Updates
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Senior SEC Official Provides Regulatory Clarity for Digital Assets

During a speech in San Francisco last week at the Yahoo Finance All Markets Summit, William Hinman, Director of the Division of Corporation Finance of the Securities and Exchange Commission (SEC), provided some welcome clarity regarding the applicability of the federal securities laws to digital assets and tokens projects.[1] The focus of the speech, titled "Digital Asset Transactions: When Howey Met Gary (Plastic)," focused on whether a digital asset offered as a security can, over time, become something other than a security. According to Hinman, the answer to this question is a qualified "yes" when a digital asset is sold only to be used to purchase a good or service available through a network. Hinman also expressed his view that Ether—the cryptocurrency of the Ethereum network—is not a security[2] and so is not subject to the U.S. federal securities laws. Hinman said that, in his view, Bitcoin is not a security either, reinforcing what SEC Chairman Jay Clayton stated in his remarks recently on CNBC[3] and what many who follow virtual currency developments thought was a foregone conclusion. On June 21, 2018, as discussed below, SEC Chairman Jay Clayton gave congressional testimony that provided further support for the SEC staff's approach as outlined by Hinman.

Hinman's speech was even more significant to the universe of those who pay close attention to regulators' views on digital assets, in particular when a digital asset is deemed to be a security.[4] Hinman suggested that in limited circumstances, the SEC believes that blockchain startups can raise money by selling tokens (or agreements for future tokens) as securities before a network is launched (i.e., before it has functionality or utility), but then further sales of these same tokens can be made as non-securities once the circumstances surrounding that sale transaction have changed in a manner than no longer constitutes an investment contract.

Hinman discussed certain factors to be considered in assessing whether a digital asset is offered as an investment contract in a securities transaction. In particular, Hinman focused on the fourth prong of the *Howey* investment contract test (as explained below) and whether the efforts of an identifiable third party—be it a person, an entity or a coordinated group of actors—drives the expectation of a return. Also noteworthy was Hinman's comment that the SEC is "happy to help promoters and their counsel work through . . . issues . . . [and] . . . stand[s] prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use." As in the cases Hinman discussed, this summary focuses on an analysis under the Securities Act of 1933 and the Securities Exchange Act of 1934. Note that, based on context, an analysis under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 may have different results, as may analysis under state laws due to different definitions or interpretations.

Key Components of Hinman's Speech

Digital Asset: Product vs. Security. Hinman began by describing promoters selling tokens or coins to raise money to develop networks on which the digital assets will operate, rather than selling shares, issuing notes or obtaining bank financing. In many cases, the economic substance is the same as a conventional securities offering—funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument, Hinman noted. In such cases, Hinman said that it would be "easy to apply" the longstanding "investment contract" test from the 1946 U.S. Supreme Court's decision in *SEC v. W.J. Howey Co* .[5] (*Howey* test): (1) An investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the entrepreneurial or managerial efforts of others.

Hinman next focused on the specific facts of the *Howey* case, which involved a hotel operator, Howey, selling interests in a nearby citrus grove coupled with a service contract obligating the hotel operator to harvest and market the oranges on the purchaser's behalf. Howey unsuccessfully claimed it was selling real estate rather than securities. Hinman highlighted that while the transaction in *Howey* was recorded as a real estate sale, it also included a service contract to cultivate and harvest the oranges, which meant that the investors were relying on the efforts of Howey for a return. Hinman emphasized that regardless of whether something is called a "token" or a "coin," the analysis turns on *how an asset is sold*, which may cause investors to have a *reasonable expectation of profits* based on the efforts of others.

Just as in *Howey*, Hinman stressed, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit.[6] And, as in *Howey*—where interests in the grove were sold to hotel guests who were passive investors, not farmers—tokens and coins typically are sold to a wide audience rather than to persons who are likely to use them on the network.

Gary Plastic. As the title of the speech signals, Hinman analogized certain sales of tokens to the facts in *Gary Plastic Packaging v. Merrill Lynch*,[7] in which the court held that a transaction may be subject to the securities laws even if the underlying instrument would not be a security, based on the manner of their sale and the promises associated with such sale. In *Gary Plastic*, the court found that, despite the fact that conventional certificates of deposit (CD) issued by a bank are not securities, they were securities in that instance because they were sold in a manner that satisfied the *Howey* test. The CDs were sold through a program organized by Merrill Lynch that promised retail investors that it would maintain a secondary market for the CDs. The court found that the CDs represented a joint effort by the issuers of the CDs and Merrill Lynch and that the CDs were investment contracts because investors expected to receive profits through the extra services provided by Merrill Lynch.

Applying the same reasoning to tokens, Hinman stated that while tokens themselves (which are, after all, "simply code") may not be securities, "how [tokens are] being sold and the reasonable expectations of purchasers" are central to the securities law determination. Therefore, in the context of a token sale that resembles the sale of a security, the application of the securities laws is appropriate because such laws' disclosure requirements (among other protections) are necessary to mitigate the information asymmetry between promoters and investors.

Mutability: From Security to Utility Tokens. Hinman explained that a digital asset transaction may no longer represent a security offering, i.e., an investment contract, if, in addition to the token or coin lacking other security-like features, the network on which the token or coin is to function is sufficiently decentralized—where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts. Moreover, Hinman added, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede, and as a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

Ether and Bitcoin. Hinman expressed his view that sales of Ether are not securities transactions, stating: "Based on my understanding of the present state of Ether, the Ethereum network, and its decentralized structure, current offers and sales of Ether are not securities transactions." Hinman also said that, in his view, Bitcoin is not a security either, because network participants are not reliant upon the efforts of a central third party. Hinman stated:

I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would

seem to add little value.

Hinman cautioned that the analysis of whether something is a security is not static and does not strictly inhere to the instrument, specifically noting that even digital assets with utility that function solely as a medium of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security.[8]

Director Hinman reiterated that while the token or coin by itself is not a security, the packaging and sale of such token or coin could bring it within the purview of the securities laws.

Token Sales. Hinman provided additional context to Chairman Clayton's prior remarks in which the chairman noted that an overwhelming number of the token sales he has seen likely qualify as securities offerings under the *Howey* test. Hinman reiterated that merely calling the token a "utility token" does not give it the substance needed to avoid being a security. He focused on the concepts of full decentralization and consumptive intent of the purchasers as two important factors but noted that a broader facts-and-circumstances analysis is required.

In what appears to be the SEC's nod to token pre-sale agreements, such as the SAFT (simple agreement for future tokens) or SAFE-T (simple agreement for equity or tokens), where tokens are issued as securities to accredited investors pursuant to the private offering regime of Regulation D, Hinman noted the possibility of structuring a blockchain-based enterprise with funding through token pre-sale agreements without necessarily affecting the ability of the token to be sold later as a non-security.[9]

Facts-and-Circumstances Assessment

Ultimately, the question of whether the offering of a token qualifies as a security will turn on a facts-and-circumstances analysis. Hinman provided the following illustrative (but not exhaustive) list of considerations:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, whose efforts 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 the person or group 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 protections make sense? Is there a person or entity that others are relying on and that plays a key role in the profit-making of the enterprise such that disclosure of the person's or entity's 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?

In addition, the director set forth the following seven non-exhaustive questions that help market participants evaluate whether a digital asset functions more like a consumer item and less like a security:

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 that 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 users who can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

Growing Consensus Among SEC Officials

On the very same day as Hinman's speech in San Francisco, Valerie Szczepanik, the SEC's new Senior Advisor for Digital Assets and Innovation,[10] and Gary Goldsholle, Senior Advisor to the Director of Trading and Markets, corroborated Director Hinman's remarks while speaking at a panel event in Washington, D.C. on Capitol Hill.[11] Specifically, Goldsholle reiterated Hinman's position that something can transform from a security to a non-security. Goldsholle made sure to also add that the same instrument could transform back into a security if the facts and circumstances changed yet again. Relatedly, Szczepanik acknowledged that there is a spectrum for tokens, stretching from those that are intended purely for fundraising (i.e., securities) to those that are purely consumptive (i.e., not securities). Both Goldsholle's and Szczepanik's comments indicate a building consensus among the SEC staff on these issues.

On June 21, 2018, SEC Chairman Clayton provided further confirmation that the framework outlined in Hinman's speech is the "approach [SEC] staff takes to evaluate whether a digital asset is a security" in testimony to the U.S. House of Representatives Financial Services Committee.[12] Clayton emphasized that the SEC will consider the facts and circumstances of a given token sale and utilize a principles-based framework to reach a conclusion on whether the token sale constitutes a securities offering. Under such a framework, persons "attempting to fund a project—whether it be opening a new manufacturing plant or creating an application on a distributed network—by inviting others to invest in the enterprise based on the expectation that they will profit from other people's efforts" must register their offerings with the SEC or rely on an appropriate exemption from registration.

Canadian Securities Administrators Weigh In on Tokens

In the same week, the Canadian Securities Administrators (CSA) separately released a staff notice that addressed the question of when an offering of tokens may or may not involve an offering of securities. While the CSA did not explicitly address the concept of mutability, it did provide an illustrative list of situations where tokens implicate securities law concerns under Canadian law. Although the SEC and the CSA operate in different jurisdictions, Canada and the United States share similar legal tests for determining an "investment contract," so the Canadian examples may also provide some persuasive instruction.[13]

Conclusion

Hinman's speech offers support to software developers, technologists, inventors and supporters of innovation in applying a framework for evaluating token sales under the *Howey* test. It is a helpful guide for developers of distributed networks and tokenized products, for enterprises looking to raise money by offering a security that

will later become a decentralized token, and exchange platforms seeking to determine when compliance with the securities laws and regulations related to token distribution and secondary trading is necessary.

Importantly, it clarifies the legal standard and factual details that the SEC is likely to consider when evaluating a token sale. Given the significant penalties for violations of the federal securities laws and regulations by those who, among other things, publicly offer unregistered securities, operate a securities exchange that should be registered, or act as a broker-dealer or investment adviser without registration or relying on an exemption, this clarification of the SEC staff's position will be very well received.

For any questions regarding these developments and how they might apply to you or your business, please contact experienced counsel.

ENDNOTES

[1] William Hinman, Dir. of the Div. of Corp. Fin., Sec. & Exch. Comm'n, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018) (speech), available at https://www.sec.gov/news/speech/speech-hinman-061418 ("Hinman Speech").

[2] Technically speaking, the token by itself is not a security, so what Hinman pointed out is that, currently, sales of Ether are not occurring under circumstances that would form an investment contract.

[3] CNBC.com, "SEC Chairman: cryptocurrencies like bitcoin are not securities" (June 6, 2018), *available at* https://www.cnbc.com/video/2018/06/06/sec-chairman-cryptocurrencies-like-bitcoin--not-securities.html.

[4] The SEC first officially confirmed its view that tokens sold through initial coin offerings may qualify as securities when it issued a 21(a) Report outlining its investigation of The DAO. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC Release No. 81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.

[5] *SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

[6] See *Munchee Inc.*, Securities Act of 1933 Release No. 10445 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf (Although Munchee's token was labeled a "utility token" that would allow purchasers to buy goods and service on the Munchee ecosystem, Munchee and other promoters emphasized that investors could expect that efforts by the company would lead to an increase in value of the tokens. The company also emphasized it would take steps to create and support a secondary market for the tokens. Because of these and other company activities, the SEC found that the tokens were securities.); *see also* Perkins Coie Client Alert - SEC Takes Aim at Initial Coin Offerings Again (Jan. 11, 2018), *available at* https://www.perkinscoie.com/en/news-insights/sec-takes-aim-at-initial-coin-offerings-again.html.

[7] *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985).

[8] Hinman stated that "if a promoter were to place Bitcoin in a fund or trust and sell interests, it would create a new security. Similarly, investment contracts can be made from virtually any asset (including virtual assets), provided the investor is reasonably expecting profits from the promoter's efforts."

[9] See Hinman Speech, FN 15. In this footnote Hinman noted that a token obtained via a SAFT, through a securities offering, may later be sold in a non-securities offering.

[10] SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation (June 4, 2018) (press release), *available at* https://www.sec.gov/news/press-release/2018-102.

[11] Amir Zaidi (Director of Market Oversight, CFTC), Rep. Sean Duffy (House of Representatives), and Jim Newsome (former Chairman, CFTC) also participated.

[12] Jay Clayton, Chairman of Sec. & Exch. Comm'n, Testimony on "Oversight of the U.S. Securities and Exchange Commission" Before the Committee on Financial Services, U.S. House of Representatives (June 21, 2018) (testimony), available at https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission.

[13] Canadian Securities Administrators Staff Notice 46-308, *Securities Law Implications for Offerings of Tokens*, June 11, 2018, available at: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20180611_46-308_securities-law-implications-for-offerings-of-tokens.htm

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