER (Aug. 26, 2017), https://www.crowdfundinsider.com/2017/08/121075-protocol-labs-files-two-form-ds-sec-regarding-enormous-filecoin-ico/.

[363] Aaron Kaplan, *Reg A-Plus Is Perfect for Initial Coin Offerings*, LAW360 (Jan. 10, 2018), https://www.law360.com/

the resale restrictions applicable to securities offered under the Regulation D exemptions may prove "problematic" for token purchasers seeking immediate liquidity.[364]

Other concerns about Regulation D ICOs are grounded not in alleged shortcomings of Regulation D itself, but in worries about whether the SAFT framework in fact achieves its intended goal of avoiding classification of certain tokens as "securities."[365] If the SEC or a court were to determine that SAFTs do not invariably accomplish this goal, and that certain tokens issued pursuant to SAFTs in fact qualify as "securities," the tokens distributed pursuant to SAFTs offered under Regulation D would likely qualify as "restricted securities" subject to resale restrictions, contrary to the intentions of token issuers and purchasers.[366] Such a scenario would present token issuers and purchasers with significant legal risks.[367]

Regulation A

Regulation A offers another exemption from the Securities Act's registration requirements.[368] Regulation A provides exemptions for two "tiers" of offerings. Tier 1 offerings allow issuers to raise up to $20 million and are open to accredited and non-accredited investors.[369] Tier 2 offerings allow issuers to raise up to $50 million, but involve limitations on the amounts that non-accredited investors are allowed to invest.[370] Unlike issuers who avail themselves of the Regulation D exemptions, issuers who avail themselves of the Regulation A exemption are required to file an offering statement and to disclose a variety of information that would otherwise be required in a registration statement (though the relevant disclosures are more limited than those required of non-exempt offerings).[371] However, unlike securities offered pursuant to Regulation D, securities offered pursuant to Regulation A are not subject to resale restrictions.[372]

While it appears that token issuers have utilized Regulation A less frequently than Regulation D, some commentators have argued that Regulation A "appears to have more potential" for ICOs than Regulation D.[373] Specifically, these observers have noted that the absence of resale restrictions for securities offered under Regulation A may prove attractive to token issuers.[374]

Regulation Crowdfunding

Regulation Crowdfunding (Reg CF) offers an exemption from the Securities Act's registration requirements for certain offerings of up to $1.07 million.[375] This regulation (1) limits the amounts that certain individual investors are permitted to invest, (2) requires that issuers relying upon the

articles/1000365/reg-a-plus-is-perfect-for-initial-coin-offerings.

[364] Rohr & Wright, *supra* note 120 at 76.

[365] *Id*.

[366] *Id*. at 82.

[367] *Id*. at 84.

[368] 17 C.F.R. § 230.251.

[369] *Id*. § 230.251(a)(1).

[370] *Id*. § 230.251(a)(2).

[371] *Id*. §§ 230.251-259.

[372] THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 177 (6th ed. 2009).

[373] Rohr & Wright, *supra* note 120 at 86. *See also* Kaplan, *supra* note 363.

[374] *Id*.

[375] 17 C.F.R. § 227.100.

exemption conduct offerings through a single funding portal registered with the SEC and the Financial Industry Regulatory Authority,[376] or an online platform operated by a registered broker-dealer, and (3) imposes a variety of disclosure obligations on issuers.[377] Like securities issued pursuant to Section 4(a)(2) and Regulation D, securities issued pursuant to Reg CF are subject to a variety of resale restrictions.[378]

Although some commentators have raised the possibility of conducting ICOs pursuant to Reg CF,[379] others have argued that resale restrictions on Reg CF securities and the $1.07 million limit on Reg CF offerings make it a poor option for ICOs.[380]

Legal Considerations for Congress

While discussion of the legal issues raised by ICOs is still in its relative infancy, commentators have offered a variety of proposals to improve ICO regulation. The subsections below review a number of these proposals.

Guidance

Some commentators have criticized the SEC's policy of "regulation through enforcement," in which the agency has made its views of ICOs known primarily through actions taken against individual defendants rather than by providing more general guidance applicable to all regulated entities.[381] According to these commentators, this type of "piecemeal" approach "leaves token sale participants without ready answers to the questions that will determine whether or not the tokens they offer are securities."[382] These observers contend that this absence of legal certainty may drive token sales overseas, "harming healthy innovation in the U.S."[383] In order to avoid these innovation-chilling effects, some commentators have proposed that the SEC issue interpretive guidance clarifying its views on ICOs or, in the absence of such guidance, offer "meaningful guideposts to token sale participants" in future administrative orders and reports.[384]

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[376] The Financial Industry Regulatory Authority is a self-regulatory organization for the broker-dealer industry. *See About FINRA*, FIN. IND. REG. AUTH., https://www.finra.org/about.

[377] *Id*.

[378] *Id*. § 227.501.

[379] JD Alois, *Initial Coin Offerings: Is this How it Should've Been a Few Years Ago When US Securities Crowdfunding First Became Legalized?*, CROWDFUND INSIDER (Mar. 4, 2018), https://www.crowdfundinsider.com/2018/03/128615-initial-coin-offerings-shouldve-years-ago-us-securities-crowdfunding-first-became-legalized/; Edward Dartley, Anthony R.G. Nolan Mary Burke Baker, John ReVeal & Amanda M. Katlowitz, *Initial Coin Offerings: Key Considerations You Absolutely, Positively Need to Know About Before Launching an ICO*, K&L GATES (Oct. 26, 107), http://www.klgates.com/initial-coin-offerings-key-considerations-you-absolutely-positively-need-to-know-about-before-launching-an-ico-10-26-2017/.

[380] *See* Kaplan, *supra* note 363; Rohr & Wright, *supra* note 120 at 89; *How to hold an ICO in 2018 and beyond*, MEDIUM (Dec. 31, 2017), https://medium.com/@EtherSportz/how-to-hold-an-ico-in-2018-and-beyond-83f4555705fc.

[381] *See* Rohr & Wright, *supra* note 120 at 92; *Coinbase's Written Testimony for the Subcommittee on Capital Markets, Securities, and Investment*, COINBASE (Mar. 13, 2018), https://blog.coinbase.com/coinbases-written-testimony-for-the-subcommittee-on-capital-markets-securities-and-investment-47f8a260ce41 [hereinafter "Lempres Testimony"].

[382] Rohr & Wright, *supra* note 120 at 89-90.

[383] Lempres Testimony, *supra* note 381.

[384] Rohr & Wright, *supra* note 120 at 101. *See also* Diego Zuluaga, *Should Cryptocurrencies Be Regulated Like Securities?*, CATO INSTITUTE at 3 (June 25, 2018), https://object.cato.org/sites/cato.org/files/pubs/pdf/cmfa-briefing-paper-1-updated.pdf (arguing that greater clarity on the question of when ICOs will qualify as securities offerings "would have a number of benefits, including reducing price volatility induced by the lack of a stable regulatory

If the SEC does not issue such guidance of its own volition, Congress has the authority to require it to do so.

Registration Exemption

Some commentators have proposed that the SEC promulgate an exemption from the Securities Act's registration requirements for token issuers that is modeled after Regulation A.[385] As discussed, Regulation A provides for two tiers of exempt offerings (Tier 1 offerings are capped at $20 million, while Tier 2 offerings are capped at $50 million), and securities sold pursuant to Regulation A are not subject to resale restrictions.[386] Commentators have proposed retaining these features of Regulation A for a token-specific exemption, but modifying Regulation A's disclosure requirements "to better fit with tokens and token-funded projects."[387] Among other changes, a token-specific exemption could require disclosure of the relevant computer code supporting a network on which tokens can be used (which may be relevant to the network's viability), and any evaluations of the code performed by technical experts.[388] If the SEC does not promulgate such an exemption pursuant to its general exemptive authority,[389] Congress could adopt one statutorily or direct the SEC to do so.[390]

Safe Harbor for Token Exchanges

Some observers have proposed that Congress adopt legislation providing a "safe harbor" for token exchanges, under which exchanges are immune from liability for facilitating the sale of unregistered securities in certain circumstances.[391] Specifically, commentators have proposed granting immunity to exchanges that (1) perform technical due diligence to verify a token's cybersecurity practices, (2) obtain an opinion from qualified counsel concluding that a token is not a "security," and (3) immediately de-list tokens that are subsequently found to be "securities."[392] These commentators contend that such a safe harbor would prevent "utility tokens" from moving to overseas exchanges in response to refusals by U.S. exchanges to incur the risks associated with listing them.[393]

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framework for cryptocurrencies").

While there has been limited discussion regarding the SEC issuing a binding rule concerning ICOs, the agency would presumably have the authority to promulgate such a rule pursuant to its general rulemaking authority under the Securities Act. *See* 15 U.S.C. § 77s (granting the SEC the authority "to make, amend, and rescind such rules and regulations as may be necessary to carry out" the provisions of the Securities Act concerning domestic offerings of securities).

[385] Rohr & Wright, *supra* note 120 at 110-111.

[386] 17 C.F.R. § 230.251(a).

[387] Rohr & Wright, *supra* note 120 at 111.

[388] *Id*. at 111-112.

[389] *See* 15 U.S.C. §§ 77z-3, 78mm(a)(1).

[390] *See id*. § 77d (specifically listing exempted transactions).

[391] Rohr & Wright, *supra* note 120 at 108-09.

[392] *Id*.

[393] *Id*. at 107.

Regulatory Structure

Finally, a number of commentators have called upon Congress to consider changes to the regulatory structure surrounding ICOs. Currently, a variety of federal regulatory agencies have responsibility for different aspects of virtual currency regulation. The SEC is responsible for regulating virtual currencies that qualify as "securities."[394] The CFTC has general jurisdiction over derivatives markets for virtual currencies like Bitcoin that qualify as "commodities,"[395] and has the authority to police "spot" markets for such virtual currencies for fraud and market manipulation.[396] However, no federal agency has general jurisdiction over virtual currency "spot" markets.[397] The Financial Crimes Enforcement Network (FinCEN), a bureau within the Treasury Department, also has responsibility for regulating virtual currencies. FinCEN is responsible for enforcing the Bank Secrecy Act (BSA), a major federal anti-money laundering statute, and has issued guidance clarifying the BSA's application to various actors in the virtual currency industry.[398]

Dissatisfied with this multi-agency approach to virtual currency regulation, some commentators have proposed creating a new federal agency to focus specifically on the regulation of virtual currencies.[399] Other observers have proposed that Congress designate an existing regulator as having "primary jurisdiction" over virtual currencies.[400] To date no legislation has been introduced in the 115th Congress on such a proposal.

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[394] *See* Chairman's Testimony, *supra* note 256.

[395] The Commodity Exchange Act defines the term "commodity" as including as variety of agricultural products and "all other goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1(a)(9).

[396] CFTC Backgrounder on Oversight and Approach to Virtual Currency Futures Markets, COMMODITY FUTURES TRADING COMM'N (Jan. 4, 2018), https://www.cftc.gov/sites/default/files/idc/groups/public/@customerprotection/documents/file/backgrounder_virtualcurrency01.pdf.

A "spot" market for a commodity is a market for immediate delivery, as opposed to a market for future delivery. *See Spot Market*, INVESTOPEDIA, https://www.investopedia.com/terms/s/spotmarket.asp.

[397] CFTC Backgrounder, *supra* note 396.

[398] *See* FIN-2013-G001, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN. CRIMES ENFORCEMENT NETWORK (Mar. 18, 2013), https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf.

[399] Peter J. Henning, *Should Congress Create a Crypto-Cop?*, N.Y. TIMES DEALBOOK (Feb. 14, 2018), https://www.nytimes.com/2018/02/14/business/dealbook/bitcoin-cryptocurrency-regulation.html.

[400] Testimony on "Examining the Cryptocurrencies and ICO Markets" by Robert Rosenblum, Partner, Wilson Sonsini Goodrich & Rosati, Before the Capital Markets, Securities and Investment Subcommittee of the House Committee on Financial Services, United States House of Representatives (Mar. 14, 2018), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-rrosenblum-20180314.pdf.

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