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CLIENT ALERT

Senior SEC Staff Member's Remarks Provide Guidance on Scope of SEC's Jurisdiction Over Cryptocurrency Transactions.

Summary

- On June 14, 2018, William Hinman, Director of the Division of Corporation Finance at the SEC, spoke about the treatment of cryptocurrenciesⁱ under securities laws at the Yahoo Finance All Markets Summit.ⁱⁱ
- Director Hinman confirmed that a cryptocurrency that was originally offered as a security can be later sold in a manner that does not constitute a sale of a security.ⁱⁱⁱ For instance, a cryptocurrency that was offered as a security in an initial coin offering (ICO) would not necessarily be regarded as a security in subsequent sales if the cryptocurrency functions on a decentralized network or platform.
- Director Hinman reaffirmed the commonly accepted view that bitcoin and ether are not securities because they function on sufficiently decentralized networks.
- However, even though a cryptocurrency may not be a security, the manner in which the cryptocurrency is promoted or marketed can result in a securities transaction.
- Hinman's speech suggests that certain cryptocurrencies are inherently securities, while others do not have intrinsic characteristics of a security. However, even in the latter case, the sale of the cryptocurrency may amount to a security offering if the manner of sale is such that purchasers would reasonably expect a developer or promoter to carry out managerial efforts or entrepreneurial efforts on their behalf.
- Ultimately, Hinman reiterates that the touchstone of the securities analysis is whether a purchaser would reasonably expect his or her profits from the cryptocurrency purchase to be derived from the efforts of a third party.^{iv}

Background

The treatment of cryptocurrencies under securities laws has been sharply debated since the inception of digital assets. Few asset classes have tested the contours of the definition of a security and the scope of the SEC's regulatory jurisdiction to the same extent as cryptocurrencies. The characterization of digital assets as securities has broad-reaching effects on the vitality, liquidity and soundness of the burgeoning cryptocurrency market. For example, if the sale of a digital asset involves the offering of a security, the sale must be made pursuant to a registration statement or an exemption from registration (*e.g.*, a private placement).^v In addition, platforms that provide for secondary market transactions in digital assets that are securities have to register with the SEC as a national securities exchange or an alternative trading system,^{vi} parties that sell the digital assets have to register as broker-dealers and advisors or managers that provide advice or otherwise manage investments in the digital assets have to register as investment advisers. In addition, purchases and sales of digital assets that are securities are subject to anti-fraud provisions of the securities laws.^{vii}

The SEC has consistently maintained that cryptocurrencies may be securities and that ICOs typically involve the offering of a security.^{viii} The SEC's approach to cryptocurrencies has been based on *Howey*,^{ix} which has historically been applied by the SEC to establish that certain financial instruments and contracts fall within the ambit of the definition of a "security" under Section 2(a) of the Securities Act by virtue of being "investment contracts." In *Howey*, a hotel operator sold interests in citrus groves to its guests. The sale also included a service contract for the hotel operator to cultivate and harvest oranges. The hotel operator recorded the sale of the citrus groves as a real estate sale. The Supreme Court concluded that even though citrus groves themselves are not securities, the contracts sold by the hotel operators constituted investments contracts, which are securities, because purchasers of the citrus grove were passive investors that relied on the managerial efforts of the hotel operator for a return. The *Howey* Court concluded that an investment contract exists if, with respect to a financial arrangement, a person invests money in a common enterprise and is led to expect profits from the efforts of the promoter or a third party.^x

The SEC has applied *Howey* to both assert jurisdiction over transactions in digital assets in anti-fraud enforcement actions^{xi} and to block certain ICOs on the theory that the ICO involved the offering of a security and therefore should have been registered.^{xii} The SEC anchored this position in its seminal report on the DAO,^{xiii} which is an unincorporated, digital assets organization embodied in computer code and executed on blockchain. The founders of the DAO issued DAO tokens to investors who purchased the tokens in exchange for ether. According to the DAO white paper, the proceeds from the token sale would be used by founders to fund certain blockchain projects. The white paper further provided that investors in the tokens would be able monetize their tokens by re-selling them on web-based platforms that supported trading in the tokens. The DAO Report concluded that the ICO of the DAO tokens was an illegal unregistered offering of securities^{xiv} and that the platforms set up for the

exchange of the DAO tokens should have registered as a national securities exchange or an alternative trading system.^{xv} The SEC's conclusion was predicated on the DAO ICO satisfying the *Howey* test. In particular, the SEC asserted that the profits of investors in DAO tokens were derived from the managerial efforts of the developers and founders of DAO. According to the SEC, this position is evidenced by the marketing efforts of DAO founders, which primed investors to believe that the success of DAO depended on the significant managerial efforts and expertise of the DAO developers. The SEC also emphasized the levers of control over the DAO platform were heavily centralized in the hands of the developers and investors lacked meaningful influence over the platform.^{xvi}

Following the DAO Report, the SEC relied on the principles set forth in *Howey* and the DAO Report to halt the ICO of tokens of Munchee, Inc., the creator of a restaurant review iPhone app.^{xvii} *In re Munchee* is significant because it represents the first action that the SEC brought to halt an ICO that did not involve an allegation of fraud. The SEC's actions in *In re Munchee* were a surprise to those who assumed that the SEC would not assert jurisdiction over ICOs of tokens that were billed as utility tokens, which are tokens that are acquired primarily to purchase goods or services rather than for investment purposes. The SEC eviscerated this assumption by characterizing the Munchee tokens as investment contracts due to Munchee's marketing efforts, which emphasized that the tokens would be used to improve Munchee's apps and its token ecosystems in a manner that would increase the value of the tokens and that the tokens would be tradeable on a secondary market.^{xviii} In its ruling, the SEC highlighted that it would consider substance over form. The SEC also highlighted that Munchee's network was largely undeveloped and, in consequence, the tokens had little utility at the time of the of the ICO.^{xix} *In re Munchee* demonstrates that the SEC will liberally use *Howey* to encompass a broad array of cryptocurrencies and ICOs. However, it left open the question of whether the SEC would enforce against utility token offerings that did not tout the managerial efforts of the developers or the potential for the token to increase in value as well as offerings for utility tokens that function on well-established, decentralized networks.

The formal action taken by the SEC in the DAO Report and *In re Munchee* has been supplemented by statements by SEC Chairman Jay Clayton that foreshadow additional enforcement by the SEC and a broad view of ICOs constituting offering of securities. These statements coincide with dizzying volatility in the cryptocurrency market, which has whipsawed many retail investors. In his December 11, 2017 statement, Chairman Clayton remarked that "merely calling a token a 'utility token' does not prevent the token from being a security" and "tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law." Chairman Clayton also stated "by and large, the structure of initial coin offerings that I have seen promoted involve the offer and sale of securities."^{xx}

Director Hinman's Remarks

Director Hinman's remarks are largely consistent with prior positions taken by the SEC. However, the remarks help forge a more coherent conceptual approach for analyzing cryptocurrency transactions under the lens of securities laws. Director Hinman makes clear that not all cryptocurrencies are securities. In addition, a cryptocurrency that was previously offered as a security may no longer be a security when sold on the secondary market. The crux of the analysis is predicated on *Howey* and inquires whether buyers of a cryptocurrency reasonably rely on the managerial efforts of promoters or developers for a return on their investment. Digital assets that function on a centralized network appear to have the unequivocal status of a security. Similarly, digital assets that do not have a developed, fully-functioning network may also be securities, especially if developer uses the proceeds of the sale of the digital asset to promote or develop the network. Conversely, decentralized digital assets where a centralized third-party effort is not an integral part of the success of the enterprise are likely not securities. For example, Director Hinman cites bitcoin and ether as not currently being securities due to them having sufficiently developed and decentralized structures.

More importantly, Director Hinman emphasizes that "the analysis of whether something is a security is not static." While certain digital assets are inherently securities by virtue of the centralized control, even decentralized digital assets can be marketed "or packaged and sold as an investment strategy that can be a security." For example, the sale of interests of bitcoin or ether deposited into a fund or a trust would involve the sale of a security. As such, determining whether a digital asset is itself a security is only the starting point of the analysis. Even if a digital asset is not a security, the manner in which it is sold or offered may involve a security offering if purchasers are reasonably led to conclude that their returns depend significantly on the managerial efforts of a third party.

Director Hinman attributes his fluid approach to *Gary Plastic*.^{xxi} In *Gary Plastic*, an investment bank sold certificates of deposits to its customers. The CDs were exempt from the definition of security under Section 3(a)(2) of the Securities Act. In marketing the CDs, the investment bank committed to maintaining a secondary market in the CDs and stated that it has reviewed and approved each issuing bank and would monitor each issuer on a regular basis. The Second Circuit applied *Howey* to conclude that even though the CDs themselves are not securities, the investment bank's dealings with its customers in connection with the CDs resulted in an investment contract that is a security. In particular, the Second Circuit determined that the customers relied on the efforts of the investment bank to achieve a return on the CD in light of the investment bank's promise to maintain a secondary market and to review and monitor the issuing banks. Director Hinman reasoned that a cryptocurrency itself is merely "digital code," but, just as *Gary Plastic* established that the sale of a CD that is exempt from the definition of security can result in a security offering, so too can the sale of a cryptocurrency if the manner of sale bears the indicia of a securities offering. According to Hinman, the analysis ultimately hinges upon whether the protections of the securities law are

necessary. Where investors depend on the managerial efforts of developers or promoters, the disclosure requirements and protections of securities laws are warranted to “remove the information asymmetry between promoters and investors.” Conversely, where a digital asset functions on a developed network that is controlled by a diffuse and decentralized group, the benefits of the disclosure requirements and other protections offered by the securities laws attenuate.

Implications

Director Hinman’s remarks advance a more coherent conceptual approach to the question of which transactions involving digital assets amount to an offering of a security. The following are key implications of the remarks:

- Consistent with previous remarks by Chairman Clayton, ICOs will ordinarily involve the offering of securities.
- The SEC will look at substance over form and will not apply a static test in determining whether a cryptocurrency transaction involves the offering of a security. A cryptocurrency that was once a security may no longer be a security if the cryptocurrency’s network is developed and control over the network is decentralized.
- Certain cryptocurrencies are inherently securities, such as cryptocurrencies that grant holders an ownership interest in an issuer or that are linked to a network that is managed by a single person or a centralized group.
- Even if a cryptocurrency is not a security, the manner in which it is sold or promoted can result in a securities offering. This will be the case if purchasers are led to reasonably expect their returns to be based on the managerial or entrepreneurial efforts of third parties.
- Utility alone does not obviate the risk that a cryptocurrency will be a security. Just as *Howey’s* citrus groves had utility but nonetheless gave rise to a securities transaction, so too can a security be found in a transaction involving a utility token. The gravamen of SEC claims revolves around the question of whether the cryptocurrency transaction engenders a reasonable expectation of investors to rely on the significant efforts of others to obtain a profit from the cryptocurrency.
- White papers or other marketing documents that tout potential returns in a coin or token, indicate that the developer or promoter intends to use proceeds of a sale to improve the network or to otherwise cause the coin or token to appreciate in value or discuss the existence of a secondary market will often result in a transaction involving a securities offering.

- Fund advisers should be cognizant of the coins or tokens that they invest in to ensure that either do not involve securities or that they comply with the requirements under the Investment Advisers Act.
- Platforms and personnel involved in the sale or exchange of cryptocurrencies should carefully consider both the nature of the cryptocurrencies that they are being sold and exchanged as well as the manner in which the sales and exchanges are being executed to determine whether the sales or exchanges give rise to any broker-dealer or securities exchange registration requirements.
- Secondary market exchanges of cryptocurrencies that are true utility tokens (*i.e.*, the token is used for the purchase of a good or service and do not have other features of a security) that function on a decentralized and highly developed network will likely not involve the sale of a security. However, the manner of sale remains critical and can result in a securities transaction if it leads an investor to reasonably conclude that returns are based on the efforts of a third party.
- Simple Agreement for Future Tokens (SAFTs)^{xxii} should be carefully reviewed to ensure that, at the time tokens are saleable under the SAFT, the underlying network or blockchain is sufficiently decentralized and functioning so that purchasers of the tokens are not relying on the significant managerial efforts of the promoters to achieve a return on the token.

Despite the guidance provided by Director Hinman's remarks, this topic remains rife with open questions. For example:

- At what point in time does a network becomes sufficiently developed and decentralized so as to result in the related token shedding its status as a security?
- When is a token deemed to have sufficient utility so as to no longer be viewed as primarily a tool for investment?
- To what extent does manner of sale, including discussion of appreciation in value and secondary markets in white papers and other marketing materials, cause a utility token to fall within the scope of *Howey* and its progeny? Does the mere mention of secondary markets or the potential for appreciation in value taint a coin or token that would otherwise not be considered a security?
- If the status of cryptocurrencies under the securities laws is transitory, are there any fungibility concerns that require tracing coins to differentiate between those that were securities at the time they were purchased and those that were purchased when they

are no longer securities? Director Hinman's focus on manner of sale suggests that tracing would be unnecessary, but additional guidance on this topic would be useful.

- Will significant concentration in the ownership of a cryptocurrency cause the cryptocurrency to be viewed as having centralized control?
- Do comments by developers and large holders of a cryptocurrency encouraging purchasers to buy the cryptocurrency constitute a securities offering, even if the cryptocurrency in question would otherwise not qualify as a security?
- What are the implications for managers or advisers that invest in cryptocurrencies that once were, but are no longer, securities? Is investment adviser registration necessary?
- What is the status of ripple and other major cryptocurrencies not specifically referenced in Hinman's remarks?^{xviii}
- How will the SEC's views impact state securities regulators that also assert jurisdiction over cryptocurrency transactions?

Formal SEC guidance and the development of case law will be necessary to fully address some of these questions. Until greater certainty is achieved, with the exception of bitcoin and ether, market participants will have to analyze each specific cryptocurrency to determine its status in light of the principles set forth to date by the SEC. This ad hoc analysis is likely to induce prudent market participants to err on the side of caution and assume that transactions and investments in cryptocurrency are subject to securities regulations.

Endnotes

ⁱ This Client Alert uses the terms “cryptocurrency” and “digital asset” interchangeably, despite technical differences between the two terms.

ⁱⁱ Speech of Director William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), available at <https://www.sec.gov/news/speech/speech-hinman-061418>.

ⁱⁱⁱ This statement is consistent with the view that has been expressed by the CFTC on cryptocurrencies. CFTC Commissioner Brian Quintenz has stated that digital assets “may actually transform from something that starts off as a security and transforms into a commodity.” As a commodity, the CFTC has both regulatory and enforcement authority over derivatives on cryptocurrencies, but only enforcement authority (*i.e.*, the ability to police fraud and manipulation) with respect to spot transactions. See Remarks of Commissioner Brian Quintenz before the Eurofi High Level Seminar 2018 (April 26, 2018), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz11#_ftnref9. The treatment of cryptocurrencies by regulators other than the SEC is beyond the scope of the Client Alert.

^{iv} The analysis is based on the so-called *Howey* test, which has been used consistently by the SEC to determine whether a digital asset is an “investment contract,” which would result in it being a security under Section 2(a)(1) of the Securities Act of 1933. The *Howey* test, which is derived from a 1946 Supreme Court case, determines if an instrument is an investment contract based on whether there “is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. See *SEC v. Edwards*, 540 U.S. 389, 393 (2004); *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

^v See *e.g.*, *In re Erik T. Voorhees* (Securities Act Rel. No. 9592) (June 3, 2014).

^{vi} See *e.g.*, *In re BTC Trading, Corp. and Ethan Burnside* (Securities Act Rel. No. 9685)(Dec. 8, 2014); Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (March 7, 2018), available at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

^{vii} See *e.g.*, *SEC v. Shavers*, No: 4:13-CV-416, (E.D. Tex. 2014); *SEC v. PlexCorps*, No. 1:2017cv07007 (E.D.N.Y. 2017).

^{viii} See, Public Statement of Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

^{ix} 328 U.S. 293, 301 (1946).

^x *Id.* at 298-99. See also, SEC Rel. No. 33-5018 (Nov. 4, 1969); Investment in Interests in Whisky, SEC Rel. No. 33-5451 (Jan. 7, 1974)(applying *Howey* to conclude that the sale of whisky warehouse receipts can constitute investment contracts).

^{xi} *Infra* at vi.

^{xii} *Supra* at xiv.

^{xiii} *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934; The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017)(the “DAO Report”).

^{xiv} *Id.* at 15-16.

^{xv} *Id.* at 17-18.

^{xvi} *Id.* at 12-15.

^{xvii} *In the Matter of Munchee Inc.*, SEC Release No. 33-10445 (Dec. 11, 2017).

^{xviii} *Id.* at 5-6.

^{xix} *Id.* at 9.

^{xx} *Infra* at xii.

^{xxi} *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 756 F.2d 230 (2d Cir. 1985).

^{xxii} A SAFT is generally a contract by a cryptocurrency developer to sell a coin or token to accredited investors in an ICO that is treated as a securities offering. The tokens are typically only made available for resale by the accredited investor once the network that underlies the token is fully functioning. The theory behind a SAFT is that the token sale will not involve a securities offering because when the token becomes saleable it will be a utility token that is primarily used to purchase the good or service offered by the network that was developed with the proceeds of the ICO.

^{xxiii} There are numerous open class action complaints against developers of cryptocurrencies alleging that sales of the cryptocurrency constituted unregistered securities offerings. These cases address some of the open questions posed in this Client Alert. See e.g., *Coffey v. Ripple Labs Inc. et al.*, No. 3:18 cv-03286 (N.D.C.A.), complaint dated May 3, 2018 (alleging, among other things, that ripple is offered in a continuous unregistered ICO because ownership of ripple is heavily concentrated and ripple's founders market ripple to drive demand and increase its price); *Brola v. Nano f/k/a RaiBlocks, et al.*, No. 1:18-cv-02049 (E.D.N.Y.), complaint dated April 6, 2018 (alleging that sales of nano amounted to an unregistered securities offering).

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