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Mutually assured disruption: The rise of the security token

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Introduction

The advent of blockchain technology, with all of its promise for disrupting existing business, economic, and even governmental and social models, more immediately has disrupted traditional models of capital markets activity, as well as the sleep of many a securities regulator. Initial coin offerings (also known as ICOs, token sales, token generation events, or TGEs)[2] are increasingly displacing venture capital fundraising and initial public offerings as a favoured means of raising capital and funding the development of product and service offerings. Whether driven by well-intentioned technologists, financial professionals or scammers, burgeoning technological capabilities and the ability to build and leverage network effects have frequently outpaced legal understanding and compliance.

While the earliest token sale occurred in 2013,[3] it was 2016 and 2017 that brought ICOs into the mainstream media focus.[4] Many of those selling or otherwise distributing digital tokens to fund project development, drive network adoption and monetise goodwill believed that they had created something new, that fell entirely outside of existing United States securities laws – token sales were sales of software, after all.

However, long before the U.S. Securities and Exchange Commission (the "SEC") made clear that token sales could be sales of securities, experienced securities lawyers counselled that this likely was the case. Indeed, months before the SEC provided formal guidance on the topic (via *The DAO 21A Report*),[5] blockchain industry pioneer Emma Channing had already structured as a sale of securities the Blockchain Capital token sale, which, among other things, was conducted pursuant to Regulation D and Regulation S, in each case, of the Securities Act of 1933, as amended (the "Securities Act"). Launched from Singapore, the Blockchain Capital token sale is believed by many to be the first self-described security token offering.

This chapter is titled "The Rise of the Security Token," and not "The Birth of the Security Token," because, while popular belief within the blockchain community at one time bifurcated the universe of ICO tokens into broad categories of so-called "utility tokens," purported not to be securities, and tokens with securities-like features that were understood to be securities, it now is widely recognised that, in the eyes of U.S. federal securities regulators, sales of tokens to U.S. persons in ICOs generally have been sales of securities all along. In other words, with limited exceptions, utility tokens sold to U.S. persons via ICOs were born as securities after all, by virtue of the investment contracts through which they were marketed or sold. While applicable law and interpretive guidance remain scant, it also now appears that certain of those tokens might one day, as a legal matter, "morph" into non-securities, as in the case of Ethereum (as discussed below).

Even if it is presumed that all token sales to U.S. persons are sales of investment contracts and, hence, securities, for token sellers and their counsel, there remain many unanswered questions, particularly in the cases of tokens that have a "consumptive" use. Not only is it unclear how and when a token may be said no longer to be a security under U.S. securities laws, but issuance of a token as a security raises questions under *existing* U.S. securities laws. For instance, certain unresolved issues include the requirement to file periodic reports with the SEC under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), flowback of tokens into the United States from regulated and unregulated exchanges around the world, broker registration requirements and the risk of inadvertent status as an investment company under the Investment Company Act of 1940, as amended (the "40 Act").

This chapter provides a brief review of the nature of a blockchain token (alternately referred to as a token or digital token),[6] and highlights some of the most prominent U.S. federal securities law guidance[7] and market developments that have led to practitioners' current understandings. Finally, it explores some of the key unanswered legal questions being wrestled with by market participants, their counsel and regulators alike.

Part 1: What are digital tokens?

Despite regulatory uncertainty and pronounced market volatility, digital token sales have emerged as an important capital markets activity. According to some estimates, more than US $10 billion in the aggregate was raised via token sales during the first half of 2018 alone,[8] with token sales increasingly rivalling traditional IPO and venture capital markets:

> "*The initial coin offering (ICO) market – defined as capital raised on open blockchains via token sales – was 45% and 31% of the traditional IPO and venture capital markets during Q2 2018, respectively, up from 40% and 30%, during Q1 2018. ICO volume during Q2 2018 was approximately $7.2 billion, according to Coindesk, while the US IPO market raised $16.0 billion (as reported by PwC), and US venture capital markets raised $23 billion (as reported by CB Insights and PwC) during the same period.*"[9]

But what are these digital tokens? At core,

> "*digital tokens are no more or less than numbered entries on a blockchain-based electronic ledger. These ledger entries may indeed be structured to look very much like traditional 'securities' – representing promises to pay amounts in the future, ownership, or other interests in an entity, etc. However, digital tokens can also represent units of value, which may make them look more like commodities; they can function as property records or warehouse receipts; they can entitle owners to the right to use a software system, which makes them look more like licenses. Some digital tokens may simply represent data points in a larger data structure. This is what many lawyers and others mean when they caution that there is no single type, nor set of clear categories, of digital tokens. There is tremendous flexibility in how to structure digital tokens and what those digital tokens may represent.*"[10]

If, rather than imagining a token as a physical coin, one thinks of a digital token as more akin to a credit card number, one can begin to see how there may be no single "paradigmatic" token, as well as why U.S. regulators may, at various times and sometimes at the same time, view a token alternatively as property (the IRS), a commodity (the CFTC), money (FinCEN) or a security (the SEC). For instance, when a user purchases computer software, upon installation, she may be prompted to enter in a licence key, typically a string of letters or numbers. In an alternative model, each person who holds a string of numbers issued by a company or project could have the right to receive $5, or a specified percentage interest in the company's or project's economic returns, or the right to vote on certain activities or developments of the company or project. Alternatively, each string of numbers could entitle the holder to entrance to a particular members-only event, with the lowest number being the first in line. In another of endless potential examples, one could identify individual items of personal property, such as a treasured watch or ring, or authenticate a legal document by specifying a string of numbers that corresponds to it.

As one lawyer noted while reflecting on 2017, in his view:

> "*[....] most blockchain tokens are something very different from traditional securities. Rather than representing fungible contractual rights or claims, such as the right to receive dividends or a residual claim on the assets of a corporation, in the case of stock, or the right to payments of principal or interest in the case of debt instruments, they are particularized digital assets, each immutably tied to a specific cryptographic key. It is not financial sophistication that is needed to understand these assets but rather technological sophistication and [....] a healthy amount of imagination as to what the future will look like and the types of products and services that will be appealing to people.*"[11]

This tremendous variability in token characteristics has led many individuals and certain nations[12] to posit that sales of certain tokens that have nonincidental utility[13] or consumptive use (in the nature of tokens at a laundromat or video game arcade) are not sales of securities. Over the past couple of years, some in the crypto community have referred to such tokens alternatively as utility tokens, consumer tokens or consumptive tokens, in an attempt to distinguish them, categorically, from tokens that are securities.[14]

Notwithstanding such terminology, U.S. securities regulators have made clear that even if an individual token is not structured to have characteristics of traditional debt or equity securities, an initial token sale may be – and in most cases, almost certainly is – a sale of an investment contract, and, therefore, a security, under U.S. securities laws.[15]

Part 2: The rise of the security token

The DAO report: ICOs may be sales of securities

The most famous, or infamous, token sale of 2016, The DAO, now stands as a cautionary example of how not to conduct a token sale.

The DAO,[16] a "decentralised autonomous organisation" that sought to be a virtual venture fund, has been described as a token sale where the project's marketing efforts were superior to its smart contracts. The DAO token generation event, launched from Switzerland by a Swiss foundation, was wildly successful, rapidly raising some $150 million to $250 million[17] in digital currency, depending on the date of calculation. However, due to a vulnerability in the smart contract code, a bad actor was able to remove roughly US$50 million shortly thereafter. This caused a heated debate in the blockchain community, with some taking the position that "code is law", and that, essentially, it is rightful to exploit a software design flaw, while others argued that "code is code" and "law is law", and that no-one who participated in The DAO crowdsale would have done so with the expectation that their contributions would be removed in such a way. The ensuing struggle led to the so-called "hard fork" of Ethereum, which resulted in a new blockchain diverging from the then-existing Ethereum blockchain. On what is now referred to as "Ethereum," an earlier block was appended to the blockchain, essentially resulting in those who contributed to The DAO crowdfund being "refunded" the digital tokens that they had donated, so that no-one was harmed. On the legacy blockchain, now called "Ethereum Classic," the original transaction by the bad actor was not "erased" and lives on.

Understanding the story of The DAO is important for multiple reasons.

First, in 2016, The DAO initially was viewed – by token sellers and investors alike – as a success story, a model of how to conduct a token offering (other than with respect to the smart contract vulnerabilities).

> "*The DAO was launched on April 30, 2016, at 10:00am GMT/UTC (by several "anonymous" submissions associated with DAOhub, who executed the open source bytecode on the Ethereum blockchain), with a set funding or "creation" period of 28 days (A2be, 2016). As the funding period came to a close (concluding May 28, 2016), The DAO went live with the equivalent of about US$250m[illion] in funding, breaking all existing crowdfunding records. Some 10,000 to 20,000 (estimated) people invested in The DAO, contributing 11,994,260.98 Ethereum tokens (known as ether, or ETH), which amounted to about 14% of the total ETH supply.*"[18]

When certain lawyers, including the author of this chapter, raised U.S. securities law concerns, responses from certain token sellers often approximated, "Well, The DAO did it, and no one is going after them." Despite many of the same lawyers noting that The DAO likely ran afoul of myriad laws around the world, some organisations and individuals were unpersuaded. In fact, anecdotally, some token sellers may have decided to follow The DAO's Swiss foundation token-generation model at the specific behest of potential contributors. Why? While reasons may vary, some token generators (and contributors) evidently believed that a non-profit entity could not issue securities,[19] as well as that the term "foundation" would sound trustworthy to prospective purchasers or contributors.[20]

Second, because all of those who had contributed money to The DAO token generation event had been refunded and The DAO itself had been disbanded, it gave the SEC a strong, useful opportunity for a "teachable moment" to warn the blockchain and crypto community, and their lawyers, that digital token sales may be sales of securities, without the backdrop of continuing harm requiring practical redress. In July 2017, the SEC's Division of Enforcement published a "report of investigation" ("The DAO Report") making clear that The DAO violated U.S. federal securities laws when it sold tokens with the goal of funding certain projects without registering the offering.[21,22] The DAO fundraising had been a sale of securities under U.S. federal securities laws.

In The DAO Report, the SEC emphasised that sales of digital tokens may be "investment contracts," and, therefore, securities. In doing so, the SEC applied the so-called *Howey* test, an over 70-year-old, four-prong, facts-and-circumstances test that asks whether there has been (i) an investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profit, (iv) with such profit being solely or primarily based on the managerial or entrepreneurial efforts of others.[23]

The DAO Report didn't stop there, however. The SEC also indicated that, because The DAO Tokens were securities, the platforms on which The DAO Tokens were bought, sold or traded were securities exchanges, which meant that The DAO platform needed to register as a national securities exchange, or avail itself of an exemption from registration, such as by registering as an alternative trading system or broker-dealer.[24] This had follow-on implications for the many unregulated crypto exchanges around the world serving U.S. persons, of which the SEC reminded exchanges in 2018.[25]

In a footnote to The DAO Report, the SEC raised the possibility that The DAO also may have been an investment company but noted that, because The DAO had never commenced its business operations funding projects, the SEC declined to conduct such analysis.[26]

Some other key takeaways from The DAO Report included the following:

- No matter where in the world one launches a token sale from, a token issuer must comply with U.S. securities laws if tokens are being marketed, issued or sold to U.S. persons. Indeed, the fact that The DAO was a Swiss foundation did not exempt it from compliance with U.S. federal securities laws.
- The SEC will disregard form and focus on substance when it comes to sales of digital tokens. Notwithstanding the creation of new technology and new terminology, the principles-based U.S. securities laws are intended to be broad enough to contemplate such innovations. For instance, although The DAO involved a decentralised autonomous organisation, the SEC still found that there was an "issuer" as contemplated by U.S. securities laws. And although contributions were made to The DAO in digital tokens, including Ethereum, which the SEC referred to in The DAO Report as a "virtual currency," the SEC found that there had been an investment of money.

However, while informative, and while it confirmed the views of many responsible securities lawyers,[27] The DAO Report left many questions unanswered. As noted previously, The DAO was a virtual venture fund. It was an example of a digital token that in many ways looked just like a traditional security. While the SEC made clear that a token that looked just like a security was in fact a security, it did not provide guidance as to the facts and circumstances under which a token would not be a security. For instance, if a token had a consumptive use, or some non-incidental utility, what were the boundaries for when a sale of such a token was not a sale of a security? While The DAO Report provided clear guidance based on its idiosyncratic facts, it did not provide much clarity in other contexts.

A brief word on why it matters at all if a token sale is a sale of securities. With roots in the stock market crash of 1929 – the culmination of a period rife with speculation, poor investor disclosure and rampant fraud – the mandate of U.S. securities regulators is investor protection. Many investors lack the sophistication, experience, savings cushion or income level to appreciate the risks inherent in investments in securities, or to bear the risk of a failed investment. For that reason, sales of securities are required to comply with robust disclosure requirements (including disclosure of things that are likely to be material to a purchase decision, such as information about the issuer and the proposed use of proceeds) that sales of software typically do not include, as well as explicit descriptions of potential investment risk factors. As evidenced by the tremendous variability among token project white papers, some of which may contain false promises, little to no description of the team, nearly incomprehensible token and network descriptions, or mere marketing fluff, full and fair disclosure is a goal that likely would be helpful, even if tokens were deemed not to be securities.[28]

Notably, the SEC had focused on The DAO and not on Ethereum (or, Ethereum Classic). Had Ethereum been deemed to be a security, presumably the entire economy of ERC-20 and, later, ERC-721 and other tokens, built on the Ethereum blockchain, would have been in legal peril. The SEC could have cut off at the knees nearly the entire token sale industry, but it chose not to.

Searching for solutions

By autumn 2017, the *Howey* test was being quoted (*ad nauseum*) at cocktail parties by lawyers, technologists and investors alike. Industry groups, such as the Wall Street Blockchain Alliance Legal Working Group and Wharton Reg@Tech, among others, were wrestling actively with the application of *Howey* and its progeny on token sales, trying to develop a common view of situations in which an initial token sale was unlikely to be a sale of securities.

Many in the community drew a distinction between those tokens that were being sold for consumptive use (albeit usually at an uncertain future date) and those that were being sold for investment purposes. However, the growing popularity of token sales and interest by traditional accredited investors, including VC funds, high-net-worth individuals, and certain family offices, in purchasing or pre-purchasing digital tokens (sometimes for a deep discount and little to no lockup) appeared in some ways at odds with the assertion that a given token was being sold other than as an investment. Often, those traditional investors had little interest in actually using the purchased tokens, or purchased or pre-purchased tokens in a quantity that such investors were unlikely to use.

In the background, many of these digital tokens were being traded around the world on unregulated token exchanges, many of which were accessible to U.S. persons, whether accredited or "Main Street" (i.e., "mom-and-pop") investors. While some in the crypto community pointed to the importance of such exchanges for helping to get tokens in the hands of potential users worldwide and amplifying a "network effect" and demand to access a particular token ecosystem, others acknowledged that unregulated exchanges were critical for driving appreciation of the token's price. Intentionally or not, the existence of the secondary market for digital tokens contributed to the expectation of profit by token purchasers.

Unfortunately for investors, if a token were deemed to be a security, The DAO Report made clear that such token could not trade on a platform accessible by U.S. persons, unless such platform registered as a national securities exchange or as an alternative trading system or broker-dealer (with attendant significant compliance requirements). Many unregulated exchanges did not want to register as such, and some therefore attempted to restrict access by U.S. persons to such exchanges, or limited listed tokens to those that they were confident – or had been advised by lawyers or token sellers – were less likely to be securities. Unfortunately, even if one were to acknowledge that a given token sale was a sale of securities, no alternative trading systems then existed on which such tokens could be traded.[29]

Moreover, if token sales were sales of securities, then such sales would need to be registered pursuant to U.S. securities laws (perhaps on a Form S-1) or be effected pursuant to an exemption from registration, such as Regulation D (accredited investors), Regulation S (non-U.S. persons), Regulation A+ (mini-IPO) or Regulation CF (crowdfunding capped at US$1,070,000), in each case, under the Securities Act. For token sellers that wished to sell tokens to U.S. persons who were *not* accredited investors[30] – which arguably may have included some of the very people who most wanted to purchase tokens for their intended consumptive use – some of the most convenient exemptions from registration, such as conducting a private placement under Regulation D, generally would not permit that.

And even for U.S. accredited investors, if tokens were securities and were sold pursuant to Regulation D, there would be corresponding compliance requirements, such as significant transfer restrictions (typically one year for companies that are not already SEC reporting companies) and, for Rule 506(c) offerings, a statutory requirement to take reasonable steps to verify that the token purchasers were, in fact, accredited.[31]

If tokens were securities, then there would be potential follow-on effects for nearly the entire universe of crypto market participants. Those marketing token sales risked becoming unregistered broker-dealers and unlicensed investment advisors, and transaction-based pricing for token transactions (whether or not paid in tokens) risked raising broker-dealer issues. Investment company and investment advisor rules and regulations would be implicated for funds investing in tokens. The domino effects would be significant for the nascent and burgeoning cryptocurrency community.

However, as significant funds were being raised by token sellers in presales, sometimes long before the tokens or the token networks were created, to fund the projects' development, could anything be done to stop the resulting tokens – which presumably were intended for consumptive use – from being deemed securities?

<u>The SAFT</u>

Enter the SAFT Project.[32] Introduced as a proposal for discussion and further iteration, the SAFT (Simple Agreement for Future Tokens) was embraced quickly by a market hungry for a solution. Based generally on a SAFE (Simple Agreement for Future Equity), SAFTs were not invented by the creators of the SAFT Project, but they were made immensely popular by it. At its most basic, the SAFT white paper proposed that a SAFT, an executory contract for the future sale of tokens, was itself a security but that the resulting token – to be delivered at a time when the token and network were "functional" – would not be a security. By conceptually bifurcating the presale of a token from the token itself, one purportedly could sell a SAFT to accredited investors, pursuant to Regulation D, who were purchasing the SAFT for investment, yet allow such investors ultimately to receive a token that was not a security. The rationale was that before the network and token were "functional," purchasers of "pre-functional" tokens would bear enterprise risk, while, once the token was "functional," token purchasers would bear product risk.[33] The form of SAFT proposed by the SAFT white paper expressly stated that purchasers of the SAFT were purchasing the SAFT solely for investment, rather than for use, and did not describe the terms or minimum characteristics of the tokens ultimately to be delivered.

Many in the market began using SAFTs, including the verbatim form of SAFT attached as a discussion piece to the SAFT white paper, sometimes without even engaging legal counsel. Some reportedly created SAFTs without consulting non-U.S. lawyers, sometimes resulting in non-U.S. entities (such as Swiss foundations) being obligated to do things that they simply could not do under their applicable jurisdiction of formation's laws. Critics of the SAFT spoke out, identifying limitations in the proposed form of SAFT and potential weaknesses in the underlying legal rationale. Among them, the Cardozo Blockchain Project released "Not So Fast – Risks Related to the Use of a 'SAFT' for Token Sales" (the "Cardozo Blockchain Report").[34] The Cardozo Blockchain Report argued, among other things, that conceptually separating the SAFT from the underlying token was an artificial distinction, and if a significant percentage of those tokens were being presold by the token seller to persons who had expressly represented that they were purchasing the tokens for investment and not for use, that could make it more, rather than less, likely that the tokens themselves were being sold as investment contracts. Moreover, the Cardozo Blockchain Project asserted that the line between when software is "pre-functional" versus "functional" is not bright. It also raised policy questions regarding whether sales of software should be limited to accredited investors.

In some ways, it seemed that opinions for or against the SAFT white paper divided traditional VCs and other accredited investors, who looked to SAFTs as a way to facilitate investment in the space and help technologists fund the building of token ecosystems, and decentralisation purists, who stressed that many of those most likely to use tokens for their intended purpose were not accredited investors, and that classifying tokens as securities would cause them to be more difficult to obtain and more complicated to use. Today, with the benefit of regulatory hindsight, some in the market continue to use pre-sale documents, including some executory contracts that may be called "SAFTs," but often with the assumption that the underlying token will at all times be a security and employing substantially different substantive terms from the SAFT Project's illustrative starting point.

While the SAFT framework continues to be a lightning rod for strong opinions, and ongoing debate ensues regarding whether the overall SAFT model is, or should be, dead[35] or alive,[36] one of the underlying themes raised in the SAFT white paper – the importance of token functionality to the securities law analysis – appears to have been validated by certain regulators. Notably (and irrespective of whether one believes that software functionality is a grey area), in 2018, certain governmental bodies, including Switzerland's Financial Market Supervisory Authority ("FINMA")[37] and, more recently, SEC Director Hinman,[38] have referenced the "pre-functional" versus "functional" distinction as a factor when assessing whether the sale of a token with a consumptive use would be a sale of a security (or jurisdictional equivalent).[39]

Indeed, to some, an October 2017 quote from one of the crypto industry's most ardent and vocal supporters of the SAFT framework may now sound almost prescient:

> "*I think almost all pre-functional tokens result in a security per U.S. law," says [Marco] Santori, noting that this is a controversial stance in a world in which so many token sales occur before the issuers have launched a network. "Just because utility tokens will one day have a consumptive use, does that remove them from security status prior to that use? On its face, the answer is no.*"[40]

<u>Chairman Clayton and "Hallmarks of a Security"</u>

Despite regulatory uncertainty, initial token sales continued to accelerate as 2017 wore on. SEC Chairman Jay Clayton's bold statement, "I have yet to see an ICO that doesn't have a sufficient number of hallmarks of a security," demonstrated the SEC staff's concern that, notwithstanding The DAO Report, non-compliant token sales were continuing.[41] Chairman Clayton also targeted unregulated token exchanges, noting, "In addition to requiring platforms that are engaging in the activities of an exchange to either register as national securities exchanges or seek an exemption from registration, the Commission will continue to seek clarity for investors on how tokens are listed on these exchanges and the standards for listing; how tokens are valued; and what protections are in place for market integrity and investor protection."[42]

<u>Munchee and manner of sale</u>

In the months after The DAO Report was released, the SEC announced[43] its new Cyber Unit focused on the token sale space, cracked down on ICO-related scams and frauds[44] and engaged in educational outreach to potential token purchasers.[45] Many founders, lawyers and others in the space concentrated on devising tokens with a consumptive use, trying to "fail" the *Howey* test. While the term "utility token" had existed prior to The DAO Report, post-DAO Report, the term was used so frequently and in so many situations as to make the label nearly meaningless. As one industry reporter noted in 2017, "Recently, terms like 'app coin,' 'app token,' 'utility token' and 'utility coin' have seemed to proliferate. But, what they all have in common is this: people use them interchangeably to mean 'a token that is not a security.'"[46]

One hurdle with the *Howey* test related to its "reasonable expectation of profits" prong, and whether that should be a subjective or objective test. If it were a subjective test, it could result in different outcomes, depending on the individual purchaser. For instance, one could purchase Ethereum with the intent to use it as "gas"[47] to execute smart contracts on the Ethereum blockchain. Alternatively, one could purchase Ethereum for investment purposes, as a store of value, with the expectation that its value likely would increase over time.

If the "reasonable expectation of profits" were an objective test, one would look to the actions of the token seller and its agents to see whether they had given purchasers a reasonable expectation of profits. To some lawyers in the crypto space, this seemed to be a more appropriate and consistent method of determining whether a token sale was a sale of securities. It also found support in the line of cases that followed *Howey*, including *Glenn W. Turner*,[48] which focused on the manner of sale of the token seller – namely, that by marketing a token as an investment, one could create a security, even if the token characteristics, on their face, would not appear to be those of a security.

At the time, seemingly countless, carefully structured "utility" tokens were being marketed by those promising returns on investment or network growth, whether by token sellers or by those promoting token sales. Indeed, some token sellers offered "bounties" to token purchasers[49] who encouraged their friends to purchase tokens, without policing the sales activities of the individual promoters. In many cases, the token sellers and others in the space were well intentioned and not fraudsters; however, they still may have been selling unregistered securities without availing themselves of an exemption from registration.[50]

In December 2017, the SEC announced its next warning to the token industry, when it published a Cease and Desist Order (the "Munchee Order") issued to a California corporation, Munchee, Inc. ("Munchee"), halting an ongoing token sale for the MUN Token and requiring the token seller to return funds to those who already had purchased tokens.[51]

The Munchee Order was notable because it reportedly was the first time that the SEC had stopped a token sale without any allegations of fraud. The MUN Token was a self-described "utility token" that would be used in connection with an iPhone app to rank restaurant meals, and Munchee's white paper referenced having received legal guidance that the MUN Token was not a security under the *Howey* test, although it did not include such legal analysis in the white paper.

Nonetheless, the SEC found that the MUN Token sale was a sale of securities, because, among other things, Munchee's and its agents' marketing and sales activities primed MUN Token purchasers to have a reasonable expectation of profit.[52] In other words, those lawyers who had cautioned of the importance of "manner of sale" had been correct. It really did matter – and it mattered a lot.

In the Munchee Order, the SEC detailed a number of activities that promoted a reasonable expectation of profit by token purchasers:

- Although the restaurants were to be located only in the United States, Munchee had marketed the MUN Token to potential purchasers worldwide.
- Rather than marketing the MUN Token to those interested in the restaurant industry who might use the MUN Token, Munchee had marketed to those in Bitcoin chat rooms, who were interested in investing in digital tokens.
- The MUN Token white paper contained a flow-chart illustration showing that as market adoption increased, the value of the MUN Token was likely to increase. While

this objectively may have been a true statement, the SEC said that it gave potential purchasers an expectation of an increase in value of their investments.

- Munchee noted that it would promote secondary market liquidity and expected to have the MUN Token listed on unregulated token exchanges.[53]

The SEC's Cyber Unit had also scoured social media and cited evidence of a YouTube video in which a person unrelated to the Munchee team had been predicting great increases in the value of the MUN Token, which Munchee evidently had "liked" or linked to, arguably endorsing those statements.[54]

The SEC did not stop there, however. Instead, the SEC cautioned that even if the MUN Token had had a "practical use at the time of the offering" (which it did not), that still would not have insulated the MUN Token from being a security.[55]

Moreover, the SEC emphasised that "[w]hether or not a particular transaction involves the offer and sale of a security – regardless of the terminology used – will depend on the facts and circumstances, including the economic realities of the transaction." In other words, merely referring to a token as a "utility token" would not make its sale not a sale of securities.

While the MUN Token sale provided the SEC with a virtual treasure trove of "what not to do" examples, similar to The DAO Report guidance, the Munchee Order left many unanswered questions. For example, had Munchee and its agents not marketed the token sale as a sale of securities, would the outcome had been different? Or did the "economic realities" that the value of the token would be based on the efforts of others – in this case, Munchee – and the mere existence of a robust secondary market mean that all initial token sales were, nearly by definition, sales of securities? Unfortunately, no definition of "economic realities" was given in the Munchee Order, leaving many technologists' and their lawyers' hunger for bright-line guidance unsated.

Post-Munchee, many responsible lawyers took the position that the window for determining which initial token sales to U.S. persons, if any, were not sales of securities had become exceedingly narrow. In turn, many adopted the conservative view that any initial token sale to U.S. persons should be conducted as a sale of securities, absent express SEC guidance to the contrary.

<u>SEC Chairman Clayton's call to gatekeepers and joint statement by SEC and CFTC Chairmen</u>

On the day of the Munchee Order's publication, SEC Chairman Clayton issued a powerful reminder to "gatekeepers," such as lawyers, exchanges, accountants, broker-dealers and consultants involved in the token sale space, of their obligations to exercise their judgment and expertise with the goal of investor protection. Some in the market viewed this as a criticism by the SEC Chairman of market participants who may have encouraged "utility token" sales without considering manner of sale or economic realities.[56] In the same piece, Chairman Clayton cautioned retail (i.e., "Main Street") investors to pose extensive and tough questions to token sellers and to be sure that such investors understand and appreciate the risks of purchasing digital tokens prior to purchasing them.

One month later, in an op-ed published in the *Wall Street Journal, portions of which were published on the SEC's website*, Chairman Clayton and J. Christopher Giancarlo, the Chairman of the CFTC, said that the risks of ICOs are high and that "[c]aution is merited."[57]

> "*The two Chairmen described the challenges that they face in attempting to monitor and regulate cryptocurrency activities. For example, they noted that federal authority to apply anti-money laundering rules to these activities is clear, but the ability to regulate other aspects of this market is 'murkier.' Acknowledging that distributed*

ledger technology 'may in fact be the next great disruptive and productivity-enhancing economic development,' the regulators made it clear that they 'will not allow it or any other advancement to disrupt our commitment to fair and sound markets.'"[58]

Litigation and enforcement activity

The intensification of ICO activity in 2017 and 2018 saw a concomitant rise in private securities litigation against ICO issuers and promoters, as well as regulatory enforcement activity (including, notably, by the SEC). Of particular note, in late 2017, multiple class action lawsuits were filed against the founders and issuer of the US$232 million Tezos ICO (one of the largest ICOs completed during the recent market cycle).[59] With the benefit of hindsight in the form of the Munchee ruling and other SEC pronouncements that, in many cases, was unavailable to token sellers and their legal counsel at the time of the ICOs themselves, plaintiffs' lawyers may be well positioned to identify securities law compliance deficiencies in a number of completed ICOs.

At the time of this writing, litigation activity can be expected to continue, particularly in the face of an arguable cryptocurrency bear market, and as some blockchain projects may fail to realise the visions of their respective white papers. It is important to distinguish, however, between fraudsters and scammers, on the one hand, and those technologists and founders that have proceeded in good faith to develop their projects[60] and may have sought, and followed, the advice of their legal counsels. Similarly, given the volatility of the crypto markets, it is key to distinguish those token purchasers who may have been defrauded from those who may merely regret having used one form of token, such as Bitcoin or Ethereum, to obtain in an ICO a different kind of digital token – particularly if, as sometimes was the case in the latter part of 2017, the value of the Bitcoin or Ether later rose, while the value of the purchased token may have fallen.[61] This is similar to the famous "Bitcoin Pizza Day" purchaser, who likely wishes that he could return the two Papa John's pizzas that he purchased in 2010 for 10,000 Bitcoins (then equal to about US$25.00).[62]

For its part, the SEC has clearly marked ICO activity as a high enforcement priority, including by taking enforcement action to halt fraudulent ICO schemes[63] and, in a likely harbinger of future significant enforcement action, issuing subpoenas to dozens of ICO issuers and their advisors.[64]

A new asset class?

Even as U.S. securities regulators continued to characterise tokens sold to U.S. persons as securities and flexed enforcement muscles, prominent voices in the crypto community opined that the token sale space had contributed to the emergence of not just a new method for distribution and sale of software and project fundraising, but, potentially, a new asset class. Unlike traditional securities, such as equity or debt, many tokens had – and, in fact, were intentionally designed to have – consumptive uses, entitling the holder to purchase goods or services or granting access rights to a blockchain platform or decentralised application. Shoehorning such tokens into a rigid U.S. securities law framework might work, if imperfectly, for governance of initial sales and resales but, almost paradoxically, would not likely work in any logical or efficient manner for purchasers who actually had purchased such consumptive tokens for such tokens' intended uses.

In March 2018, the Wyoming Blockchain Coalition, led by Caitlin Long and Wyoming House Representative Tyler Lindholm,[65] among others, celebrated the successful passage by the State of Wyoming of five popular new blockchain-related laws, including House Bill 70,[66] which exempted from Wyoming state securities and money transmitters laws a category of consumptive tokens. Taking the position that consumptive blockchain tokens constituted a new asset class, and that property typically is the purview of state, rather than federal, law, House Bill 70 was loosely modelled on token classifications promulgated by FINMA (the Swiss securities regulator)[67] and provided exemptions for what it defined as "open blockchain tokens" that are not marketed as investments and that are exchangeable for goods or services.

SEC staff express openness to technological innovations

By early May 2018, SEC Commissioner Hester Peirce had delivered "Beaches and Bitcoin: Remarks before the Medici Conference,"[68] a contemplative speech that examined different types of tokens and invited questions about whether traditional U.S. federal securities law exemptions, such as Regulation D, worked well for token sales. Peirce's remarks were well received by many in the crypto community who appreciated that the regulator appeared to understand that tokens' innovative and flexible structuring might cause existing U.S. securities to fit imperfectly or be inappropriate. Commissioner Peirce lauded so-called "regulatory sandboxes" as a means of testing new technology without a heavy yoke of regulation and, extending the analogy, likened the appropriate role of a regulator to that of a lifeguard on a beach. Of particular note, Commissioner Peirce posited that all ICOs are not necessarily securities offerings: "Given the undeveloped nature of this area, I am wary of any blanket designation for all ICOs. Instead, the best path forward, at least for the time being, is to evaluate the facts and circumstances of each offering."

In June 2018, the SEC announced that Valerie Szczepanik had been named Associate Director of the SEC's Division of Corporation Finance, and Senior Advisor for Digital Assets and Innovation for Division Director, Bill Hinman.[69] Noting that it had newly created such advisory position, the SEC explained that "[....] Szczepanik will coordinate efforts across all SEC Divisions and Offices regarding the application of U.S. securities laws to emerging digital asset technologies and innovations, including Initial Coin Offerings and cryptocurrencies." Previously Assistant Director in the SEC's Division of Enforcement's Cyber Unit, and, currently, Head of the SEC's Distributed Ledger Technology Working Group, Co-Head of its Dark Web Working Group, and a member of its FinTech Working Group, Szczepanik's thought leadership within, and comprehension of, the crypto space made her appointment heartening to many in the blockchain community.[70]

> "*[....] Not only is her promotion a sign that the Feds are ready to tackle crypto regulation in earnest, but also a hint that they are willing to cooperate meaningfully with the blockchain industry. Recognized as someone who roots for the healthy balance between investor protection and facilitating technology development, she is well-situated to reconcile the two to the extent it is possible at all. [....]*"[71]

Later that month, in an interview with CNBC, SEC Chairman Clayton appeared to draw a distinction[72] between cryptocurrencies, such as Bitcoin, which he characterised as being a substitute for dollars or yen, and which he indicated was not security, with tokens sold pursuant to initial token sale to fund a venture, which he described as being securities. While Chairman Clayton reiterated that most ICOs involve an offering of securities, and indicated that the SEC would not change the definition of a security to suit the ICO community, he did acknowledge that blockchain technology has "incredible promise," and "can drive efficiencies not only in the financial markets but in a lot of markets."[73]

Director Hinman's speech: present-day Ethereum sales are not sales of securities

In a move that was celebrated by many in the crypto community, on June 14, 2018, William Hinman, Director for the Division of Corporation Finance for the SEC, gave a landmark speech[74] (the "Hinman Speech") that appears to have settled, at least unofficially, an enduring and troubling securities law question for the token sale industry: What about sales of Ethereum?[75] Were they sales of investment contracts?

Born via a token generation event using a Swiss foundation structure not unlike the one employed by The DAO, Ethereum had since attained broad adoption and use as "gas" by developers wishing to build and run smart contracts on the Ethereum blockchain, including other tokens or decentralised applications (dApps). The native token of Ethereum was also purchased in the secondary market by many who hoped that it would increase in value. Ethereum was also accepted as payment by numerous token generators, including The DAO, in their token offerings. Indeed, in The DAO Report, the SEC had referred to Ethereum as a "virtual currency."

Unlike Bitcoin (which SEC Chairman Clayton had clarified was not a security),[76] which relies upon a "proof of work" consensus model pursuant to which miners can be awarded an intentionally finite number of Bitcoin (capped by its creator(s), Satoshi Nakamoto, at 21 million),[77] the Ethereum Foundation originally had held an ICO for a then "pre-functional" token. However, was anyone really thinking about the Ethereum Foundation's 2018 activities, if any, when determining the value of Ethereum? Were accredited investors or retail purchasers thinking about the Ethereum Foundation at all when making purchasing decisions? Would it make sense to restrict Ethereum purchases by computer programmers, who might have PhDs and understand precisely how the tokens worked, yet not qualify as accredited investors, while permitting token purchases by those who had sufficient wealth or income, yet no comprehension of the technology?

If the SEC were to say that Ethereum was an illegally issued security, it arguably would have been perilous for the entire crypto industry. And to what avail? In 2018, was any token issuer in a position to provide periodic reporting under the Exchange Act? Would purchasers be better served by requiring that Ethereum be traded on alternative trading systems or by requiring developers to employ a brokerage account in order to use Ethereum for its intended purpose? Arguably, if Ethereum were determined to be a security, would that help protect those vulnerable investors whom U.S. regulators wanted to protect, or would it, in fact, cause the very economic harm that the SEC and other regulators were trying to avoid?

The Hinman Speech was striking because it addressed head-on a token-related situation that was neither a scam, nor an obvious sale of securities. The facts of Ethereum did not add up clearly to a lesson in what not to do, unlike The DAO or Munchee. There was no easy answer for the SEC.

It is difficult to prove a negative. The Hinman Speech arguably marked the first time that the SEC said that a specific token born from an ICO was <u>not</u> a security. In doing so, however, Hinman did not say that the initial Ethereum Foundation crowdfund, of the token now known as Ethereum Classic, had not been a sale of securities. In fact, Hinman specifically declined to comment on whether Ethereum had been born as a security, stating: "[P]utting aside the fundraising that accompanied the creation of Ether . . . current offers and sales of Ether are not securities transactions."

By making such a distinction, Hinman built on concepts raised by Commissioner Peirce's speech and introduced the concept that a token's status as a security need not be fixed at the moment of its sale, stating that the securities law analysis is "not static and does not strictly inhere to the instrument." Instead, the attributes of a particular token that cause it to be a security may evolve over time, and that such evolution ultimately may cause such token, or a subsequently issued token, no longer to be a security.

Importantly, Hinman drew a nuanced distinction between a digital token itself, and the way that such token is sold, stating:

> "*[....] Returning to the ICOs I am seeing, strictly speaking, the token – or coin or whatever the digital information packet is called – all by itself is not a security, just as the orange groves in Howey were not. Central to determining whether a security is being sold is how it is being sold, and the reasonable expectations of purchasers. When someone buys a housing unit to live in, it is probably not a security.[6] But under certain circumstances, the same asset can be offered and sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others. For example, if the housing unit is offered with a management contract or other services, it can be a security.[7] Similarly, when a CD, exempt from being treated as a security under Section 3 of the Securities Act, is sold as a part of a program organized by a broker who offers retail investors promises of liquidity and the potential to profit from changes in interest rates, the Gary Plastic case teaches us that the instrument can be part of an investment contract that is a security.[8]*
>
> *The same reasoning applies to digital assets. The digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract. And regulating these transactions as securities transactions makes sense.*"[78]

Decentralisation, according to Hinman, is a key determinant of whether a sale or resale of a given token was likely to be a sale of securities, and decentralisation could develop over time, even after an ICO. Indeed, Hinman stated, "[I]f the network on which the token or coin is to function is sufficiently decentralised – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract."

Just as purchasers of Ethereum may be unlikely to look to the Ethereum Foundation to carry out managerial or entrepreneurial efforts concerning Ether, Hinman indicated that it may be possible for certain tokens sold to U.S. accredited investors via SAFTs ultimately to no longer be securities, if they one day become part of a sufficiently decentralised token ecosystem. This fluid and ongoing analysis was heartening to many in the market who feared that a token born as a security via an ICO or purchase via a SAFT would forever after remain a security, even in subsequent secondary market transactions. Indeed, some legal practitioners had lamented that "Wall Street plumbing,"[79] and periodic reporting and other traditional U.S. federal securities law requirements, would not work for and would, in fact, thwart the use of consumptive tokens, as well as stymie network growth.

Why would sufficient decentralisation be a meaningful distinction that would enable certain consumptive token sales no longer to be classified as sales of securities, meaning that purchasers would no longer have the benefit of certain protections afforded by the U.S. federal securities laws? The Hinman Speech reminded listeners that the "impetus of the Securities Act is to remove the information asymmetry between promoters and investors," by requiring that sellers of securities make certain disclosures and engage in periodic reporting. This disclosure may be critical when a purchaser must rely on a seller's entrepreneurial or managerial efforts to develop and promote a project, in order for the value of a token to be maintained or increased. "When the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralised, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful."

Hinman advised those in the market, including lawyers, to "consider whether a third party – be it a person, entity or coordinated group of actors – drives the expectation of a return" when assessing whether a given token sale may be a sale of securities. To help guide this facts-and-circumstances analysis, Hinman suggested a non-exhaustive list of considerations:

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

Director Hinman also focused on whether a token may, in certain circumstances, cease to be a security, emphasising "contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security."

Noting that the SEC staff "would look to the economic substance of the transaction," Hinman asked that token "promoters and their counsels" consider the following questions, among other possible features:

"1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?

5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?"

In a footnote to the Hinman Speech, Director Hinman expressly declined "to opine on the legality or appropriateness of a SAFT," and reminded listeners that "[b]ecause the legal analysis must follow the economic realities of the particular facts of an offering, it may not be fruitful to debate a hypothetical structure in the abstract." Yet, the Hinman Speech arguably provided the possibility of a path forward for those who may have been parties to certain SAFTs, whether as token sellers or purchasers, and had sought ultimately to sell or purchase "functional" tokens that were not securities. For instance, the Hinman Speech identified the question of an application's stage of functionality (e.g., "fully functioning" *vs*. "early stages of development") as one of several factors for consideration when determining whether a given consumptive token was a security.[80] In addition, Director Hinman continued in a footnote, "From the discussion in this speech, however, it is clear I believe a token once offered in a security offering can, depending on the circumstances, later be offered in a non-securities transaction. I expect that some, perhaps many, may not. I encourage anyone that has questions on a particular SAFT structure to consult with knowledgeable securities counsel or the staff."

While groundbreaking in its assertion that certain consumptive tokens sold pursuant to an initial token sale might someday morph into non-securities, the Hinman Speech did not provide a clear roadmap pursuant to which token sellers, other market participants and their lawyers could objectively identify a consumptive token that was sufficiently decentralised as to no longer be a security, or how a token that initially may have been expressly issued as a security might extricate itself from securities law requirements, including any ongoing reporting requirements.[81]

Subsequent to the Hinman Speech, SEC Chairman Clayton made public statements in support of the points raised by the Hinman Speech,[82] and many legal practitioners expect during the second half of 2018 to participate in ongoing discussions in working groups and with regulators to elucidate the markers of sufficient decentralisation.

<u>Tomahawk: Token giveaways as sales of securities</u>

Even as the SEC continued to reinforce that tokens sold to U.S. persons through ICOs were very likely to be sales of securities, some in the crypto space continued to believe that token give-aways were different. Perhaps taking the view that the Howey test's "investment of money" prong would not be implicated if tokens were gifted or made available for no monetary consideration, rather than being "sold" pursuant to an ICO, some believed that token give-aways provided a method to allow both retail and accredited investors to receive tokens that were not securities.

While certain legal advisors had long cautioned token issuers that giving away a particular token, whether through "bounties" or so-called "air-drops," could still be a sale of securities,[83] the SEC had not addressed this issue directly in the digital token context. On August 14, 2018, that changed, when the SEC published a cease-and-desist order (the "Tomahawk Order")[84] focusing, among other things, on a token issuer that had instituted a token bounty program to promote its ICO. While the issuer, Tomahawk, "did not raise any money through" and, ultimately, abandoned its planned ICO, Tomahawk nonetheless issued, pursuant to its "Bounty Program," more than 80,000 TOM tokens to third parties who had assisted in marketing the token, whether using social media or otherwise.

Having first determined that the TOM token was an equity security,[85] the SEC stated that "[t]he ICO and Bounty Program constituted an offer of securities" under the Securities Act, "because it involved 'an attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.'" Moreover, the SEC's analysis clarified that the token giveaway was, in fact, a sale of securities, stating: "the distribution of TOM pursuant to the Bounty Program constituted sales under Section 2(a)(3) of the Securities Act, which applies to "every disposition of a security or interest in a security, for value.'"

Explaining that "a 'gift' of a security is a 'sale' within the meaning of the Securities Act when the donor receives some real benefit," the SEC made clear that "the lack of monetary consideration for 'free' shares does not mean there was not a sale or offer for sale for purposes of Section 5 of the Securities Act." Rather, the analysis turns on whether the token issuer received real benefit or value.

The SEC determined that Tomahawk "received value in exchange for the bounty distributions, in the form of online marketing," as well as "in the creation of a public trading market" for the TOM tokens. Specifically, the SEC stated that "[d]istribution of tokens that are securities in exchange for promotional services to advance the issuer's economic objectives or create a public market for the securities constitute sales" for purposes of both the Securities Act and the Exchange Act (including Rule 10b-5 thereunder).[86]

In the case of Tomahawk, an ICO had been planned and substantially pursued. But in the absence of any proposed ICO (or follow-on sale in exchange for fiat or digital currency), or under circumstances in which the token recipients had not provided promotional support, would the mere creation of a market or demand for the TOM token be sufficient "value" to constitute a sale of securities? In other words, had Tomahawk merely delivered the TOM token to wallet addresses with no action being taken whatsoever by token recipients, could that have constituted a securities sale? If the particular token is a security, the SEC's answer appears to be yes. Citing *SEC v. Sierra Brokerage Services, Inc.*,[87] which the SEC noted supports its view that "where a 'gift' disperses corporate ownership and thereby helps to create a public trading market it is treated as a sale," the Tomahawk Order suggests that mere creation of a public market for a security token, such as on token exchanges, would suffice.

The Tomahawk Order reminded market participants and their lawyers that purported gifts of securities may, in fact, be deemed securities sales, which is consistent with SEC guidance dating from the early internet days relating to equity give-aways in exchange for recipients providing personal information (such as email addresses) that was of value to the equity issuer.[88] However, it is notable that the SEC did not say that by virtue of a token giveaway, the particular token *became* a security. Rather, the token first was determined to be a security. Both Tomahawk and the early internet cases focused on an established security (e.g., equity or an equity-linked token). Conversely, in the case of a token that the SEC determines not to be a security, such as present-day Ethereum or Bitcoin, it would seem that a token give-away may not in fact necessarily be a sale of securities. As a legal matter, not every freely distributed item of potentially consumptive value (such as a coupon in a newspaper) necessarily is a security. Importantly, however, "manner of sale"-related factors described in both the Munchee Order and the Hinman Speech (for instance, whether the token issuer suggests or promises that a given token will increase in value) would seem to continue to have relevance to the then-current analysis of whether such a give-away may constitute an investment contract and, therefore, the sale of a security.

While providing useful guidance concerning token give-aways, the Tomahawk Order raises at least one thorny related question: Where is the line between a token recipient doing work to "earn" a token, on the one hand, and providing value or benefit to a token issuer, on the other hand? At first glance, the concepts would seem to go hand in hand, yet potentially pull in opposite directions when analysing whether a sale of securities has occurred. Some believe that when token recipients do work to "earn" a token (such as through "mining"), rather than relying on the entrepreneurial or managerial efforts of others, the delivery of that token is less likely to be an investment contract, and, hence, a sale of securities, because the *Howey* test's "efforts of others" prong would be less likely to be implicated. By contrast, looking from the perspective of a token seller, a token recipient doing work to earn a token may provide value to the token seller, for instance, by creating a market for the token, by validating transactions or by creating demand for the application itself. Based on *Tomahawk*, that would seem to suggest that a "sale" had occurred, particularly if the value derived is meaningful.

So does a token recipient doing work in order to receive a token make it more or less likely that a sale of securities has occurred?

Perhaps one way to navigate this conceptual tangle is to reflect upon the Hinman Speech and its concept of decentralisation. Rather than "going down the rabbit hole" of trying to distinguish between the concepts of "doing work" *vs*. "providing value," or between different kinds or "work" or degrees of "benefits," instead, one might ask who is receiving the benefit of the work? Is there a central promoter or recognisable "issuer" that is deriving benefit or value from the work of the token recipients? Or is it more like the Bitcoin blockchain, where miners earn tokens, but there is no "issuer" or central beneficiary? Perhaps Director Hinman's decentralisation framework may not only be critical for determining whether a given token is a security, but also of heuristic use in distinguishing when a "gift" of tokens is, in fact, a "sale." Maybe if a token is sufficiently decentralised as to no longer be a security, there no longer would be a true "who" receiving value for token recipients' work. And alternatively, as noted above, if the token itself were deemed not to be a security, perhaps one may not need to assess the work *vs*. value question at all.

Part 3: Current challenges with security tokens

While crypto thought-leaders, regulators and others in the token sale space grapple with the circumstances under which a security token may in the future evolve from a security to a non-security, token sellers that wish to affirmatively issue and sell their tokens as securities in compliance with U.S. federal securities laws face challenges of their own.

Unfortunately, as noted earlier in this chapter, opting into the securities law framework[89] may be an imperfect fit at best for token sellers, particularly in the case of tokens that have a consumptive use and have not been structured to resemble traditional debt or equity securities. Even once security token platforms, such as tZERO and Templum, are capable of permitting secondary market sales of security tokens, aspects of U.S. federal securities laws may not quite fit.

It is beyond the scope of this particular article to identify and solve all of the potential U.S. securities law pinch points. However, below is a non-exclusive list of issues for consideration, which relate to some of the more popular exemptions from registration under U.S. securities laws for securities offerings. (The below are intended to be in addition to the reporting requirement questions identified by Hinman's speech.)

Two of the arguably more favored, and potentially less expensive, exemptions from registration under U.S. securities laws are Regulation D and Regulation S, in each case, of the Securities Act, neither of which generally requires pre-sale interaction with the SEC. Below is a brief summary each:

Regulation D is an exemption available for private placements (transactions not involving a public offering). Under Rule 506 of Regulation D, two exemptions from registration are available, without any limitation on the amount of money raised.[90] Under Rule 506(b), a "safe harbour" under Section 4(a)(2) of the Securities Act, an issuer need not register securities so long as specified criteria are met, including that no general solicitation or advertising has been used to market the securities, and that there are no more than 35 non-accredited investors. By contrast, under Rule 506(c), an issuer may engage in broad solicitation and general advertisements of the offering so long as, among other things, all investors meet accreditation criteria (which the issuer has taken reasonable steps to verify, such as through review of W-2s, tax returns and the like). Companies that elect to comply with Rule 506(b) or 506(c) are required to file an electronic notice (Form D) with the SEC.[91]

Regulation S is an exemption available for offers and sales made outside of the United States, to non-"U.S. persons" (as that term is defined in the Securities Act). At its base, the Regulation S exemption may be an acknowledgment that U.S. securities regulators may be less concerned about protecting the interests of potential purchasers that are not U.S. persons, than such regulators would be about protecting those who are U.S. persons. Although frequently combined with Regulation D sales to accredited investors pursuant to Rule 506(b) or Rule 506(c), when used by itself, Regulation S prohibits any "directed selling efforts" from being made in the United States.

While the contours of Regulation D and Regulation S are familiar to securities lawyers, and while their effective use manifestly does avoid registration under the Securities Act, particular characteristics of ICOs may continue to pose challenges under U.S. federal securities laws even for issuers squarely fitting into these exemptions. Notable issues include:[92]

- <u>Issues under Section 12(g) of the Exchange Act</u>: In connection with the JOBS Act liberalisations to the U.S. federal securities laws, the Exchange Act was amended in 2016.[93] Section 12(g) of the Exchange Act specifies the thresholds that trigger the requirement that an issuer register with the SEC a class of securities. Under Section 12(g), an issuer of securities that is not a bank, bank holding company or savings and loan holding company, is required to register a class of equity securities under the Exchange Act if the issuer has more than US$10 million of total assets; and the securities are "held of record" by either 2,000 persons, or 500 persons who are not accredited investors, subject to certain exceptions.[94] While, depending on the facts and circumstances, tokens may not be "equity securities," the widespread holding by persons of digital tokens could trigger Exchange Act registration and corresponding ongoing reporting requirements (*i.e.*, the filing of annual reports on Form 10-K and quarterly reports on Form 10-Q, which would necessitate public disclosure tantamount to that of any public company).[95] To compound matters, it can be extraordinarily difficult to ascertain the number of holders of record of a token, where holders are pseudonymous and a single holder may have numerous digital wallets. One possible solution is to programmatically limit the number of holders (or digital wallets) within the blockchain protocol. (The alternative of aggregating multiple holders within a single "street name" holder would seem to be at odds with the ethos of decentralisation.)
- <u>Flowback issues</u>: While there are multiple categories of issuers under Regulation S, foreign issuers must reasonably believe at the commencement of a securities offering under Regulation S that there is no "substantial U.S. market interest" in the securities being sold. With respect to debt securities, for example, "substantial U.S. market interest" may be satisfied, among other things, by 300 or more U.S. persons being holders of record of such securities. In the context of global markets and unregulated exchanges that may list tokens of their own accord, even a token seller that carefully polices its ICO could nonetheless end

up with tokens that, without the token seller's participation or encouragement, are sold in the secondary market to U.S. persons. While some posit that tokens' smart contracts may be programmed to require know your customer/anti-money laundering checks prior to each resale, the current market reality appears to be that some unregulated token exchanges do not or cannot effectively prevent U.S. persons from accessing such exchanges and purchasing tokens that may have been issued pursuant to Regulation S. And while a substantial portion of many tech startups' compensatory packages includes equity incentives, reliance on Regulation S could tend to preclude compensating domestic employees with tokens.

- Broker registration requirements: If a token issuer engages a third party to find U.S. investors or to act as a placement agent in connection with a token offering, that party generally would be required to register as a broker (or be acting on behalf of a registered broker), with attendant compliance requirements.[96] To date, many traditional broker-dealers have been averse to facilitating ICO activity, and, at present, few service firms within the blockchain space have sought broker-dealer registration.[97]
- Investment Company Act issues: ICO issuers typically receive digital tokens in consideration for the tokens issued by them, and may hold a substantial amount of their own tokens. Accordingly, in certain circumstances, an ICO issuer could inadvertently become an "investment company" under the Investment Company Act of 1940, and thereby be subject to regulation as a mutual fund, if the issuer is deemed to hold "investment securities" with a value exceeding 40% of its total assets.[98]

Conclusion

As of August 2018, the date of this chapter, when it comes to ICOs, particularly in the case of tokens designed to have a consumptive use, there appears to be no "perfect fit" within U.S. federal securities laws for issuances to U.S. persons. As regulators, thought leaders,[99] other legal practitioners active in the space actively identify and try to reconcile friction points between existing laws and emerging technologies, the markets continue to move forward and grow. In a sense, there may be "mutually assured disruption," as technological development, legal understanding and compliance best practices grow together. The token sale genie is not going back in the bottle,[100] and moving forward with a goal to promote investor and consumer protection is critical, no matter what we ultimately may call a given token.

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Finally, the author thanks the many, many colleagues and friends in the space with whom she has been traveling this exciting blockchain and crypto path, some of whom are named or cited in, and several of whom kindly provided an advance read of, this chapter. "As soon as I saw you, I knew a grand adventure was about to happen." — A.A. Milne (*Winnie-the-Pooh*).

Endnotes

1. While this chapter attempts to provide a comprehensive view of the United States securities law guidance concerning digital tokens, this chapter does not exhaustively describe developments within the space. The views expressed in this chapter reflect the author's own views and may not necessarily reflect the views of any other person, any entity or any regulator. Nothing in this chapter is intended to be, and nothing should be relied upon as, legal advice or investment advice.
2. This chapter uses the term "ICO" for consistency. More recently, terms such as "security token offering" and "STO" have grown in popularity.
3. Buterin, Vitalik, *Mastercoin: A Second-Generation Protocol on the Bitcoin Blockchain*, Bitcoin Magazine (Nov. 4, 2013), available at https://bitcoinmagazine.com/articles/mastercoin-a-second-generation-protocol-on-the-bitcoin-blockchain-1383603310/.
4. *See, e.g.*, Channing, Emma, *State of the ICO Market – A GC's View*, Chambers and Partners Professional Advisors Fintech Guide 2018, (2017), *available at* https://www.chambersandpartners.com/state-of-the-ico-market ("2017 was the year that Initial Coin Offerings ('ICOs') broke onto the wider public consciousness (not to-date, assisted by the fact that ICO is a misnomer for digital token offerings in every single way conceivable).").
5. *See infra* Part 2: The rise of the security token.
6. This chapter presumes a background understanding of blockchain, smart contracts and digital tokens. For foundational information on the topics of blockchain, smart contracts and digital tokens, *see* Baris, Jay G. & Klayman, Joshua Ashley, *Blockchain Basics for Investment Managers: A Token of Appreciation*, 51 Nos. 6 and 7 The Review Of Securities And Commodities Regulation 68 (Mar. 21, 2018), available at https://www.shearman.com/-/media/Files/Perspectives/2018/03/Baris_Klayman_RSCR_Final_1.pdf?la=en&hash=4CD602B56ED60D38CB5EAC232EF3D80981026B0F.
7. For purposes of this chapter, we generally will not consider U.S. state securities laws, alternative tests that have arisen under case law for whether something may be a security under U.S. law, such as the "family resemblance test" or the "risk capital test," or legal requirements apart from securities regulation.
8. Lewitinn, Lawrence, *Study Rings Alarm Bells on Some of the Biggest ICOs*, Modern Consensus (Jul. 20, 2018), *available at* https://modernconsensus.com/cryptocurrencies/alt-coins/icos-code-white-paper-penn-study/ ("The analysis in 'Coin-Operated Capitalism' calculates some $3.8 billion went to 200 ICOs in 2017. 'By July of 2018, an additional 430 ICOs had raised almost $10 billion,' it said."), citing Coney, Shaanan; Hoffman, David A.; Sklaroff, Jeremy; & Wishnick, David A., *Coin Operated Capitalism* (Jul. 17, 2018; last rev. Aug. 7, 2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3215345 ("This Article presents the legal literature's first detailed analysis of the inner workings of Initial Coin Offerings").
9. Long, Caitlin, *ICOs Were 45% of IPOs in Q2 2018, As Cryptos Disrupt Investment Banks*, Forbes (July 22, 2018), *available at* https://www.forbes.com/sites/caitlinlong/2018/07/22/icos-were-45-of-ipos-in-q2-2018-as-cryptos-disrupt-investment-banks/#2f9a4d8a794c.
10. Klayman, Joshua Ashley; Cohen, Lewis Rinaudo; & Sosnow, Robin, *There are Two Sides to the Initial Coin Offering Debate*, Crowdfund Insider (Oct. 31, 2017), *available at* https://www.crowdfundinsider.com/2017/10/123863-perspective-two-sides-initial-coin-offering-debate/.
11. Cohen, Lewis, *A Crypto-Capital Markets Lawyer Looks Back on 2017*, Medium (Mar. 19, 2018), *available at* https://medium.com/@nycryptolawyer/a-crypto-capital-markets-lawyer-looks-back-on-2017-d5eb2123e570.

12. FINMA, Guidelines For Enquiries Regarding The Regulatory Framework For Initial Coin Offerings (ICOS)(Feb. 16, 2018), available at https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/1bewilligung/fintech/wegleitung-ico.pdf?la=en&hash=9CBB35972F3ABCB146FBF7F09C8E88E453CE600C (the "FINMA Guidelines").
13. An example of incidental (*vs*. non-incidental) utility for a particular user may be the right to vote at the annual stockholders' meeting of a large public company. Ownership of a single share of that stock may entitle the purchaser to vote at the annual meeting – which may mean that such share has utility – but that right to vote likely may not be the real impetus for purchasing the share of stock. In that sense, the share of stock could be said to have non-incidental utility. *See, e.g.*, A Securities Law Framework for Blockchain Tokens, Coinbase, Coin Center, Union Square Ventures & Consensys (Dec. 7, 2016), *available at* https://www.coinbase.com/legal/securities-law-framework.pdf (the "Securities Law Framework").
14. Bennington, Ash, *Utility Coins or Crypto Assets? Token Terminology Is One Big Gray Area*, Coindesk (Sept. 5, 2017), *available at* https://www.coindesk.com/utility-coins-crypto-assets-token-terminology-one-big-gray-area/.
15. Jurisdictions around the world have reached a variety of different conclusions, with some, including Switzerland, Gibraltar, Singapore and Malta, determining that certain token sales and token generation events are not sales of securities.
16. *See* DuPont, Quinn, *Experiments in Algorithmic Governance: A History and Ethnography of "The DAO," a Failed Decentralized Autonomous Organization*, Bitcoin And Beyond: The Challenges and Opportunities of Blockchains for Global Governance, 157 (Malcolm Campbell-Verduyn ed., Routledge 2018); *See generally The DAO (organisation)*, Wikipedia, *available at* https://en.wikipedia.org/wiki/The_DAO_(organization).
17. Dupont, *supra* n.16, at n.1 ("Values and dates for The DAO were initially collected through online sources, but later confirmed and adjusted to correspond with internal data provided by Stephan Tual of Slock.it. The largest discrepancy between publicly-reported [*sic*] values and internal values is the maximum USD-converted monetary value of The DAO, which online sources claimed reached a maximum of $150m. Using historical market data, Slock.it's internal data showed a maximum of $250m, from 11,944,260.98 ETH. Due to wild ETH price swings during this period, the USD-converted monetary value changed rapidly.")
18. *Id*. at 158.
19. Horner, Timothy L. & Makens, Hugh H., *Securities Regulation of Fundraising Activities of Religious and Other Nonprofit Organizations*, 27 Stetson L. Rev. 473, 473 (Fall 1997) ("There is a common misconception that religious and other nonprofit organisations are exempt from compliance with the securities laws. They are not.").
20. Others may have believed that, if an ICO were launched from Switzerland using a Swiss Foundation model and in compliance with Swiss law, that U.S. securities laws would not be implicated, even if U.S. persons were contributors.
21. *See* SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Release No. 81207 (July 25, 2017), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf (hereinafter, The DAO Report).
22. *See* Baris & Klayman, *supra* n.6, at 75-76.
23. *45 SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). Notably, a well-known crypto industry memorandum dated December 5, 2016, titled Securities Law Analysis of Blockchain Tokens (and informally referred to as the "Debevoise memo" or the "Lee Schneider memo") had asserted that the Howey test should be applied. *See* the

Securities Law Framework, *supra* n.13, at Part 3.

24. *See* The DAO Report, *supra* n.21 at 16-17 ("[….]The DAO arrangement involved a platform that provided users with 'an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.' This activity, the SEC said, also required The DAO to register as a national securities exchange because, among other things, it created an exchange for 'securities.' On the same day that it published the DAO Report, the SEC published an Investor Bulletin, cautioning investors about the risks of investing in initial coin offerings (ICOs), and suggesting questions to ask before investing.")
25. SEC, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (Mar. 7, 2018), *available at* https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.
26. The DAO Report, *supra* n.21 at n.1. See also Baris & Klayman, *supra* n.6 at 81.
27. *See* the Securities Law Framework, *supra* n.13.
28. Adlerstein, David M., *The ICO Governance Deficit*, COINDESK (Sep. 10, 2017), *available at* https://www.coindesk.com/ico-governance-deficit.
29. Templum and tZERO are among those that are trying to provide platforms for trading security tokens. *See* Dale, Brady, *ICOs Iced: A 12-Month Freeze on US Token Trading May Just Be Beginning*, COINDESK (Mar. 19, 2018), available at: https://www.coindesk.com/icos-iced-12-month-freeze-us-token-trading-just-beginning/.
30. "An accredited investor, in the context of a natural person, includes anyone who:
    - earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, OR
    - has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

    On the income test, the person must satisfy the thresholds for the three years consistently either alone or with a spouse, and cannot, for example, satisfy one year based on individual income and the next two years based on joint income with a spouse. The only exception is if a person is married within this period, in which case the person may satisfy the threshold on the basis of joint income for the years during which the person was married and on the basis of individual income for the other years.

    In addition, entities such as [certain] banks, partnerships, corporations, nonprofits and trusts may be accredited investors." SEC Investor Bulletin, Accredited Investors, SEC Pub. No. 158 (Sept. 2013), *available at* https://www.sec.gov/files/ib_accreditedinvestors.pdf.
31. For a discussion of Regulation D in greater detail, *see infra* Part 3: Current challenges with security tokens.
32. Batiz-Benet, Juan; Clayburgh, Jesse; & Santori, Marco, *The SAFT Project: Toward a Compliant Token Sale Framework*, THE SAFT PROJECT (Oct. 2, 2017), *available at* https://saftproject.com/static/SAFT-Project-Whitepaper.pdf.
33. *See* Shin, Laura, *Are ICOs for Utility Tokens Selling Securities? Prominent Crypto Players Say Yes*, FORBES (Oct. 2, 2017), *available at* https://www.forbes.com/sites/laurashin/2017/10/02/are-icos-for-utility-tokens-selling-securities-prominent-crypto-players-say-yes/#155bbb4734fa.
34. *Cardozo Blockchain Project Research Report #1, Not So Fast—Risks Related to the Use of a "SAFT" for Token Sales*, CARDOZO BLOCKCHAIN PROJECT (Nov. 21, 2017), *available at* https://cardozo.yu.edu/sites/default/files/Cardozo%20Blockchain%20Project%20-%20Not%20So%20Fast%20-%20SAFT%20Response_final.pdf.
35. *See*, e.g., Zeoli, Anthony, *Initial Coin Offerings: Why the SAFT is Dead*, CROWDFUND INSIDER (Mar. 26, 2018), available at https://www.crowdfundinsider.com/2018/03/131044-initial-

coin-offerings-why-the-saft-is-dead/; *see* Telpner, Joel, LinkedIn (Aug. 2018), *available at* https://www.linkedin.com/feed/update/urn:li:activity:6433027407199903744 ("Great pleasure participating in last night's panel on SAFTs. May they Rest in Peace"); *see* Kaplan, Aaron, *SEC Subpoenas Show the SAFT Approach to Token Sales is a Bad Idea*, VentureBeat (March 3, 2018), *available at* https://venturebeat.com/2018/03/03/sec-subpoenas-show-the-saft-approach-to-token-sales-is-a-bad-idea/ ("The proposition that utility tokens are not securities, as posited by the SAFT White Paper, is nonsense."); see BlockWorks Group, Everything You Need to Know About the SAFT (And Why It's Already Dead), YouTube (Aug. 28, 2018), *available at* https://www.youtube.com/watch?v=ZDykAgigcvs (video of Aug. 7, 2018 panel discussion moderated by Michael Ippolito, featuring Joshua Ashley Klayman, Joel Telpner & Stephen Wink); *c.f.* Shin, Laura, *How Crypto and Blockchain Technology Should Be Regulated*, Forbes (Dec. 12, 2017) (Laura Shin moderating a debate by Joshua Ashley Klayman and Marco Santori regarding the utility and viability of the SAFT framework), *available at* https://www.forbes.com/sites/laurashin/2017/12/12/how-crypto-and-blockchain-technology-should-be-regulated/#62fe51d467ba, podcast *available at* http://unchainedpodcast.co/how-crypto-and-blockchain-technology-should-be-regulated.

36. *See* Crea, Robert M.; Nolan, Anthony R.G.; & Rohrer, Eden L., *Metamorphosis: Digital Assets and the U.S. Securities Laws*, K&L Gates LLP (Jun. 27, 2018), *available at* http://www.klgates.com/metamorphosis-digital-assets-and-the-us-securities-laws-06-27-2018 ("Director Hinman's theory of decentralisation as a means to morph a security into a non-security also might restore some credibility to the "simple agreement for future tokens" or "SAFT" as a technique to insulate tokens from being deemed securities."); *see* Dale, Brady, *After Millions Raised, the SAFT Is Alive, But Who Knows How Well*, Coindesk (Apr. 27, 2018), *available at* https://www.coindesk.com/saft-alive-knows-well/ ('If you want non-dilutive financing, your choices are a SAFT or try to stay outside of the US.') (quoting Mark Radcliffe, a partner at the law firm DLA Piper).
37. *See Switzerland's Financial Regulator Clears the Path for ICOs*, MME (Feb. 28, 2018), *available at* https://www.mme.ch/fileadmin/files/documents/MME_Compact/2018/180228_Swiss_Financial_Regulator_clears_the_Path_for_ICOs.pdf.
38. *See* Hinman, William, SEC Div. of Corp. Fin. Director, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.
39. As discussed later in this chapter, SEC Director Hinman declined to opine about the legality or appropriateness of a SAFT. *Id*.
40. Shin, *supra* at n.33.
41. Michaels, David & Vigna, Paul, *SEC Chief Fires Warning Shot Against Coin Offerings*, Wall Street Journal (Nov. 9, 2017), *available at* https://www.wsj.com/articles/sec-chief-fires-warning-shot-against-coin-offerings-1510247148.
42. Clayton, Jay, SEC Chairman, Remarks at the PLI 49th Annual Institute on Securities Regulation (Nov. 8, 2017), *available at* https://www.sec.gov/news/speech/speech-clayton-2017-11-08.
43. SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors, SEC Press Release 2017-176 (Sep. 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-176.
44. *See, e.g.*, SEC Emergency Action Halts ICO Scam, SEC Press Release 2017-219 (Dec. 4, 2017), *available at* https://www.sec.gov/news/press-release/2017-219; Spotlight on Initial Coin Offerings and Digital Assets, SEC ICO Updates, *available at* https://www.sec.gov/spotlight-initial-coin-offerings-and-digital-assets.
45. *See, e.g.*, Investor Alert: Celebrity Endorsements, Investor.gov (Nov. 1, 2017) *available at* https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-

alert-celebrity-endorsements. This investor educational outreach continues in 2018. See, e.g., The SEC Has an Opportunity You Won't Want To Miss: Act Now!, Investor.gov (May 16, 2018), *available at* https://www.investor.gov/additional-resources/news-alerts/press-releases/sec-has-opportunity-you-won't-want-miss-act-now.

46. *Supra* n.14.
47. Satis Group (Satis Group research team led by Sherwin Dowlat, assisted by Michael Hodapp), *Cryptoassset Market Coverage Initiation: Network Creation*, Bloomberg LP [US] (Jul. 11, 2018), *available at* https://research.bloomberg.com/pub/res/d28giW28tf6G7T_Wr77aU0gDgFQ, at 5.
48. *SEC v. Glenn W. Turner Enterprises, Inc.*, 348 F. Supp. 766 (1972).
49. The SEC subsequently directly addressed "bounties" in its August 14, 2018 guidance. See *Tomahawk Exploration LLC and David Thompson Laurance*, Securities Act of 1933 Release No. 10530 (Aug. 14, 2018); *see also* Securities Exchange Act of 1934 Release No. 83839 (Aug. 14, 2018) (the "Tomahawk Order").
50. Baris & Klayman, *supra* n.6, at 79.
51. *Munchee, Inc.,* Securities Act of 1933 Release No. 10455 (Dec. 11, 2017), *available at* https://www.sec.gov/litigation/admin/2017/33-10445.pdf (the "Munchee Order").
52. For an analysis of the Munchee Order, see Klayman, Joshua Ashley & Baris, Jay G., *Food for Thought: SEC Turns Up the Heat on Utility Token Sales*, Crowdfund Insider (Dec. 18, 2017), *available at* https://www.crowdfundinsider.com/2017/12/126033-food-for-thought-the-sec-cyber-unit-halts-munchee-token-sale/.
53. Munchee Order, *supra* n.51, at 6-7.
54. *See id*. at 6, which states,

    "In addition, Munchee made public statements or endorsed other people's public statements that touted the opportunity to profit. For example, on or about October 25, 2017, Munchee created a public posting on Facebook, linked to a third-party YouTube video, and wrote '199% GAINS on MUN token at ICO price! Sign up for PRE-SALE NOW!' The linked video featured a person who said 'Today we are going to talk about Munchee. Munchee is a crazy ICO. If you don't know what an ICO is, it is called an initial coin offering. Pretty much, if you get into it early enough, you'll probably most likely get a return on it.' This person went on to use his 'ICO investing sheet' to compare the MUN token offering to what he called the 'Top 15 ICOs of all time' and 'speculate[d]' that a $1,000 investment could create a $94,000 return."
55. Some believe this to have been a direct statement concerning the SAFT white paper, interpreting the SEC's use of the term "practical use" to mean token functionality or usability (whether full or partial) at the moment of sale. Id. This is not a uniform view, however, and certain SAFT supporters hold the view that the SEC specifically declined to use the term "functionality" and that "practical use" focused on the labelling of the token as a "utility token." *See id*. at 9. Paragraph 35 of the Munchee Order reads:

    "Even if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security. 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.' [United Housing Found, Inc. v.] Forman, 421 U.S. [389, 849 (1975)]. All of the relevant facts and circumstances are considered in making that determination. See Forman, 421 U.S. at 849 (purchases of "stock" solely for purpose of obtaining housing not purchase of "investment contract"); see also SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352-53 (1943) (indicating the 'test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect')."

56. Clayton, Jay, SEC Chairman, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.
57. Baris & Klayman, *supra* n.6, at 77 (citing Clayton, Jay & Giancarlo, J. Christopher, Regulators Are Looking at Cryptocurrency, Wall Street Journal (Jan. 24, 2018), *available at* https://www.wsj.com/articles/regulators-arelooking-at-cryptocurrency-1516836363.)
58. *Id*. (*citing* SEC Public Statement, Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: Regulators are Looking at Cryptocurrency (Jan. 25, 2018), *available at* https://www.sec.gov/news/public-statement/statement-clayton-giancarlo-012518.)
59. *See* Lewis-Kraus, Gideon, *Inside the Crypto World's Biggest Scandal*, Wired (Jun. 19, 2018), *available at* https://www.wired.com/story/tezos-blockchain-love-story-horror-story/.
60. *Id*.
61. Klayman, Joshua Ashley, *The Token Sale Sky is Not Falling, Unless We Cause It To*., Crowdfund Insider (Nov. 5, 2017), *available at* https://www.crowdfundinsider.com/2017/11/124118-token-sale-sky-not-falling-unless-cause.
62. Caffyn, Grace Bitcoin Pizza Day: Celebrating the Pizzas Bought for 10,000 BTC, Coindesk (May 22, 2014), *available at* https://www.coindesk.com/bitcoin-pizza-day-celebrating-pizza-bought-10000-btc.
63. *See*, *e.g.*, Press Release, SEC, Halts Alleged Initial Coin Offering Scam (Jan. 30, 2018), *available at* https://www.sec.gov/news/press-release/2018-8.
64. Popper, Nathaniel, *Subpoenas Signal S.E.C. Crackdown on Initial Coin Offerings*, The New York Times (Feb. 28, 2018), *available at* https://www.nytimes.com/2018/02/28/technology/initial-coin-offerings-sec.html. ("Nick Morgan, a former lawyer in the SEC's enforcement division, said that according to his contacts in the industry, the subpoenas had gone out to as many as 80 companies and individuals.")
65. Long, Caitlin & Lindholm, Tyler, *A Haven for Blockchain: The Case for Wyoming*, coindesk (January 27, 2018), *available at* https://www.coindesk.com/haven-blockchain-case-wyoming.
66. Open blockchain tokens-exemptions, H.B. 70, 64th Leg., Budget Sess. (Wyo. 2018), *available at* https://legiscan.com/WY/bill/HB0070/2018.
67. *See generally* FINMA, *supra* n.12.
68. Peirce, Hester, SEC Commissioner, Beaches and Bitcoin: Remarks before the Medici Conference (May 2, 2018), *available at* https://www.sec.gov/news/speech/speech-peirce-050218.
69. SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation, SEC Press Release 2018-102 (Jun. 4, 2018), *available at* https://www.sec.gov/news/press-release/2018-102.
70. *See*, e.g., Roberts, Jeff John, *SEC's 'Crypto Czar' Says Smart Contracts Can Help Regulation,* Fortune, The Ledger (Jun. 7, 2018), *available at* http://fortune.com/2018/06/07/valerie-szczepanik-sec/.
71. Bryanov, Kirill, *What Do We Know About Valerie Szczepanik, the First Crypto Czar, CoinTelegraph* (Jun. 12, 2018), *available at* https://cointelegraph.com/news/what-do-we-know-about-valerie-szczepanik-the-first-crypto-czar.
72. Haan, Cali, *SEC Boss Jay Clayton Says Crypto Tokens Traded and Used to Fundraise are ALWAYS securities and Thus Regulated*, Crowdfund Insider (June 7, 2018), *available at* https://www.crowdfundinsider.com/2018/06/134623-sec-boss-jay-clayton-says-cryptocurrency-used-to-fundraise-traded-are-always-securities-and-thus-regulated (citing a CNBC interview with Bob Pisani).
73. *Id*.

74. See the Hinman Speech, *supra* n.38.
75. While the native token of the Ethereum blockchain often is referred to as "Ether" or "ETH," for purposes of this chapter, the token will be referred to as "Ethereum".
76. Haan, *supra* n.72.
77. Nakamoto, Satoshi, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008), *available at* https://bitcoin.org/bitcoin.pdf.
78. See the Hinman Speech, *supra* n.38.
79. Long, Caitlin; Cohen, Lewis; Tinianow, Andrea; & Slater, Rich, *A Ray of Hope for Utility Tokens*, Coindesk (Feb. 27, 2018), *available at* https://www.coindesk.com/ray-hope-utility-tokens/.
80. Certain supporters of the SAFT framework have taken the position that this in some ways parallels or supports the "functionality" distinction raised by the SAFT Project. *See* Marco Santori (@msantoriESQ), Twitter (Jun. 14, 2018), *available at* https://twitter.com/msantoriESQ/status/1007317386721218560; *see also* Roberts, Jeff John, *The SEC's Big Cryptocurrency Speech: 5 Things to Know*, Fortune (Jun. 15, 2018), *available at* http://fortune.com/2018/06/15/sec-ethereum/.
81. *See, e.g.,* Crea, Nolan & Rohrer, *supra* n.36; de Martino, F. Dario, Gault-Brown, Susan I., Kahan, Daniel R., Klayman, Joshua Ashley, Klein, Spencer D., Silva, Alfredo B.D. & Wojciechowski, Mark, *The Journey from Security to Non-Security: SEC Director Comments on Mutability of Token Treatment*, Morrison & Foerster LLP (Jun. 19, 2018), *available at* https://media2.mofo.com/documents/180619-sec-mutability-token.pdf.
82. "While Hinman's remarks are not the official view of the SEC, Commissioner Clayton gave testimony June 21, 2018, before the Committee on Financial Services of the U.S. House of Representatives where he noted Hinman's framework is 'the approach staff takes to evaluate whether a digital assetis a security.'" Lom, Andrew & Browndorf, Rachael, *SEC's Jay Clayton and Willliam Hinman reiterate Howey Is Here To Stay*, Financial Services: Regulation Tomorrow (Jun. 22, 2018), *available at* https://www.regulationtomorrow.com/us/secs-jay-clayton-and-william-hinman-reiterate-howey-is-here-to-stay/, (citing Testimony on "Oversight of the U.S. Securities and Exchange Commission" by SEC Chairman Jay Clayton, *available at* https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission.)
83. Baris & Klayman, *supra* n.6, at 76.
84. *See generally* Tomahawk Order, *supra* n.49.
85. While it is beyond the scope of this chapter, it should be noted that the TOM token was convertible into an equity security and that the SEC's cease-and-desist order was not limited to the Bounty Program analysis, see Telpner, Joel S.; Kaufman, Scott,; & Tomunen, Mari, *Low Risk, High Potential Rates of Return are Achievable*, Sullivan & Worcester LLP (Aug. 16, 2018), *available at* https://blog.sandw.com/financialservicesspotlight/low-risk-high-potential-rates-of-return-are-achievable.
86. As noted by the Tomahawk Order, "Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraud in connection with the purchase or sale of securities. Specifically, Rule 10b-5(b) prohibits making untrue statements of material fact or omitting to state a material fact necessary to make statements made not misleading in connection with the purchase or sale of any security. Violations of Section 10(b) and Rule 10b-5(b) require a showing of scienter", *supra* n.49, at 8.
87. 608 F. Supp. 2d 923, 940 (S.D. Ohio 2009).
88. *See Loofbourrow*, Securities Act of 1933 Release No. 7700 (July 21, 1999), *available at* https://www.sec.gov/litigation/admin/34-41631.htm (finding defendant offered free stock to investors via misleading websites); see also Sotirakis, Securities Act of 1933 Release No. 7701 (July 21, 1999), *available at* https://www.sec.gov/litigation/admin/33-7701.

htm (finding that for a short period of time the defendant offered unregistered free stock to people who registered on a website); *see also Web Works Marketing.com, Inc.*, Securities Act of 1933 Release No. 7703 (July 21, 1999) *available at* https://www.sec.gov/litigation/admin/34-41632.htm (finding that defendant offered unregistered free shares via misleading website); *see also WowAuction.com Inc.*, Securities Act of 1933 Release No. 7702 (July 21, 1999), *available at* https://www.sec.gov/litigation/admin/33-7702.htm (finding that defendant offered unregistered free stock via online auctioneer).

89. It should be noted that some securities lawyers may question whether one could choose to "opt into" the U.S. federal securities law framework (and afford purchasers the attendant securities law protections) if a particular token otherwise would not be a security. That consideration is beyond the scope of this chapter.

90. Apart from Regulation D, other exemptions permitting domestic offerings of securities include Regulation A and Regulation Crowdfunding. (*See Regulation A*, SEC, *available at* https://www.sec.gov/smallbusiness/exemptofferings/rega) ("Regulation A has two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period"); *See also Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC (May 13, 2017) (updated Apr. 6, 2017), *available at* https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm ("[An Issuer] is permitted to raise a maximum aggregate amount of $1,070,000 in a 12-month period"). Tokens sold pursuant to Reg A+ and Reg CF may be purchased by both accredited and unaccredited investors, however, Reg A+ requires that the token issuer be a U.S. or Canadian entity, while Reg CF requires that the issuer be a U.S. entity. Notably, while numerous would-be token issuers reportedly have pursued Reg A+ offerings, as of the date this chapter is written, the SEC has not yet qualified any Reg A+ offerings of tokens.

91. Failure to timely file a Form D will not cause the exemption to be unavailable. *See Securities Act Rules*, SEC (updated Nov. 6, 2017), *available at* https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

92. Prudent issuers will consider a range of legal matters separate and apart from securities law compliance, including (to name but a few) compliance with Bank Secrecy Act and anti-money laundering requirements, compliance with money transmittal law and regulation, secure and legally compliant custodianship, and compliance with any state licensure requirements. *See generally* Shin, Laura, *Crypto Industry Frustrated by Haphazard Regulation*, the New York Times / Dealbook (Jun. 27, 2018), *available at* https://www.nytimes.com/2018/06/27/business/dealbook/crypto-industry-regulation.html (discusses various relevant U.S. regulators); Alois, JD, *FinCen Director Kenneth Blanco Addresses Tough Topic of Cryptocurrency, Attorney Joshua Klayman Adds Insight to Topics Discussed*, Crowdfund Insider (August 10, 2018), *available at* https://www.crowdfundinsider.com/2018/08/137683-fincen-director-kenneth-blanco-addresses-tough-topic-of-cryptocurrency-attorney-joshua-klayman-adds-insight-to-topics-discussed/.

93. *Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act*, SEC (May 24, 2016), *available at* https://www.sec.gov/info/smallbus/secg/jobs-act-section-12g-small-business-compliance-guide.htm.

94. "[...] In calculating the number of holders of record for purposes of determining whether Exchange Act registration is required, your company may exclude persons who acquired their securities in an exempt offering:
    - under an employee compensation plan;
    - under Regulation Crowdfunding if the issuer:
        - is current in its ongoing annual reports required pursuant to Rule 202 of Regulation Crowdfunding;
        - has total assets as of the end of its last fiscal year not in excess of $25 million; and

  - has engaged the services of a transfer agent registered with the Commission pursuant to Section 17A of the Exchange Act; or
- as a Tier 2 offering under Regulation A if the issuer:
  - is required to file and is current in filing annual, semiannual and special financial reports under Securities Act Rule 257(b);
  - had a public float of less than $75 million as of the end of its last semiannual period, or if it cannot calculate its public float, had less than $50 million in annual revenue as of the end of its last fiscal year; and
  - engaged a transfer agent registered pursuant to Section 17A of the Exchange Act." *Exchange Act Reporting and Registration*, SEC, *available at* https://www.sec.gov/smallbusiness/goingpublic/exchangeactreporting.

95. Depending on the facts and circumstances of how a blockchain token is administered, a requirement to file periodic reports under the Exchange Act could also implicate transfer agent registration requirements under Section 17A(c)(1) of the Exchange Act, under which it is unlawful for a "transfer agent" to perform any "transfer agent function" unless the transfer agent is registered with an appropriate regulatory authority.
96. *Guide to Broker-Dealer Registration*, SEC (Apr. 2008), *available at* https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html.
97. In June 2018, both Coinbase and Circle Internet Financial Ltd., respectively, reportedly announced plans to become among the first crypto broker-dealers. *See, e.g.,* Katz, Lily, *Coinbase Says It Won Approval for Trio of Acquisitions*, Bloomberg (Jul. 16, 2018), available at: https://www.bloomberg.com/news/articles/2018-07-16/coinbase-says-it-has-green-light-to-lost-coins-deemed-securities; Georgiev, Georgi, *Coinbase to Become First Broker-Dealer to Offer SEC-Regulated Crypto Securities*, Bitcoinist.com (Jun. 6, 2018), *available at* https://bitcoinist.com/coinbase-to-become-first-broker-dealer-to-offer-SEC-regulated-crypto-securities.
98. Section 3(a)(1)(A) of the Investment Company Act of 1940. For more information about regulation of investment companies, see Baris & Klayman, *supra* n.6, at 80-82.
99. *See e.g.,* Chambers and Partners, *Legal: Blockchain & Cryptocurrencies – Global-wide*, Chambers and Partners Professional Advisors: Fintech Guide 2018, (2017), *available at* https://www.chambersandpartners.com/15649/2804/editorial/49/1 (first-ever Chambers and Partners' list of top 12 Global-Wide Blockchain & Cryptocurrency Lawyers, including Grant P. Fondo, Joey Garcia, Reuben Grinberg, Dax Hansen, Joshua Ashley Klayman, Brian Klein, Richard B. Levin, Luka Müller-Studer, Patrick Murck, Marco Santori, Lee Schneider, & Carol van Cleef); *Blockchain for Wall Street Presents a Brains Trust of Experts on Blockchain and Cryptoassets in the Financial Markets – Annual Education Day Will Provide Answers to Pressing Blockchain, Smart Contracts, Cryptoasset and ICO Questions and Concerns*, Mondovision (Jul. 11, 2017), *available at* www.mondovisione.com/media-and-resources/news/blockchain-for-wall-street-presents-a-brains-trust-of-experts-on-blockchain-and/; Alois, JD, *Legal Guidance on ICOs? Wall Street Blockchain Alliance Will Publish Recommendations Soon*, Crowdfund Insider (Sep. 19, 2017), *available at* https://www.crowdfundinsider.com/2017/09/122014-legal-guidance-icos-wall-street-blockchain-alliance-will-publish-recommendations-soon/; https://zicklincenter.wharton.upenn.edu/regtech/ (Wharton Reg@Tech: https://zicklincenter.wharton.upenn.edu/wp-content/uploads/2018/06/Reg@Tech-March-2018-participant-list-1.pdf); Morris, Angela, *BigLaw Firms Are Working Together to Influence How Blockchain Technology Will Operate in the Future*, ABA Journal (Aug. 2018), *available at* www.abajournal.com/magazine/article/biglaw_cryptocurrency_blockchain_smart_contracts/.
100. *See* Klayman, Joshua Ashley, *A Legal Renaissance, Blockchain Style*, Coindesk (Jan. 7, 2018), *available at* https://www.coindesk.com/2017-legal-renaissance-blockchain-style/.

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Joshua Ashley Klayman is one of the best-known blockchain and cryptocurrency lawyers in the world. Recognized by *Chambers and Partners* as one of the top 12 Blockchain and Cryptocurrency lawyers globally, Ms. Klayman is the Managing Member of Klayman LLC, a boutique blockchain law firm based in New York, and the CEO of Inflection Point Blockchain Advisors, LLC, a blockchain strategy consulting firm. Ms. Klayman also is a consultant to global elite law firm, Shearman & Sterling.

Active in the community, Ms. Klayman chairs the prominent Wall Street Blockchain Alliance Legal Working Group and is a member of the global Wharton Reg@Tech think tank. In addition to serving on the State of Delaware's Blockchain Strategy Committee, she speaks frequently with regulators and other government leaders from around the world regarding blockchain- and digital asset-related matters. Committed to promoting diversity, Ms. Klayman is a co-founder of Diversity in Blockchain, Inc. and a founding member of Collective Future. She collaborates with blockchain leaders from across the community to advance the industry, anticipate and address regulatory concerns and seize strategic opportunities. *Chambers and Partners*' inaugural *Professional Advisers: FinTech* (2018) edition called Ms. Klayman "[....]an up-and-coming star in the blockchain space. One highly regarded contemporary described her as being 'very good – very thoughtful and with the appropriate talents. She deserves a lot of credit.'" Additionally, *Chambers and Partners' State of the ICO Market – A GC's View*, by Emma Channing, CEO & General Counsel of Satis Group, deemed her "highly talented."

Ms. Klayman was named to *Super Lawyers*' New York Metro Area "Rising Star" and "Top Women Attorneys" list(s) in 2015, 2016 and 2017, in the areas of Securities & Corporate Finance; Banking; and Business/Corporate Law. *The Information* named her one of six "Lawyers Calling the Shots in the Crypto World," and she is one of only two lawyers in private practice included in BCB Group's "Women to Watch in Crypto & Blockchain." *Decade of Women* named Ms. Klayman one of the "Top 10 Frontier Women in Blockchain and Digital Assets" in connection with the UN's "Decade of Women" launch, and she is a founding member of the Digital Future Council.

A recognized thought leader in the blockchain space, Ms. Klayman is a globally sought-after writer and speaker. She has appeared on television, including on Bloomberg TV and *Today's Verdict with David Lesch*, and has been featured in podcasts, including Forbes' *Unchained* podcast, Law.com's *Unprecedented* podcast, and *The Third Web* podcast, and on radio. Ms. Klayman's writings have been featured in major publications, including *Forbes*, *Coindesk* and *Crowdfund Insider*, and she is quoted regularly in the press, ranging from the *Wall Street Journal* and the *New York Times* to blockchain industry publications. Nicknamed the "Mother of Blockchains," Ms. Klayman is the mother of five children. Before founding her own firm, she co-founded, and led for over two years, a global law firm's 70+ person Blockchain + Smart Contracts Group.

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