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The yellow brick road for consumer tokens: The path to SEC and CFTC compliance

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Developing a framework for consumer tokens

With the rapid growth in the development of blockchain technology, virtual currencies and token sales (sometimes referred to as initial coin offerings, or ICOs) in 2017 and beyond, ICOs came under increased regulatory scrutiny, particularly in the United States. The question on the minds of many entrepreneurs and their counsel during this period, has been whether the issuance and sale of "consumer" or "utility" tokens – those designed for use by consumers on a distributed platform and not intended to constitute securities – is possible in the United States.[1] Based on recent statements of senior officials at the US Securities and Exchange Commission (the SEC), it appears there may be a viable regulatory path to the issuance of consumer tokens that would not necessarily be viewed as "securities" subject to SEC oversight. In this chapter, we discuss the legal issues surrounding such issuances under the US federal commodities and securities laws.

Existing frameworks

The securities law framework

The initial inquiry is whether the token sale would be considered an offer or sale of a security under the US federal securities laws. The SEC's approach to whether a digital asset is a security derives from its application of the test set forth in *SEC v. W.J. Howey Co.* (the *Howey* Test).[2] The *Howey* Test determines whether an asset constitutes an "investment contact," one of the enumerated types of instruments defined in the securities laws.[3] 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 entrepreneurial or managerial efforts of one or more third parties.[4] 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.[5] In short, the heart of the analysis is to focus on the economic reality of the arrangement in question.

In July 2017, the SEC applied the *Howey* Test to digital assets for the first time, and arrived at the conclusion that the sale of Decentralized Autonomous Organization tokens (DAO tokens), a digital asset, was an unregistered securities offering that proceeded without a valid exemption from Section 5 of the Securities Act of 1933 (the Securities Act). 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.[6] The SEC made clear that to the extent instruments have the indicia of investment contracts, they should be offered and sold in compliance with the securities laws, and any intermediaries for such sales, including exchanges on which such instruments were traded, would likewise need to comply with the registration and compliance requirements of these laws. While this was not an unexpected outcome for practitioners,[7] 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 instituting cease-and-desist proceedings with respect to an offering by Munchee Inc. (Munchee).[8] At the time the order was issued, Munchee was in the process of offering digital tokens (the MUN Tokens) to investors through an ICO.[9] 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 much of the requisite indicia that could lead to their characterisation as utility or consumer tokens, rather than securities. Nonetheless, the MUN Tokens were classified as securities, in large measure because they were marketed as investments amid a substantial marketing blitz that bypassed Munchee's actual user base, focusing instead on regular purchasers of digital assets. A key lesson of the *Munchee* order was that despite the utility design 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.[10]

William Hinman, Director of the SEC's Division of Corporation Finance, recently indicated a possible path for token transactions to no longer be characterised exclusively as securities transactions.[11] He began by querying whether "a digital asset offered as a security can, over time, become something other than a security." Director 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 decentralised ecosystem, could evolve such that it would cease to be classified as a security under US securities laws.

Director Hinman emphasised that, similar to the assets in *Howey* (which involved assets that were clearly not securities, but 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 Director Hinman's reference to *Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*,[12] in which 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 establishment 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 constitute securities because the entrepreneurial efforts of the enterprise's promoters will be the primary source of value creation in the token. According to Director 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 decentralised – 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 commodities law framework

The US Commodity Futures Trading Commission (the CFTC) regulates the swaps (*i.e.*, the CFTC's term for derivatives) and futures markets and retains general enforcement authority to police fraud and manipulation in cash or "spot" commodities markets.[13] In 2014, then-CFTC Chairman Timothy Massad observed that what the CFTC has referred to as virtual currencies are "commodities" subject to provisions of the Commodity Exchange Act, as amended (the CEA).[14] Since 2015, the CFTC has been active in bringing enforcement actions when virtual currency enterprises run afoul of regulatory requirements[15] and in the enforcement against fraud and manipulation in the virtual currency "spot" markets.[16]

Pre-functional consumer token sales[17]

Sales of tokens to fund a promoter's development of a token-based network have long been considered to constitute investment contracts, regardless of the form of instrument evidencing the sale. That is, the efforts of the promoter remain central to the value of the instrument being sold, thus satisfying the *Howey* Test as an investment contract. As a result, in an effort to separate the pre-functional sale and the underlying consumer token, new financing instruments – including the Simple Agreement for Future Tokens (the SAFT)[18] and other similar token presale instruments – were designed. While such instruments attempted to solve the securities law issues with presales, they raised significant other concerns.[19]

Securities law issues

These instruments commonly fail to address the status of the underlying tokens and the impact of the presale offering on the marketing of the underlying tokens. That is, by marketing the token presale as an investment opportunity, these instruments were implicitly marketing the investment value of the underlying token. As a general matter, such instruments have been and continue to be marketed to purchasers with investment intent, such as hedge funds, venture capital funds and others, and, in at least some cases, purchasers are required to represent that they are purchasing for investment purposes.[20] In addition, settlement of these instruments contemplates delivery of the token at network launch,[21] and thus, at least with respect to the initial iteration of these instruments, the delivery of tokens for consumptive use will occur contemporaneously, or at least nearly so, with the delivery of tokens to purchasers who were investors. This would seem to argue in favour of the proposition that a token launch with delivery of tokens in settlement of these instruments is not directed solely to consumers, and, under the logic of *Gary Plastic* and the *Munchee* order, is a securities transaction, not a consumer token launch.[22]

While recent iterations of these instruments have begun to acknowledge that issuances of the underlying tokens could be securities transactions, they continue to subject issuers and purchasers to significant risks by potentially increasing the likelihood that the underlying tokens will be deemed to be securities. This does not represent a viable outcome for many token-based networks, which require the free transfer of tokens on the network as part of their necessary function, because the US securities laws often require the existence and registration of an intermediary in securities transactions (*i.e.,* the transfer of tokens deemed to be securities). Accordingly, an issuer or platform may be required to register as a broker-dealer or exchange (or alternative trading system)[23] to permit the functioning of its token-based network,[24] which would render many token-based networks unusable. Although recent statements indicate an acceptance of the notion that a digital asset originally issued as a security could subsequently cease to be a security once the network is sufficiently decentralised,[25] the uncertainty that remains regarding the viability and timing of the consumer token sale raises challenges for appropriate disclosures to investors and potential liability for issuers. This is particularly the case when the entire investment decision is based on the availability and functionality of the underlying token, and it would seem to be challenging to craft sufficient disclosure in such a circumstance where the entire investment proposition is subject to this level of uncertainty.

Commodities law issues

Beyond the securities law concerns, the SAFT, and more recent iterations of the SAFT and similar presale instruments, also raise commodities laws concerns. Because cryptocurrencies are commodities,[26] a presale of consumer tokens through an instrument that provides the right to receive tokens in the future, or confer the right to exchange or convert such instrument into tokens that are not securities, may be a forward contract for the sale of a commodity or a commodity option, and subject to regulation by the CFTC as a swap, if an exemption is not available.

(a) *Commodity forward contracts*

Forward sales of commodities fall within the CEA's broad definition of "swap," which encompasses numerous types of derivatives, and are subject to regulation by the CFTC absent an applicable exclusion.[27] Notably, the sale of a non-financial commodity for deferred shipment or delivery is excluded from the swap definition, so long as it is intended to be physically delivered,[28] but provided such forward contract also qualifies as a commercial merchandising transaction (Non-Financial Forward Contract Exclusion).[29] If such instruments are purchased by investors or speculators, they will not satisfy the requirement of the Non-Financial Forward Contract Exclusion because the purchasers are not "commercial market participants."[30] The CFTC has expressly stated that hedge funds, acting in their capacity as investors, are not commercial market participants.[31] The SAFT is effectively a prepaid forward contract of a commodity whereby parties have agreed a price or percentage discount on the token to be delivered at a later date. As discussed above, the SAFT was (and continues to be) largely marketed to investors and not commercial market participants;[32] SAFT investors would not be eligible for the Non-Financial Forward Contract Exclusion.

(b) *Commodity options*

Later versions of the SAFT and similar presale instruments have also included convertible features, which provide investors or the issuer, as applicable, a call or put right to deliver tokens upon the consummation of a token sale at an agreed price or discount. Such an instrument may constitute a commodity option and would be subject to CFTC regulation as a swap,[33] unless an exemption applies. Trade options are generally exempt from regulation by the CFTC, other than certain large trader reporting requirements and the CFTC's general anti-fraud and anti-manipulation enforcement authority (the Trade Option Exemption).[34] In order to qualify as a trade option and benefit from the Trade Option Exemption,[35] the commodity option in question must be: (i) intended to be physically settled if exercised; (ii) entered into with an offeror who is either an ECP[36] or a producer, processor or commercial user of, or merchant handling, the commodity (or products or by-products thereof) that is the subject of the option, and such offeror is offering to enter into such option solely for the purposes related to its business as such; and (iii) entered into with an offeree who is either a producer, processor or commercial user of, or merchant handling, the commodity (or products or by-products thereof) that is the subject of the option, and such offeree is entering into such option solely for the purposes related to its business as such.

Unfortunately (as stated above in connection with the Non-Financial Forward Contract Exclusion), many of the SAFT and similar presale instruments are not offered to commercial market participants who would satisfy the "offeree" prong, even if the issuer of the instrument could satisfy the "offeror" prong. Additionally, even if such instruments are offered to "consumers" they would not necessarily satisfy the "offeree" prong of the Trade Option Exemption, unless such consumer could establish a nexus to a business activity. Accordingly, SAFT investors are unlikely to qualify for the Trade Option Exemption.

(c) *Hybrid instrument exemption*

Furthermore, since the SAFT and similar presale instruments may constitute or contain a commodity forward contract or commodity option and may not otherwise qualify for the Trade Option Exemption or the Non-Financial Forward Contract Exclusion, we also consider whether such instruments would meet the Hybrid Instrument Exemption (defined below) and, as a result, be exempt from commodities law regulation. Under CFTC Rule 34.2(a), a "hybrid instrument" is defined to include an equity or debt security with "one or more commodity-dependent components that have payment features similar to commodity futures or commodity options contracts or combinations thereof."[37] Under Section 2(f) of the CEA, a hybrid instrument that is "predominantly a security" is exempt from the provisions of the CEA if, among other things, the instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to the CEA (the Marketing Condition) (such exemption being the Hybrid Instrument Exemption).[38]

We believe that the SAFT and similar presale instruments likely do not meet the Marketing Condition of the Hybrid Instrument Exemption, given that investors in such instruments are motivated to purchase the instrument solely for the potential of receiving the underlying commodity (*i.e.,* the token) in the future. Modified versions of such instruments – including iterations convertible into either the issuer's equity or tokens – also could be subject to regulation by the CFTC because it may be challenging to successfully argue that such instruments are predominantly securities that satisfy the conditions of the Hybrid Instrument Exemption (and, in particular, the Marketing Condition).[39]

(d) *Consequences of CFTC regulation*

Because such presale instruments may have an embedded swap, which does not qualify for an exemption from regulation by the CFTC (as discussed above), such presale instrument would be subject to the full swaps regulatory framework applicable to such instruments. In particular, in order to trade over-the-counter, swaps must be entered into between eligible contract participants (ECPs).[40] While some investors may qualify as ECPs, token issuers typically are early stage companies that may not have at least $10 million gross assets, and as a result, would not satisfy the ECP test. A swap entered into by parties who are not ECPs would be in violation of the CEA and CFTC regulation and both parties could face penalties and sanctions for such actions.

Potential solutions available through traditional financing instruments

Traditional early-stage financing structures, such as preferred stock and convertible promissory notes,[41] are "tried and true" structures that generally exhibit the necessary flexibility to address the needs of early stage companies/token issuers and token platforms. We believe these structures can be augmented to address investor demand for exposure to consumer tokens, while enabling the parties to comply with applicable securities and commodities laws. This can be achieved by providing investors with various combinations of token-related purchase, economic and voting rights.

First, the conversion and exchange rights featured in currently popular presale instruments could be replaced with appropriately limited token sale participation and economic rights that reduce the regulatory risks associated with consumer token sales discussed above. For instance, the purchase right would not represent a conversion or exchange of the security, but would include these rights in addition to the rights granted to the holder of the securities. The exercise of such token sale participation rights could be limited to sales or distributions of the consumer tokens that would not be deemed to be securities transactions, such as when the network had achieved sufficient decentralisation (although the challenges in defining an objective standard for this trigger may reduce the practicality of this option). The participation rights could also be limited to purchases for actual use, or limit the consumer tokens reserved for distribution or sale to investors, and require that any distributions or sales thereof occur in a manner that supports the broader consumer token-based network.

Instead of the inclusion of pre-negotiated token prices in such instruments, which – from a commodities law point of view – may increase the risk of being considered a commodity option because such pre-agreed price could be seen as a strike price, the participation rights could be coupled with "most favoured nation" pricing provisions, guaranteeing certain investors the best token sale and distribution terms offered by the issuer to any other third party. These rights could also be supplemented with token economic rights that could be triggered in lieu of participation in the consumer token sale. For example, preferred stock could be issued with various rights tied to consumer token sales, such as pre-negotiated dividend or redemption rights, or a convertible promissory note under which the issuer pays a multiple of the note's aggregate principal amount or the note converts into preferred stock with dividend or redemption rights. Such token economic rights would have the goal of providing the investor with a similar economic outcome of participating in the consumer token sale. As a result, the careful balancing of such token sale participation and economic rights could provide issuers the flexibility to allow for the participation of investors eager to receive token economics while protecting the development of the underlying network and consumer tokens from the application of the securities laws.

Second, because consumer tokens and the corresponding network protocol often represent a significant portion of the value proposition associated with investing in such platforms, investors can reasonably expect to receive voting rights with respect to the creation and distribution of tokens by the issuer, including the right to approve the initiation of any offerings or distributions.[42] Eventually, as the pathway for consumer token sales becomes more clear, voting rights grants may be more narrowly tailored to only apply when such a sale does not meet certain specifications. In addition, investors may seek additional protections to prevent potential uses of the issuer's token-based network that circumvent their consumer token-related economic and participation rights.

Finally, these preferred stock and convertible promissory note structures may also be preferable because they more directly address the commodities law issues discussed above. First, conferring future participation rights on an investor to participate in a token sale, or conferring economic rights to an investor in respect of future distributions, is arguably not a swap subject to CFTC regulation. There is no strike price or final price differential that creates market risk that the CFTC would necessarily be incentivised to regulate in the commodity options market. Separately, if a swap were deemed to exist, in such structures where the conditions of the Hybrid Instrument Exemption other than the Marketing Condition are satisfied, one could argue that – despite the associated consumer token rights – such instruments are "predominantly securities" and unlikely to run afoul of the Marketing Condition, because the commodity forward or option would be a small portion of the value of the instrument. Accordingly, it would be much harder to argue that such instrument was marketed as a swap or purchased by investors solely for the purpose of receiving the value provided by the swap component. That is, because the predominant value of the instrument is a traditional security providing specific rights with respect to the issuer – such as traditional preferred stock rights (*e.g.,* liquidation preference, dividends, anti-dilution protection) or traditional promissory note rights (*e.g.*, returns of principal, potential conversion into equity) – such consumer token presales could arguably fall outside some (if not all) of the CFTC regulatory regime by qualifying for the Hybrid Instrument Exemption or being excluded entirely from the swap definition.[43] Of course, while each instrument would need to be analysed on its own merits, we believe this alternate structure has great promise for addressing commodities law issues.

These structures are also preferred from a securities law perspective for many similar reasons – because the investor is receiving a more traditional security, the various rights they are purchasing are far less ambiguous, and appropriate disclosures regarding the material aspects of the investment are more easily crafted.

Enabling true consumer token sales

Once a platform and token protocol has been developed, the question remains whether a viable consumer token sale may be accomplished. Director Hinman identified a number of factors centering around two main inquiries to help distinguish when digital assets transactions may be characterised as securities transactions.[44] First, he emphasised the role of the promoter or enterprise and the corresponding expectation of profits therefrom. Critical in this inquiry is the nature of the marketing of the consumer token and its platform, and the nature of the purchasers. Second, Director Hinman indicated the design of tokens and their economies should be free of the characteristics of a security.

We believe we can draw several inferences from Director Hinman's remarks that bear upon this analysis. First, tokens offered in a manner intended to appeal to an investor's investment intent will trigger the application of the securities laws. Second, when the token-based network has developed to an extent that the value of the tokens is no longer dependent upon the entrepreneurial or managerial efforts of such network's promoters, token trading on that network will not be considered securities transactions. Third, offerings of tokens with utility on a functioning token-based network that are specifically directed solely to users of that network may be conducted in a manner that renders the securities laws inapplicable.

Features of established non-security virtual currencies

Two of the most widely held and well-known digital assets – Bitcoin and Ether – provide good examples of digital assets that Director Hinman expressly posited no longer constitute securities primarily due to the decentralised nature of their use.[45] The "efforts of others" prong of the *Howey* Test requires that such efforts must be "undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[46] Two seminal cases provide guidance on this prong for instruments traded in well-developed markets such as Bitcoin and Ether.[47] In both *Noa v. Key Futures* and *SEC v. Belmont Reid & Co*., the Ninth Circuit applied the *Howey* Test to the sale of precious metals, finding that the *Howey* Test is not satisfied if the expectation of economic return is based on market forces, and not on the efforts of a promoter. Thus, the applicability of these cases to the analysis of Bitcoin and Ether within this prong of the *Howey* Test (and therefore the analysis of whether either Bitcoin or Ether is a security) depends on the existence of an established, decentralised market where the spot price is determined by ordinary market forces.

What is the role of the promoter or enterprise? Decentralised networks

As discussed above, the SEC's emerging regulatory framework for consumer tokens appears focused on a threshold question derived from the fourth prong of the *Howey* Test: is the token-based network sufficiently decentralised/independent of the entrepreneurial efforts of the promoter? There are several factors underlying this inquiry and each case requires careful analysis, and, without further guidance from the SEC, it is difficult to predict the appropriate weighting of such factors.

(a) *Ongoing development and maintenance of the network*

For a token-based network to be truly decentralised, no single enterprise should have the ability to significantly and directly influence the value of the consumer tokens exchanged on the network. This implicitly includes ongoing efforts to develop and maintain the network. In his discussion of the Bitcoin and Ether analysis, Director Hinman stated:

> *[W]hen I look at Bitcoin today, 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 decentralised for some time, perhaps from inception. . . . And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralised structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.*

Open source projects, where a variety of parties may contribute to the ongoing development of the network, clearly have a greater chance of meeting this requirement.

(b) *Use of token sale proceeds*

Similarly, the expected use of proceeds from a related token sale can impact whether a related token-based network is sufficiently decentralised. For example, a use of proceeds that involves further development and maintenance of the network could lead to a conclusion that the efforts of the issuer remain central to the value of the token, and hence, Director Hinman's focus on this characteristic.[48] This further supports the use of traditional financing instruments, coupled with economic rights in future token offerings. Issuers utilising such instruments would be able to fund the development of their network from the investments received pursuant to such instruments and would, subsequently, be able to use the proceeds from token sales to deliver a return of capital to investors, thereby clearly distinguishing early stage investments from token purchases and supporting the position that the tokens themselves should not be deemed to be securities.

(c) *Network governance*

The SEC also indicated that a token-based network's governance structure will be considered when determining whether such network is decentralised.[49] In its most simple form, a decentralised governance structure would provide token holders the ability to directly determine matters relevant to the network's development. On the other hand, voting rights are an attribute of equity securities, and thus can militate toward a conclusion that the tokens are securities. In any event, the retention of governance rights by the promoter is relevant to its ability to impact the value of the potential investment. Director Hinman specifically noted that it should be considered whether "persons or entities other than the promoter exercise governance rights or meaningful influence."[50]

(d) *Robust token economy*

The value of tokens on certain token-based networks is driven by a robust token economy pitting a number of different forces with different operating incentives against each other. These competing elements will be ascendant, and have a corresponding impact on the token value, at differing times. Courts have reasoned that this sort of market valuation mechanism is critical to distinguish a commodity from a security, as the value in the instrument is created by these broad market forces rather than the efforts of others.[51] Filecoin[52] is an apt example of a robust economic structure that helps ensure market forces drive token values independent of the promoter's efforts. The Filecoin network involves three network participants: (i) clients, who pay to store and retrieve data; (ii) storage miners, who provide data storage to the network; and (iii) retrieval miners, who provide data retrieval to the network.[53] As a result, the competing activities of these three groups create the value of a Filecoin token through the creation of supply and demand economics. This also means the success of the Filecoin network hinges upon a sufficient number of market participants contributing to the network simultaneously, which is a premise reflected in the high proportion of Filecoin tokens allocated to miners in exchange for storage and retrieval services.[54]

There are numerous token-based networks and token economy models that similarly promote the development of a robust economic structure. The success of most decentralised token-based marketplaces, whether for data storage, artificial intelligence, real estate or intellectual property, is dependent on market participants driving the value of the networks and its corresponding tokens. As a result, these marketplaces, like those for Bitcoin and Ether (which rely on market participants to record transactions on their respective blockchains), have a market valuation mechanism that is helpful in distinguishing a commodity from a security.

Is the asset designed for consumptive purposes? Consumer tokens and consumer token sales

Numerous consumer token and consumer token sale features warrant consideration in furthering the consumer token analysis to determine whether the securities laws may apply.

(a) *Functioning network*

A factor closely related to the role of the promoter discussed above, though distinct, is the question of whether the token-based network is "fully functioning or in the early stages of development."[55] A common feature of many early token sales was that they were commenced before the consumer could actually utilise the token. While some consumer goods are purchased in this manner (*e.g.,* concert tickets or a new Tesla car), consumer token presales complicate the analysis of whether "the primary motivation for purchasing the digital asset is for personal use or consumption."[56] As a result, issuers should, to the extent possible, launch their token-based network prior to initiating consumer token sales.

(b) *Secondary markets and transferability*

In February 2018, SEC Chairman Jay Clayton testified before the US Senate Committee on Banking, Housing and Urban Affairs, in part sharing his particular concern for ICO issuers and emphasising the secondary market trading potential of the tokens offered for sale.[57] This line of thinking clearly follows the *Gary Plastic* case, where the marketing of a non-security investment (*i.e.,* bank certificates of deposit) that included the promise of a secondary market transmutes the certificates of deposit into investment contracts.[58] Accordingly, the marketing of a token based on the ability to quickly sell the token in a secondary market strongly supports the view that such token is a security. However, the mere availability of a secondary market developing following a token sale arguably should not be dispositive and, perhaps, should not matter at all. Again, *Gary Plastic* stands for the notion that it is the *marketing* of the "investment" based on the potential of the secondary market that is what makes the instrument a security. Of course, there are many everyday commodities for which secondary markets regularly develop – in fact, Ebay has built a robust business on this basis – and the mere existence of such markets do not transmute the instruments into securities.

For example, a large number of active market participants is critical to the success of Filecoin's network. It is difficult to imagine a scenario where it could achieve the critical mass of network participants necessary if such network participants were restricted from exchanging in some way their Filecoin tokens with other participants for other digital assets or tokens as part of continually broadening the universe of token holders. In order for a network to work under isolated conditions, where such transfers were not permitted, not only would suppliers have to consume the resources created by the network, but maintaining a balance among suppliers and producers would be exceedingly difficult. The secondary market transactions accordingly act to balance the various economic demands without any one actor having to play all roles. Otherwise, for Filecoin, a miner would need to both provide and consume storage and retrieval services, because consumption would be the only way to realise the economic gain in exchange for providing such services. As a result, there would be little incentive for the miner to participate on such a network. A similar case can be made for any network that includes both suppliers/producers of goods or services and consumers of goods or services. Furthermore, supply on any such market would decrease rapidly if the inputs required to produce the supply of goods and services were not principally derived from the tokens received upon sale, or if an insufficient number of other goods and services were available to enable suppliers to consume all of the tokens they earn within such marketplace. Given the negative effect on network participation that limiting secondary market activity would have, it is likely that overly broad restrictions would impede competition and that only the largest and most established marketplaces would succeed.

Because of the foregoing, a measured approach to addressing secondary market activity and transferability is advisable. Fortunately, the flexibility available with second and third generation blockchain technologies provide companies with several options. First, purchasers of consumer tokens in a consumer token sale could be required to agree to a lockup mechanism, whereby a smart contract prevents the purchaser from selling their tokens for a certain period of time or until they participate on the network in the required manner. That is, they could be unlocked initially only in the event they were utilised on the platform itself first, and thereafter could be traded in the secondary market. Second, a tiered transfer fee or other incentive structure could be implemented, whereby the fees (or other similar incentives) for tokens transferred in connection with participation on the token-based network could be lower than the fees for transfers to non-network participants. In each of these cases, initial purchasers would not have the same profit motive in seeking secondary market for token sales as they may have in a typical ICO. Director Hinman appears to have suggested as much in his enumerated factors.[59]

(c) *Inflationary issuances*

Another aspect of consumer token sale structures that warrants discussion is the impact of inflationary/deflationary pressures in token economies. Depending on the token structure, there are a number of scenarios in which subsequent issuances of tokens in exchange for contributions to the economy of the network can simultaneously facilitate network growth while limiting the immediate speculative potential of the token. For example, Filecoin's token allocation design made 70% of the total Filecoin tokens available for miners in exchange for data storage and retrieval services. As those tokens will be subsequently distributed and "earned" by miners, the Filecoin token purchasers are "diluted" in an inflationary sense. However, unlike in the context of an equity security where dilution is significant because the valuation of the interest is always proportionate to the relative interest in the enterprise value, here the value of the token is based on the value of the goods and services that may be received in exchange, and the market supply and demand for such goods and services. Thus, the impact of dilution on a true consumer token is quite different and the value of the token should correspond more directly to the value to the consumer of the applicable goods and services. As a result, consideration should be given to the supply dynamics of a token economy.[60] Ultimate control over dilutive issuances is also a factor in network governance, which may impact the analysis above regarding the decentralisation of a given network.

(d) *Token retention*

To date, a common feature of ICOs has been the retention of the tokens by issuers for distribution to founders, employees, advisors and investors. In instances where there are reasonable and justifiable grounds to believe that these individuals can and will consume these tokens through their own market participation and will thus assist in the seeding of the network, then consumer token issuers should not be dissuaded from including the retention of consumer tokens in their allotment strategy. However, issuers should exercise caution in doing so, particularly in cases where the products and services offered on an issuer's network or the number of tokens retained could not reasonably be consumed by its founders, employees, advisors and investors. In such instances, it would be difficult to make a credible argument to the SEC that such tokens are not being held for investment purposes.[61] In addition, such retention of tokens also makes it more difficult for the token issuer to demonstrate that the tokens are "[d]ispersed across a diverse user base[,]" rather than being "[c]oncentrated in the hands of a few that can exert influence[.]"[62]

As a result, companies who wish to reward their teams for the successful development of a token-based network giving rise to a consumer token sale should look to traditional equity compensation methods, which can be augmented by consumer tokens to the extent a viable use case can be established. Additionally, selling restrictions with respect to both timing and price of tokens by such holders could be adopted to bolster the argument that such grants were not made to persons with an investment intent.

(e) *Token sale legal documentation*

Another means of discouraging purchasers of consumer tokens from an expectation of profit could be found in the documentation used in sales of tokens by issuers. Such agreements could include representations and warranties requiring purchasers to state that their intention is to use such consumer tokens on the issuer's network. As discussed above, such documentation could also include lockup mechanisms, whereby the purchaser's tokens could be "locked" using a smart contract for a specified period. Furthermore, instruments could grant issuers a first refusal with respect to any purchaser's tokens, whereby the issuer would be entitled to repurchase the tokens held by a user if the user had determined not to use them on the issuer's network. In many respects, this could be functionally similar to rights of return that are commonly provided by retailers with respect to tangible consumer goods, and issuers may be well advised to allocate a small percentage of any consumer token sales for such repurchases. While on most networks the issuer will only ever have privity of contract with the initial purchasers of consumer tokens, utilisation of these mechanisms could substantially reduce the risk of such purchasers having an expectation of requiring the protection of securities laws. However, establishment of valuation protocols and resale price, as well as the potential of a withdrawal of cash from an issuer, may detract from the attractiveness of this alternative.

Seeding network activity

Based on the foregoing considerations, issuers who both operate decentralised networks featuring tokens designed for consumption, and sell such tokens in a manner designed to dissuade purchases for investment, should be capable of avoiding the application of securities laws to such token sales under the *Howey* Test. However, this current paradigm appears to create a paradox, given that the process of creating a decentralised and functional network on which consumer tokens can be utilised necessitates that issuers first seed network activity by issuing consumer tokens in transactions that do not trigger the application of securities laws.

As a result, issuers may seek to seed their network through the distribution of consumer tokens via "airdrops" and other distributions to affiliates, vendors and community members. Such distributions promote network activity, facilitate the implementation governance procedures and enable network testing prior to full launch. The information garnered from this process enables developers to resolve potential issues and simultaneously enhances the credibility of the project both within and outside its community. Furthermore, such activity can help consumers better understand the value of the overall network and each consumer token, which ultimately promotes market efficiency. The benefits of such seed activity extend to consumer token issuances targeting strategic partners, who may also assist with the development of the network prior to launch. In addition, this seed activity permits the nascent token economy of the platform to grow, allowing forces beyond those of the initial promoter to begin to determine the value of the token. As a result, this activity directly addresses several of the factors identified by Director Hinman and can strengthen the case that a particular token is a consumer token.[63]

Nonetheless, issuers need to be aware that the SEC may take the view that the securities laws apply to airdrops of tokens, even though no money or digital currency funds is given by airdrop recipients. For example, in the early days of the internet, some issuers sought to issue free shares of common stock to registered website users, as part of a broader promotion to attract traffic to the website and promote brand awareness and loyalty. The SEC took the view that the free distribution of shares was a "sale" of securities.[64] Similarly, the SEC has taken the view that the spin-off of shares of a subsidiary as a free stock dividend to an issuer's shareholders can be a sale of securities.[65] As a result, unless and until the SEC gives more lenient guidance, airdrops should be considered and conducted in the same manner as token offerings, generally, as discussed above.

Conclusion

Much has been made of the need for certainty, and perhaps even innovation, in the application of various laws, including the US securities and commodities laws, to commercial activities relating to blockchain, cryptocurrencies and related technologies. After all, the applicable federal securities statute is 85 years old, and the seminal case, *Howey*, is more than 70 years old. That said, the SEC has not retreated from the application of existing precedent when examining token transactions. Nevertheless, given the underlying principles, and the SEC's public statements, there is some reason for optimism that the existing framework will permit at least some transactions in tokens – consumer token launches – to be executed without the application of the federal securities laws. We suggest, however, that it continues to be prudent for interested parties to seek guidance directly from the SEC staff before proceeding.

* * *

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* * *

Endnotes

1. The Digital Asset Taxonomy published by ConsenSys, a leader in the blockchain field, defined "consumer tokens" as "inherently consumptive in nature, which means that their intrinsic features and primary use are to represent, or facilitate the exchange of or access to, a limited set of goods, services, or content. The term "consumer" here refers to the consumptive nature of the relevant goods, services, or content, which businesses as well as individual users may ultimately use or consume[.]" Digital Asset Taxonomy: From the Perspective of Global Frameworks for Securities and Financial Instruments, https://thebkp.com/token-taxonomy/ (last visited July 26, 2018).
2. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).
3. 15 U.S.C. §§ 77b(a)(1), 78c(a)(10).
4. *See Howey* at 301.
5. *See id.*
6. *See* SEC Release No. 34-81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, 17-18 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.
7. *See* Latham & Watkins, SEC: Certain Initial Coin Offerings Are Securities Offerings, Client Alert No. 2187 (July 27, 2017), https://www.lw.com/thoughtLeadership/SEC-certain-initial-coin-offerings-securities.
8. *In re Munchee Inc.*, 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, SEC Administrative Proceeding File No. 3-18304 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf [hereinafter Munchee Order].
9. For a helpful overview of ICOs, see the SEC's Investor Bulletin on the subject. SEC Investor Bulletin, Initial Coin Offerings (July 25, 2017), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings.
10. *See* Latham & Watkins, SEC Takes Enforcement Action against Utility Token ICO, Client Alert No. 2257 (Dec. 20, 2017), https://www.lw.com/thoughtLeadership/SEC-vigorously-police-utility-token-ICO.
11. *See* William Hinman, Dir., Div. Corp. Fin., Sec. & Exch. Comm'n, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418 [hereinafter Hinman Speech].
12. *Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*, 756 F.2d 230 (2d Cir. 1985).
13. *See, e.g.,* 7 U.S.C. §§ 6c(a), 9, 12(a)(5), 15; 17 C.F.R. § 180.1; *see also* Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398 (July 14, 2011), https://www.gpo.gov/fdsys/pkg/FR-2011-07-14/pdf/2011-17549.pdf.
14. Timothy Massad, Chairman, Commodity Futures Trading Comm'n, Testimony of Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition & Forestry (Dec. 10, 2014), http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6 [hereinafter 2014 Massad Senate Testimony].
15. During this time, the CFTC has settled enforcement actions with exchanges, stressing a distinct aspect of its jurisdictional oversight in each: from establishing that virtual currencies are "commodities," to applying the retail commodity rules to leveraged virtual currency transactions, to asserting jurisdiction over virtual currency derivatives. *See* Latham & Watkins, CFTC Brings Significant Enforcement Action Against Online Cryptocurrency Exchange, Client Alert No. 1980 (June 20, 2016), https://www.lw.com/thoughtLeadership/CFTC-brings-significant-enforcement-action-against-online-cryptocurrency-exchange;

Latham & Watkins, Enforcement Trends in Cryptocurrency, Client Alert No. 1904 (Dec. 9, 2015), https://www.lw.com/thoughtLeadership/lw-enforcement-trends-cryptocurrency; Latham & Watkins, Cryptocurrencies Are Commodities: CFTC's First Bitcoin Enforcement Action, Client Alert No. 1874 (Sept. 21, 2015), https://www.lw.com/thoughtLeadership/LW-CFTC-first-bitcoin-enforcement-action.

16. *See, e.g.,* CFTC Release PR7714-18, CFTC Charges Multiple Individuals and Companies with Operating a Fraudulent Scheme Involving Binary Options and a Virtual Currency Known as ATM Coin (April 18, 2018), https://www.cftc.gov/PressRoom/PressReleases/7714-18; CFTC Release PR7614-17, CFTC Charges Nicholas Gelfman and Gelfman Blueprint, Inc. with Fraudulent Solicitation, Misappropriation, and Issuing False Account Statements in Bitcoin Ponzi Scheme (Sept. 21, 2017), http://www.cftc.gov/PressRoom/PressReleases/pr7614-17.

17. The following discussion of consumer token presales only seeks to address fundraising instruments utilised for pure consumer token issuances and not instruments utilised for pure security token issuances, which often have similar terms. We note that the presale of a token designed to be a security is a far easier analysis, as each of the instruments should be offered and sold in compliance with securities law requirements and ordinary corporate finance practices.

18. *See, e.g.,* Juan Batiz-Benet, Jesse Clayburgh & Marco Santori, The SAFT Project: Toward a Compliant Token Sale Framework (Oct. 2, 2017), https://saftproject.com/static/SAFT-Project-Whitepaper.pdf [hereinafter SAFT Whitepaper].

19. In addition to the securities law issues and commodities law issues discussed below, the SAFT and similar presale instruments can raise tax concerns in light of the uncertainty regarding their treatment for US federal income tax purposes. It is possible that an issuer could be subject to US federal income tax on proceeds from SAFT sales on a current basis, particularly where the underlying tokens are consumer tokens.

20. *Id.* (Section 5(c) of the SAFT, which is included as Exhibit 1 to the SAFT Whitepaper):

    "(c) The Purchaser has no intent to use or consume any or all Tokens on the corresponding blockchain network for the Tokens after Network Launch. The Purchaser enters into this security instrument purely to realise profits that accrue from purchasing Tokens at the Discount Price."

21. Defined in the SAFT as "a *bona fide* transaction or series of transactions, pursuant to which the [issuer] will sell the Tokens to the general public in a publicised product launch." Simple Agreement for Future Token, https://saftproject.com/static/Form-of-SAFT-for-token-pre-sale.docx (last visited July 29, 2018).

22. We note that some practitioners have proposed that if the network launch occurs more than six months after the SAFT sale, they should constitute two distinct plans of financing and thus would not be integrated in accordance with the safe harbor of Rule 502 under the Securities Act. In this regard, we would consider the concurrent settlement to negate this proposition. Similarly, the SAFT itself may constitute an offering of the underlying token that is continuous until delivery. In any event, we would expect that the tokens received by SAFT investors would nevertheless constitute securities on the date of delivery given the nature of the SAFT offering and the delivery of tokens to investors, unless the network has become sufficiently decentralised in the interim such that the "efforts" prong of the *Howey* Test was no longer satisfied.

23. It is worth noting, however, that the US House of Representatives recently passed several bills aimed at improving capital formation for smaller companies. For example, the Main Street Growth Act would amend the Securities Exchange Act of 1934, as amended, to allow registration of venture exchanges that would provide trading venues tailored for smaller companies, such as blockchain-based start-ups, whose securities are

considered less liquid than those of larger companies. Main Street Growth Act, H.R. 5877, 115th Congress (as passed by House, July 10, 2018), https://www.congress.gov/bill/115th-congress/house-bill/5877; *see* Tom Zanki, *House Passes Bill to Allow Venture Exchanges,* Law360 (July 11, 2018), https://www.law360.com/articles/1062096/house-passes-bill-to-allow-venture-exchanges.

24. *See* 15 U.S.C. § 78c(a)(4)(A) (defining "broker" as "any person engaged in the business of effecting transactions in securities for the account of others"); 15 U.S.C. § 78c(a)(5)(A) (defining "dealer" as "any person engaged in the business of buying and selling securities . . . for such person's own account"); 15 U.S.C. § 78c(a)(1) (defining "exchange" as "any organization, association or group of persons, whether incorporated or unincorporated, which constitutes, maintains or provides a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.").
25. *See* Hinman Speech.
26. *See, e.g.,* 2014 Massad Senate Testimony.
27. *See* 7 U.S.C. § 1a(47)(A)(ii) ("the term 'swap' means any agreement, contract, or transaction . . . that provides for any purchase, sale, payment, or delivery . . . that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."). Swap contracts are subject to a myriad of CFTC regulations under the CEA, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), including the requirement that over-the-counter (OTC) swap counterparties be "eligible contract participants." *Id.* § 1a(18) (defining eligible contract participants (ECPs)). An individual can only qualify as an ECP if such person has amounts invested on a discretionary basis, the aggregate of which is in excess of US$10 million; or US$5 million and enters into swaps in order to manage the risk associated with an asset owned or liability incurred (or reasonably likely to be owned or incurred) by such person. *Id.* § 1a(18)(A)(xi). If one or both of the parties to a swap transaction are non-ECPs, the swap must be executed on a CFTC-registered designated contract market. *Id.* § 2(e).
28. Both the CEA and CFTC regulations thereunder have long recognised a forward contract exclusion from futures contracts. *See* 7 U.S.C. § 1a(27) ("The term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery."). Following enactment of the Dodd-Frank Act in 2010, the sale of a non-financial commodity for deferred shipment or delivery was also excluded from the definition of "swap" in Section 1a(47) of the CEA under the Non-Financial Forward Contract Exclusion. *Id.* § 1a(47)(B)(ii).
29. *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208, 48228 (Aug. 13, 2012), https://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf [hereinafter *Products Release*].
30. As the CFTC has noted, "the underlying postulate of the [forward] exclusion is that the [CEA's] regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity." *Id.* at 48228.
31. The CFTC drew a clear distinction between commercial market participants and investors in the Products Release, stating that "[a] hedge fund's investment activity is not commercial activity within the CFTC's longstanding view of the Brent Interpretation." *Id.* at 48229. The "Brent Interpretation" refers to the CFTC's 1990 interpretation of the

application of the forward contract exclusion from the definition of "future delivery" in the context of "book-outs" transactions, which the CFTC extended in the Products Release to apply to the forward contract exclusion from the swap definition for non-financial commodities. Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39188 (Sept. 25, 1990), https://cdn.loc.gov/service/ll/fedreg/fr055/fr055186/fr055186.pdf.

Moreover, the CFTC continued to elaborate on its discerning view of "commercial" in the Products Release, stating that "an investment vehicle taking delivery of gold as part of its investment strategy would not be engaging in a commercial activity within the meaning of the Brent Interpretation." Products Release at 48229. However, if the investment vehicle were to own a chain of jewelry stores and would purchase gold on a forward basis to provide raw materials for the jewelry store, the CFTC would consider such activity to fall within the forward contract exclusion under the Brent Interpretation. *Id*. Notably, the CFTC stated in the Products Release that, for purposes of the "swap" definition, the Non-Financial Forward Contract Exclusion will be interpreted in a manner consistent with the CFTC's historical interpretation of the existing forward exclusion with respect to futures. As a result, the Brent Interpretation analysis is applicable for purposes of evaluating the Non-Financial Forward Contract Exclusion as it pertains to the "swap" definition. *Id*. at 48227-48228.

32. *See Id.*; *supra* text accompanying note 20.
33. 7 U.S.C. § 1a(47)(A)(i) ("the term 'swap' means any agreement, contract, or transaction . . . that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more . . . commodities").
34. *See* 17 C.F.R. § 32.3(c).
35. *See* 17 C.F.R. § 32.3(a).
36. *See supra* text accompanying note 27.
37. 17 C.F.R. § 34.3(a).
38. Under Section 2(f) of the CEA, a hybrid instrument is "predominantly a security" and exempt from the provisions of the CEA if:

    (i) the hybrid instrument issuer receives payment in full of the hybrid instrument's purchase price, substantially contemporaneously with delivery of the hybrid instrument;

    (ii) the hybrid instrument purchaser/holder is not required to make any payment to the issuer in addition to the purchase price described above, whether as margin, settlement payment or otherwise, during the life of the hybrid instrument or at maturity;

    (iii) the hybrid instrument issuer is not subject by the instrument's terms to mark-to-market margining requirements; and

    (iv) the hybrid instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to the CEA.

    7 U.S.C. § 2(f)(2).
39. This discussion assumes that prongs (i) – (iii) of the Hybrid Instrument Exemption are met with respect to any such presale instrument. Any such presale instrument must meet all four prongs of the exemption.
40. *See supra* text accompanying note 27; 7 U.S.C. § 2(e).
41. Such securities offerings are almost exclusively accomplished through the use of an exemption from registration, such as in a private placement that is limited to participants who are "accredited investors," as defined in 17 C.F.R. § 230.501, either under the more traditional style private placement of Regulation D, Rule 506(b), or the crowdfunding

compatible, Regulation D, Rule 506(c). Issuers may also consider utilising Regulation CF or Regulation A, which permit sales to non-accredited investors after making certain filings with the SEC. For additional information, see Latham & Watkins, SEC Adopts Final Crowdfunding Rules, Client Alert No. 1893 (Nov. 10, 2015), https://www.lw.com/thoughtLeadership/lw-sec-adopts-crowdfunding-rules; Stephen P. Wink and Brett M. Ackerman, Crowdfunding Under the SEC's New Rules, 49 Rev. of Sec. & Commodities Reg. 267 (Dec. 21, 2016), https://www.lw.com/thoughtLeadership/crowdfunding-SEC-new-rules-2016.

42. While issuers should be cautious when granting such rights, generally the enterprise and its investors are best served when their interests align. In consumer token sales, the parties share a direct interest in ensuring the offering or distribution complies with applicable securities and commodities laws. In addition, all participants should share a similar interest in the maturing of the market for token presales, as in the traditional venture capital space, to attract capital from investors that have yet to approach the sector due to regulatory risks.

43. A discussion of the types of structures that may so qualify and the nature of the availability of the possible exemptions is beyond the scope of this chapter.

44. *See* Hinman Speech; *see also* Latham & Watkins, A Path Forward for Consumer Tokens, Client Alert No. 2336 (June 27, 2018), https://www.lw.com/thoughtLeadership/lw-a-path-forward-for-consumer-tokens.

45. *See* Hinman Speech.

46. *SEC v. Glenn W. Turner Enterprises Inc*., 474 F.2d 476, 482 (9th Cir. 1973) ("[T]he fact that the investors here were required to exert some efforts if a return were to be achieved should not automatically preclude a finding that the Plan or Adventure is an investment contract. To do so would not serve the purpose of the legislation. Rather we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."); *see United Housing Found., Inc. v. Forman*, 421 U.S. 837, 855 (1975) (the "efforts of others" prong of the *Howey* Test requires that investors have a reasonable expectation of profit derived from the efforts of others).

47. In *Noa v. Key Futures, Inc*., the Ninth Circuit held that if the expectation of economic return from an instrument is based solely on market forces, and not on the efforts of a promoter, then the instrument does not satisfy this prong of the *Howey* Test. *Noa v. Key Futures, Inc*., 638 F.2d. 77 (9th Cir. 1980). The scheme in *Noa* involved the sale of silver bars through high-pressure sales efforts, and the Ninth Circuit's decision rested primarily on the existence of a separate market for the instrument that the investor could sell into, such that the economic return was driven by the market price and not the efforts of the promoter: "Once the purchase of silver bars was made, the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of Key Futures. The decision to buy or sell was made by the owner of the silver." *Id*. at 79.

SEC v. Belmont Reid & Co. involved a promoter that was involved in a gold mining operation who obtained prepayments from investors for the purchase of gold coins that would be obtained as a result of the mining operation. *SEC v. Belmont Reid & Co,* 794 F.2d 1388 (9th Cir. 1986). While the purchaser's return was highly dependent on the ability of the promoter to successfully mine and deliver the gold coins, the Ninth Circuit reasoned that the same non-performance risk exists in the context of any sale-of-goods contract in which the buyer pays in advance, and therefore that such a dependence on the promoter's efforts could not itself satisfy the *Howey* Test without making any such sale-of-goods contract a security. Instead, the Ninth Circuit held that the *Howey* Test was not satisfied in *Belmont Reid & Co*., because the purchasers who prepaid for the gold coins: "[H]ad as their primary purpose to profit from the anticipated increase in the world price of gold . . . In short, the purchaser[s] were speculating in the world gold market . . . To the extent the purchasers relied on the managerial skill of [the promoters] they did so as an ordinary buyer, having advanced the purchase price, relies on an ordinary seller." *Id.* at 1391.

48. *See* Hinman Speech ("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?").
49. *See id.*
50. *Id.* ("Do persons or entities other than the promoter exercise governance rights or meaningful influence?").
51. *See supra* text accompanying note 47.
52. Please note that we have chosen Filecoin in this example in part because we have no connection to its activities.
53. Protocol Labs, Filecoin: A Decentralized Storage Network (Aug. 14, 2017), https://filecoin.io/filecoin.pdf.
54. CoinList, Filecoin Token Sale Economics, https://coinlist.co/assets/index/filecoin_index/Filecoin-Sale-Economics-e3f703f8cd5f644aecd7ae3860ce932064ce014dd60de115d67ff1e9047ffa8e.pdf (last visited July 26, 2018).
55. Hinman Speech; *see* Munchee Order; Jay Clayton, Chairman, Sec. & Exch. Comm'n, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.
56. Hinman Speech.
57. Jay Clayton, Chairman, Sec. & Exch. Comm'n, Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC, (Feb. 6, 2018), https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission ("In short, prospective purchasers are being sold on the potential for tokens to increase in value with the ability to lock in those increases by reselling the tokens on a secondary market or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.").
58. *See Gary Plastic* at 240–241.
59. *See* Hinman Speech ("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?").
60. *See id.* ("Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?").
61. *See id.* ("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?").
62. *Id.*
63. *See id.* ("Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?").
64. Simplystocks.com, SEC No-Action Letter (Feb 4, 1999).
65. SEC Staff Legal Bulletin No. 4 (Sept 16, 1997), https://www.sec.gov/interps/legal/slbcf4.txt.

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