

## A Path Forward for Consumer Tokens?

### ***SEC's Hinman provides helpful guidance for analyzing digital assets under the US securities laws.***

William Hinman, Director of the US Securities and Exchange Commission (SEC) Division of Corporation Finance, provided substantial color on the SEC's evolving view of digital asset classification recently when he shared his thoughts on how to characterize purchases and sales of digital assets under US securities laws (the securities laws), as part of the *Yahoo Finance All Markets Summit: Crypto*.<sup>1</sup> While the headline moment occurred when he stated his belief that current transactions in Bitcoin and Ether are not securities transactions, he also laid out a framework for his reasoning that has greater implications for digital asset market participants generally.

In analyzing “whether a transaction in a coin or token on the secondary market amounts to an offer or sale of a security,” Hinman indicated that digital assets are likely not securities “where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created.” With that, Hinman pointed to what many practitioners have assumed without confirmation — it is possible to transact with a token in a manner that does not trigger the application of the securities laws. Of course, many questions remain.

### **The SEC's Evolving Approach to Digital Assets**

The SEC's approach to classifying whether a digital asset is a security derives from its application of the test set forth in *SEC v. W.J. Howey Co.*<sup>2</sup> The *Howey* test determines whether an asset constitutes an “investment contract,” one of the enumerated types of securities as defined in the securities laws.<sup>3</sup> The test states that an investment contract involves (i) an investment of money, (ii) in a common enterprise, (iii) in which the investor is led to expect profits, (iv) derived from the efforts of one or more third parties.<sup>4</sup> If the test is satisfied, it is immaterial whether the enterprise is speculative or non-speculative, or whether there is a sale of property with or without intrinsic value.<sup>5</sup>

In July 2017, the SEC applied the *Howey* test to digital assets for the first time, finding that the sale of Decentralized Autonomous Organization tokens (DAO Tokens), a digital asset, was an unregistered securities offering absent a valid exemption from Section 5 of the Securities Act of 1933. The SEC observed that the DAO Tokens satisfied the four prongs of the *Howey* test, including that they were designed to provide holders with a return on their investment.<sup>6</sup> As discussed in [this prior Latham & Watkins Client Alert](#), the analysis was not unexpected by securities practitioners,<sup>7</sup> and the report served as a helpful reminder to this nascent market that the securities laws apply regardless of the form in which the securities are created and sold.

On December 11, 2017, the SEC issued an order (Order) instituting cease-and-desist proceedings with respect to an offering by Munchee Inc.<sup>8</sup> At the time the Order was issued, Munchee was in the process of offering digital tokens (the MUN Tokens) to investors through an initial coin offering (ICO).<sup>9</sup> In the Order, the SEC concluded the ICO was an unregistered offering of securities without an available exemption, despite Munchee's argument that the MUN Tokens served a utility function. Indeed, many practitioners believed at the time that the MUN Tokens had an indicia that could lead to characterization as utility or consumer tokens, rather than securities. Nonetheless the MUN Tokens were classified as securities, in part because they were marketed as investments amid a substantial marketing blitz that bypassed Munchee's actual user base. The lesson of the Order is that despite the utility features of the MUN Tokens, the nature of the offering and the presence of investment intent will constitute material factors for the SEC in determining whether a particular transaction may be subject to the securities laws. (For additional information, see [this prior Latham & Watkins Client Alert](#)).<sup>10</sup>

In a statement contemporaneous with the Order, Jay Clayton, Chairman of the SEC, addressed what was then an extremely active market and reiterated the SEC's focus on the presence of investors in determining whether an offer and sale of tokens constitutes a securities transaction. Chairman Clayton used a broad brush, stating "[b]y and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws."<sup>11</sup> As a result, many practitioners concluded that absent further guidance from the SEC, the only safe assumption was that all ICOs in the US should be considered securities offerings.

## Hinman's Analysis

Hinman's recent remarks reaffirm the analysis in the Order, while also indicating a possible path for token transactions to no longer be characterized exclusively as securities transactions. He began by querying whether "a digital asset offered as a security can, over time, become something other than a security." Hinman offered two answers to this question. On the one hand, he posited that a digital asset representing a set of rights giving the holder a financial interest in an enterprise would remain a security. On the other hand, he reasoned that a digital asset that, for example, is used to purchase goods or services within a sufficiently decentralized ecosystem could evolve beyond its initial classification as a security.

Hinman emphasized that, similar to the assets in *Howey* (which involved fruit trees), digital assets are not necessarily securities. Rather, in addition to the underlying rights associated with such assets, the manner of sale and the reasonable expectations of the purchasers help determine whether a particular digital asset is a security. This is underscored by Hinman's reference to *Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*,<sup>12</sup> where the Second Circuit held that transactions in instruments that themselves are not securities can still be subject to the securities laws, when such instruments animate a broader investment contract. There, the court found that the existence of a secondary market as a critical part of an issuer's marketing efforts for what was otherwise not a security (specifically Certificates of Deposit), coupled with the potential for investment profits, rendered the application of the securities laws necessary. In the case of nascent platforms and networks, digital tokens sold in an offering by promoters to "develop the enterprise" will most often be a security because the efforts of the enterprise's promoters will be the primary source of value creation in the token. According to Hinman, applying the securities laws in such cases is important because they help mitigate informational asymmetries that exist between issuers and investors. But, if the network on which the token functions is sufficiently decentralized — that is, "where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts" — there is less of a public policy need to correct the informational asymmetries the securities laws aim to prevent.

## **The Beginnings of a Framework**

Hinman concluded his speech by identifying a number of factors to help determine when a transaction in a digital asset may be a securities transaction. Such factors center around two main inquiries. First, he emphasized the role of the promoter or enterprise — and thus the corresponding expectation of profits generated by such promoter or enterprise — as a key factor in assessing whether the purchase and sale of a digital asset would constitute a securities transaction. Of course, this is merely a recognition of the long case history of the most important prong of the *Howey* test. Second, Hinman indicated that the design of tokens and token-based economies are also important to the analysis. That is, for digital assets to be less likely to be deemed a security, they should be designed for consumer use rather than as an investment.

### ***What Is the Role of the Promoter or Enterprise?***

Hinman identified the following factors to determine the promoter or enterprise's role:

- 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?
- 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?
- 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?
- 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?
- Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
- Do persons or entities other than the promoter exercise governance rights or meaningful influence?
- Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?

### ***Is the Asset Designed for Investment or Consumptive Purposes?***

Hinman identified the following factors to determine whether an asset is designed for investment or consumptive purposes:

- Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
- 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?
- 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?

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

## Practical Implications

Our advice in this area has remained consistent over much of the past year: corporate finance transactions should generally be viewed as securities transactions and implemented in the customary manner, whether such instruments are represented by tokens on a blockchain or otherwise. That is, in raising capital to fund an enterprise at the development stage, the options generally revolve around time-tested structures, such as issuing securities (e.g., preferred or common stock, convertible or straight debt) or borrowings from a lender. However, the positive news delivered by Hinman evinces a recognition at senior levels of the SEC staff of a viable path to a true consumer token platform. Hinman's statement, while substantially more in line with the long case history of the *Howey* test, seems somewhat less categorical than Chairman Clayton's earlier statement that nearly every ICO he had seen was a securities offering.<sup>13</sup>

This recognition is significant for the development of many distributed ledger technology networks. Although a broad movement has occurred toward the acceptance of token offerings that comply with the securities laws, very few token networks are designed to be workable as securities trading platforms. As such, a great deal of uncertainty remains as to whether such networks can operate in a manner consistent with the many securities laws requirements, including those relating to securities intermediaries. Hinman's statement provides an indication that a token offered as a security may transmute into a utility token at some point in the lifecycle of the token. To be sure, much remains unknown, such as how to appropriately evaluate and weigh the various factors outlined above. In this regard, we note Hinman's statement that the staff "stand[s] prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use."

Going forward, without further specific guidance from the SEC, we believe that market participants should continue to err toward assuming that token sales are securities transactions. Nonetheless, there is cause for some optimism that a path toward true utility token economies may yet be blazed.

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**Endnotes**

- <sup>1</sup> See William Hinman, Dir., Div. Corp. Fin., SEC, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>.
- <sup>2</sup> 328 U.S. 293 (1946).
- <sup>3</sup> 15 U.S.C. § 77b(a)(1) (2012); *id.* § 78c(a)(10).
- <sup>4</sup> See *id.* at 301.
- <sup>5</sup> See *id.*
- <sup>6</sup> See SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), at 17–18, <https://www.sec.gov/litigation/investreport/34-81207.pdf>.
- <sup>7</sup> See *Client Alert 2187, SEC: Certain Initial Coin Offerings Are Securities Offerings* (July 27, 2017), <https://www.lw.com/thoughtLeadership/SEC-certain-initial-coin-offerings-securities>.
- <sup>8</sup> See Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.
- <sup>9</sup> For a helpful overview of ICOs, see Investor Bulletin, SEC, Initial Coin Offerings (July 25, 2017), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings>.
- <sup>10</sup> See *Client Alert 2257, SEC Takes Enforcement Action against Utility Token ICO* (Dec. 20, 2017), <https://www.lw.com/thoughtLeadership/SEC-vigorously-police-utility-token-ICO>.
- <sup>11</sup> SEC, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.
- <sup>12</sup> 756 F.2d 230 (2d Cir. 1985).
- <sup>13</sup> To be fair, Chairman Clayton had previously hinted at Hinman's approach in a speech at Princeton University. See Nikhilesh De & Mahishan Gnanaseharan, *SEC Chief Touts Benefits of Crypto Regulation*, COINDESK (Apr. 5, 2018), <https://www.coindesk.com/sec-chief-not-icos-bad/>.