THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 53 No. 1 January 15, 2020

# DIGITAL ASSET REGULATION: *HOWEY* EVOLVES

*In this article, the authors provide a comprehensive look at the SEC's evolving guidance that aims to clarify when sales of digital assets are securities transactions. The authors discuss the Commission's early application of* Howey *to digital assets, its pronouncements and enforcement actions, and the response of commentators. They then turn to the SEC's Framework, issued in 2019, and other current SEC actions. They close by addressing steps the SEC should take to provide market participants with greater clarity on the application of the securities laws to digital assets.*

By Stephen P. Wink, Witold Balaban, John J. Sikora, Jr. and Miles P. Jennings*

Recent years have seen the birth and striking growth of the global cryptocurrency markets.[1] In the face of this development, the Securities and Exchange Commission has struggled to provide a clear answer to the seminal regulatory question confronting this space in the US: when is a digital asset a security? The SEC's early pronouncements and enforcement actions suggested an expansive understanding of "security" within the world of cryptocurrencies, an approach criticized by a number of commentators and one that jeopardized many cryptocurrency projects. However, in recent months, the SEC has released guidance in the form of an analytical framework for determining when a digital asset constitutes a security, as well as two no-action letters indicating that the applicable tokens would not constitute securities and several enforcement actions involving initial coin offerings. Consequently, the marketplace is now learning how this emerging approach is applied.

## BACKGROUND: THE SEC'S EARLY APPLICATION OF *HOWEY* TO DIGITAL ASSETS

The definition of what constitutes a "security" found in the Securities Act of 1933 and the Securities Exchange Act of 1934 includes a litany of common instruments, such as stocks and bonds, as well as the less familiar term "investment contract." In the 1946 case *SEC v. W.J. Howey Co*., the Supreme Court gave meaning to this term by stating that an instrument is an "investment contract" if it involves an investment of money in a common enterprise with the expectation of profits to be derived solely from the efforts of others.[2] For over 70 years, *Howey* has remained the principal test for identifying securities that do not otherwise neatly fall within the listed instruments.

[1] Unless stated otherwise, the terms "digital assets," "cryptocurrency," "token," and "coin" are used interchangeably in this article, and are intended to refer to the spectrum of digital assets issued and transferred using distributed ledger or blockchain technology.

[2] *SEC v. W.J. Howey Co.,* 328 U.S. 293, 298-99 (1946).

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### Early SEC Actions in the Cryptocurrency Space

In 2017, the SEC issued a report in which it applied the *Howey* test to cryptocurrencies for the first time. In the report, the SEC concluded that the Decentralized Autonomous Organization ("DAO") — which effectively operated as a decentralized investment fund via open-source code and smart contracts on the Ethereum blockchain — offered and sold tokens in a manner that constituted an offering of unregistered securities.[3] The DAO tokens had several equity-like attributes, including the right to distributions or dividends as well as governance rights, and thus, the finding that the tokens were securities was unsurprising to securities lawyers. The SEC issued this finding in the form of a report of investigation rather than an enforcement action. The report was seen as a helpful way to provide information on the appropriate guardrails to the nascent marketplace and its technologists unfamiliar with securities laws.

Later that year, in its *Munchee* order, the SEC similarly found that "MUN tokens" issued for use on the Munchee App were sold in an unregistered securities offering.[4] This finding was noteworthy, as the SEC's conclusion relied on the fact that the MUN tokens were marketed and sold as investments and largely ignored their apparent consumptive use in connection with the Munchee App.[5] The SEC found that the MUN tokens were not marketed to users of the Munchee App, but rather to cryptocurrency investors via multiple YouTube channels, which touted significant potential returns. In addition, the SEC noted that Munchee had described that "MUN tokens would increase in value as a result of Munchee's efforts and stated that MUN tokens would be traded on secondary markets."[6] Therefore, the SEC reasoned that "a purchaser of MUN tokens would have had a reasonable expectation of obtaining a future profit based upon Munchee's efforts, including Munchee revising its app and creating the MUN 'ecosystem' using the proceeds from the sale of MUN tokens."[7] Accordingly, MUN tokens constituted "investment contracts" under *Howey* and qualified as "securities."

### Pronouncements and Pushback

At the same time the *Munchee* order was issued, SEC Chairman Jay Clayton issued a warning to the marketplace and investors alike that initial coin offerings ("ICOs"),[8] like other token offerings, were likely to be considered securities offerings.[9] Clayton reinforced this position before the US Senate in February 2018, stating that "to date ICOs have largely been [securities]."[10] Of course, noting the context in which these statements were made is important. At the end of 2017, the ICO

[3] Sec. & Exch. Comm'n, Release No. 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.

[4] *In re* Munchee Inc., Securities Act Release No. 10445 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf (order instituting cease-and-desist proceedings).

[5] Munchee was a restaurant review application, which allowed users to base their reviews on higher quality "food photography." To generate a rewards program for reviewers, Munchee created MUN tokens. Reviewers would receive these tokens in exchange for quality restaurant reviews and, in turn, could redeem the tokens at any restaurant within the Munchee network. For example, a reviewer could earn MUN tokens for a review of Restaurant X and Y, and then redeem those tokens at Restaurant Z. *See* Andrew J. Chapin, *What Went Wrong with the Munchee ICO*, MEDIUM (Apr. 11, 2018),

*footnote continued from previous column…*

https://medium.com/swlh/what-went-wrong-at-munchee-ico-sec-subpoena-a468cba42e10.

[6] Munchee Order, *supra* note 5.

[7] *Id.*

[8] An initial coin offering is a fundraising method through which an entity creates a certain amount of Tokens or Coins and sells them to the public.

[9] Public Statement, Jay Clayton, Chairman, SEC, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), https:// www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[10] Public Statement, Jay Clayton, Chairman, SEC, 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.

market was extremely active, and online marketers were making dubious claims about the potentially significant returns that token purchasers could earn. There can be little doubt that this approach was driven in part by the Commission's desire to protect investors by throwing cold water on an overheated market.

In June 2018, after the ICO market cooled, the SEC's Director of Corporation Finance, William Hinman, announced a more flexible understanding of digital assets. Hinman "reasoned that a digital asset . . . used to purchase goods or services within a sufficiently decentralized ecosystem, could evolve such that it would cease to be classified as a security under US securities laws."[11] Hinman identified numerous factors to help identify when a digital asset is, in fact, a security. These factors emphasize that digital assets are more likely to be securities when a promoter is central to generating an expectation of profit — with a particular eye toward the nature of token's marketing, the development and operation of the token's platform, and the nature of the purchasers themselves (*e.g.*, speculators vs. platform users). Moreover, Hinman indicated that those tokens not treated as securities should possess designs and economies "free of the characteristics of a security."[12] Ether provides a good example of a digital asset that Hinman expressly posited no longer constitutes a security primarily due to the decentralized nature of its use.

Following Hinman's pronouncements, the SEC announced a series of enforcement orders that further clarified the SEC's application of *Howey* to the cryptocurrency marketplace. In September 2018, for example, the SEC issued a cease-and-desist order against TokenLot LLC.[13] According to the SEC, TokenLot operated its online trading platform for cryptocurrencies (including certain tokens the SEC asserted were securities) as an unregistered broker-dealer, as evidenced by TokenLot LLC's investor solicitations. One month later, the SEC instituted and settled an enforcement action against EtherDelta's founder, Zach Coburn, for operating an unregistered securities exchange.[14] The SEC also proceeded to issue cease-and-desist orders against various celebrities who had allegedly received compensation in exchange for promoting certain digital assets that the SEC claimed constituted securities.[15] Finally, the SEC issued cease-and-desist orders against CarrierEQ, Inc. and Paragon Coin, Inc., asserting that both companies had issued unregistered securities. In these final examples, the SEC's remedial orders required the companies "to register their tokens as securities under Section 12(g) of the Exchange Act" and "timely file reports required by Section 13(a) of the Exchange Act for at least one year."[16] While some issuers may be able to comply with securities laws by implementing such measures, issuers operating networks that rely on the free transfer of tokens may have greater difficulty doing so. In addition to increased costs, a token-based network may be rendered unusable if the network is required to register as a broker-dealer or exchange in order to transfer tokens deemed to be securities.

### *Early Responses to the SEC's Application of* Howey *to Digital Assets*

The SEC's early enforcement actions in the cryptocurrency space drew much criticism. For example, in its publicly released Wells Submission, Kik Interactive, Inc. ("Kik") contended that the SEC had failed to "develop a regulatory structure that would make sense for [] emerging technologies," and had instead "doubl[ed] down on a deeply flawed regulatory and

[11] David L. Concannon, Yvette D. Valdez & Stephen P. Wink, *The Yellow Brick Road for Consumer Tokens: The Path to SEC and CFTC Compliance. An Update*, BLOCKCHAIN & CRYPTOCURRENCY REG. (2020). https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/08-the-yellow-brick-road-for-consumer-tokens-the-path-to-sec-and-cftc-compliance-an-update; *see also* Speech, William Hinman, Dir. of Div. of Corp. Fin., SEC, Digital Asset Transactions: When Howey Met Gary (Plastics) (Jun. 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418.

[12] Yellow Brick Road for Consumer Tokens, *supra* note 11.

[13] *In re* Tokenlot LLC, Securities Act Release No. 10543, Exchange Act Release No. 84075, Investment Company Act Release No. 33221 (Sept. 11, 2018), https://www.sec.gov/litigation/admin/2018/33-10543.pdf (order instituting administrative and cease-and-desist proceedings).

[14] *In re* Coburn, Exchange Act Release No. 84553 (Nov. 8, 2018), https://www.sec.gov/litigation/adminl2018/34-84553.pdf (order instituting cease-and-desist proceedings).

[15] *In re* Khaled, Securities Act Release No. 10579 (Nov. 29, 2018), https://www.sec.gov/litigation/admin/2018/33-10579.pdf (order instituting cease-and-desist proceedings); *In re* Mayweather Jr., Securities Act Release No. 10578 (Nov. 29, 2018), https://www.sec.gov/litigation/admin/2018/33-10578.pdf (order instituting cease-and-desist proceedings).

[16] Cameron Kates, John Sikora, Stephen Wink, and Douglas Yatter, *SEC Ends 2018 Signaling Its Approach to Regulating the Cryptocurrency Markets*, LATHAM & WATKINS CLIENT ALERT 2435 (Jan. 15, 2019), at 3, https://www.lw.com/thoughtLeadership/lw--sec-signals-its-approach-to-regulating-the-cryptocurrency-markets.

enforcement approach."[17] Specifically, Kik argued that the SEC had "mapped out a[n] . . . aggressive position . . . that effectively threatens enforcement action against nearly all token offerings," including those that did not fit comfortably within the traditional definition of a "security."[18]

In addition to calling for legislative intervention, industry leaders have requested that the judiciary clarify how the securities laws apply to digital assets by potentially checking the authority of the SEC. Although judicial scrutiny traditionally functions as the principal check on agency overreach, the gears of the court system turn slowly, and when a final judicial determination in the still nascent cryptocurrency realm will occur remains unclear.[19] In the face of this regulatory opacity, commentators have offered frameworks of their own. The works of Peter Van Valkenburgh, as well as Max Raskin and M. Todd Henderson offer illustrative examples.

### *Peter Van Valkenburgh*

In August 2018, Coin Center's Peter Van Valkenburgh released the second version of his *Framework for Securities Regulation of Cryptocurrencies* report, with the goal of "help[ing] regulators . . . identify the scams from the true innovations."[20] In this report, Van Valkenburgh asserts that "the fundamental guiding question for regulators should be: is there a person or affiliated group of persons whose honest disclosures are both sufficient and necessary to address grave information asymmetries between users of [a] network and those who are promoting investment in the network?"[21] This consideration echoes Hinman's statements that securities laws are needed where there are information asymmetries between issuers and purchasers of digital assets.[22]

Van Valkenburgh further states that "the aging *Howey* test still provides a surprisingly lucid rubric for judging the relative risks of token sales and determining which sales warrant, from a public policy perspective, some form of oversight."[23] In support of this conclusion, Van Valkenburgh emphasizes the "flexible" and "fact-specific" nature of the *Howey* test and ultimately argues that *Howey* provides "an appropriate standard to determine when buyers of a token are at risk and should therefore be protected by treating that offering as a security, and regulating it as one."[24] Specifically, Van Valkenburgh points to "the software and community variables" associated with digital assets,[25] including several that line up with the factors cited by Hinman:

- *Decentralization* — Van Valkenburgh argues that a token mined and sold by a diffuse network of participants is unlikely to meet the "efforts of others" or "common enterprise" prongs of *Howey*. Such a decentralized environment more closely resembles a commodity market, such as the one for platinum.[26]

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[17] Wells Response: In re Kik Interactive (HO-13388), SEC. & EXCH. COMM'N, at 1 (Nov. 16, 2018), https://www.kin.org/wells_response.pdf.

[18] *Id.* at 1-2.

[19] For an example of one of the few judicial opinions to even raise the issue, *see SEC v. Blockvest, LLC*, 2018 WL 6181408, at *5-8 (S.D. Cal. Nov. 27, 2018). The *Blockvest* matter provides a vivid picture of the uncertain judicial treatment of digital tokens and ICOs. In *Blockvest I*, Judge Curiel denied the SEC's attempt to enjoin Blockvest from offering its BLV tokens, holding that the Commission "ha[d] not demonstrated that the BLV tokens purchased by [] investors were "securities" as defined under the securities laws." *Id.* at *7. In *Blockvest II*, however, Judge Curiel found "clear error" in the *Blockvest I* decision and ordered a preliminary injunction of the BLV offerings, reasoning that Blockvest had, in fact, engaged in "an 'offer' of 'securities' under the Securities Act." *SEC v. Blockvest, LLC*, 2019 WL 625163, at *9 (S.D. Cal. Feb. 14, 2019).

[20] Peter Van Valkenburgh, *Framework for Securities Regulation of Cryptocurrency v2.0*, Coin Center Report, 3 (Aug. 2018), https://coincenter.org/files/securities-cryptocurrency-framework-v2.1.pdf.

[21] *Id.* at 46.

[22] Hinman Speech, *supra* note 11. Reinforcing Director Hinman's sentiments that Bitcoin lacked a central third party, in October 2019, the SEC staff issued a letter to a Bitcoin focused fund seeking to register as an investment company under the Investment Company Act of 1940, noting that "we do not believe that current purchasers of bitcoin are relying on the essential managerial and entrepreneurial efforts of others to produce a profit." Stephen Palley, *Bitcoin Isn't a Security According to SEC Staff*, THE BLOCK (Oct. 6, 2019), https://www.theblockcrypto.com/post/42174/bitcoin-isnt-a-security-according-to-sec-staff.

[23] Valkenburgh Article, *supra* note 20, at 47.

[24] *Id.*

[25] *Id.*

[26] *Id.* at 52.

- *Functionality* — Van Valkenburgh contends that "if tokens are sought primarily for their use-value because they grant access to some tool or computing platform, then there is a poor case for expectation of profits" under *Howey*. For Van Valkenburgh, consumptive tokens can be analogized to purchasing a right to use a communal facility, such as a park, and such a right is not considered a security.[27]

While Van Valkenburgh lauds the *Howey* test's fact-intensive and flexible nature, he does not address concerns that the lack of bright-line rules fails to clarify the already murky regulatory waters through which token issuers must now navigate. As SEC Commissioner Hester Peirce commented in a February 2019 public speech, "the application of the [*Howey*] test [by the SEC] will be overly broad" in certain circumstances, and cautioned that the SEC should "tread carefully" when applying this aged standard to novel technologies.[28]

### *Henderson and Raskin*

In their article on the regulatory classification of digital assets, Professors Henderson and Raskin respond to calls for clearer rules by "propos[ing] two tests that operationalize the Supreme Court's test in [*Howey*]."[29] Similar to Van Valkenburgh's work, Henderson and Raskin's proposal attempts to address the decentralization and consumptive use of tokens. Under their "Bahamas [T]est," Henderson and Raskin first ask whether "the instrument is a decentralized one that is not controlled by a single entity."[30] Put differently, "if the sellers fled to the Bahamas or ceased to show up to work" and the project "is still capable of existing," then "the risk of fraud is sufficiently reduced and the instrument is not a security."[31]

To test their theory, Henderson and Raskin apply the Bahamas Test to Bitcoin, Ethereum, and the DAO. They conclude that although Bitcoin easily passes the Bahamas Test, Ethereum would fail that test but go on to pass their Substantial Steps Test (defined below).[32] Henderson and Raskin also note that the application of the Bahamas Test to the DAO doesn't neatly fit into the analysis described by the SEC.[33] They argue that the central role of the "curators" in the DAO construct could cause them to be viewed as the central authority whose absence (if they all left for the Bahamas) would impact the value of the tokens themselves. While this argument has some merit, it may also illustrate a scenario in which the Bahamas Test should not be considered the final answer. That is, in the DAO, the tokens represented interests in an organization that would essentially make distributions or dividends to holders based on the underlying investments of the organization. As a result, whether it would be deemed an investment contract under *Howey*, these interests certainly look a lot like an equity security or "stock" regardless of the presence of a central authority. Accordingly, there appears to be some risk that the SEC, or a court, could find an instrument like the DAO token to be a security even without reference to the *Howey* test.

If the token is not sufficiently decentralized under the Bahamas Test, Henderson and Raskin propose a "[S]ubstantial [S]teps [T]est" as a solution to the "use-value" problem highlighted by Van Valkenburgh. For Van Valkenburgh, if a token is not sought for its use-value, then it is likely to "be sought in part based on an expectation that the issuer will honor a promise to redeem." If the promise is "to redeem value that will have increased or been preserved over time thanks to [the issuer's] efforts, [] an expectation of profits may be easy to find,"[34] and the token could be deemed to constitute a security. With the Substantial Steps Test, Henderson and Raskin attempt to preempt the use-value problem by asking whether "the promoters [are] taking good faith, substantial steps towards completion of a project that they believe will have use to some users of the token beyond resale value or economic income."[35] Under this test, "a seller of an instrument [who] uses [] proceeds to build a product in some way connected to the instrument . . . does not have to register the sale."[36] Such a test looks past how a promoter markets a given asset and instead considers what actions that promoter is

[27] *Id.* at 54.

[28] Speech, Hester M. Peirce, Comm'r, SEC, Regulation: A View from Inside the Machine, Remarks at Protecting the Public While Fostering Innovation and Entrepreneurship: First Principles of Optimal Regulation (Feb. 8, 2019), https://www.sec.gov/news/speech/peirce-regulation-view-insidemachine.

[29] M. Todd Henderson & Max Raskin, *A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets*, 2019 COLUMBIA BUS. L. REV. (2019), at 443.

[30] *Id*. at 461.

[31] *Id*.

[32] Henderson & Raskin, *supra* note 29, at 470-73.

[33] *See* DAO Order, *supra* note 3, at 17-18.

[34] Valkenburgh Article, *supra* note 20, at 54.

[35] Henderson & Raskin, *supra* note 29, at 483.

[36] *Id*. at 484.

taking to generate use-value. For example, the sale of concert tickets does not constitute a security if the concert promoter is taking "concrete steps to put on a concert" (*i.e.*, obtain a performer and venue). Such an approach provides issuers greater flexibility to issue tokens that initially have no use-value because they can defend against the expectation of profits categorization by arguing that they are taking substantial steps towards use-value. According to Henderson and Raskin, this approach "encourages the development of useful projects and . . . discourages the sale of unregulated securities that are solely about enriching the promoter and its affiliates through the creation of a secondary market."[37] However, the Substantial Steps Test runs into challenges when a promoter starts taking substantial steps toward completion of the project and later abandons it, raising the possibility that the non-security tokens become securities. Henderson and Raskin propose a light registration regime, ideally overseen by a self-regulatory organization, to cure this shortcoming.

Introduced to the 116th Congress a mere six days after the SEC's April 2019 guidance, the Token Taxonomy Act ("TTA") is another framework that merits review. The TTA proposes to amend the Securities Act (with corresponding amendments to the Exchange Act, Investment Advisers Act, and the Investment Company Act) to exclude "digital tokens" (TTA Digital Tokens) from the definition of a security.[38] The TTA defines a TTA Digital Token as a subset of a "digital unit," which is "a representation of economic, proprietary, or access rights that is stored in a computer-readable format." TTA Digital Tokens are a subset of digital units created through a decentralized, mathematically verified process, recorded on a distributed ledger, and tradeable peer-to-peer; they are "not a representation of a financial interest in a company or partnership, including an ownership interest or revenue share." The TTA would also amend the Securities Act to create an exemption for transactions involving the offer and sale of digital units. Such transactions would be exempt so long as the person offering or selling the digital unit had a "good faith belief" that the digital unit was a TTA Digital Token. The TTA also provides that the exemption will be revoked if such person fails to publicly post notice and "take reasonable efforts to cease all sales and return all proceeds" within 90 days of receiving notice from the SEC that it has determined the digital unit to be a security. This essentially provides a veto right to the SEC for any token issuances purported to be made under a "safe harbor."[39] Finally, the TTA preempts state regulation of digital assets as securities, only allowing states to retain the "power to bring enforcement actions with respect to fraud."[40]

## THE SEC'S GUIDANCE

### *Overview*

On April 3, 2019, the SEC responded to the marketplace's call for guidance by issuing its *Framework for* "*Investment Contract*" *Analysis of Digital Assets*.[41] With this framework, the SEC attempts to provide guidelines "for analyzing whether a digital asset is an investment contract, and whether offers and sales of a digital asset are securities transactions." Specifically, the framework reviews the factual predicates at issue when evaluating "[w]hether a particular digital asset at the time of its offer or sale satisfies the *Howey* test." Unsurprisingly, the SEC's analysis (described below) emphasizes many of the same themes addressed in the Van Valkenburgh and Henderson and Raskin commentaries.

### *The Investment of Money and the "Common Enterprise"*

As an initial matter, the framework gives short shrift to the first two prongs of the *Howey* inquiry: the investment of money and the presence of a "common enterprise." First, the framework notes that the investment of money prong "is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration."[42] Next, the framework summarily asserts that "common enterprises" typically exist in the distribution of digital assets "because the fortunes of digital asset purchasers [are] linked to each other or to the success of the

[37] *Id*.

[38] Stephen P. Wink, Morgan E. Brubaker, Cameron R. Kates & Shaun Musuka, *US Digital Asset Bills: Will April Legislation Bring May Flowers?*, LATHAM & WATKINS LLP, GLOBAL FINTECH & PAYMENTS BLOG (April 22, 2019), https://www.fintechandpayments.com/2019/04/us-digital-asset-bills-will-april-legislation-bring-may-flowers/.

[39] *Id.*

[40] *Id.*

[41] SEC, FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS (2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn1 [hereinafter, "the framework"].

[42] *Id.*

promoter's efforts." In fact, the framework goes on to note — somewhat remarkably — that the Commission does not "view a 'common enterprise' as a distinct element of the term 'investment contract'" at all.[43] This view on the need for a "common enterprise" is something of a departure from the work of Van Valkenburgh and Henderson and Raskin as discussed above. Indeed, Kik asserted in its Wells Submission that the SEC's view on the "common enterprise" prong of *Howey* "would surely come as a surprise to the Supreme Court and the Circuit Courts of Appeal."[44] Nonetheless, the SEC's view — and disregard of — the "common enterprise" inquiry comes across clearly in this framework.

### *Reasonable Expectation of Profits Derived From the Efforts of Others*

The true substance of the framework relates to determining the presence or absence of a "reasonable expectation of profits derived from the efforts of others." Here, the framework makes a number of notes that will be important for potential issuers moving forward:

- *Reliance on the Efforts of Others* — The framework emphasizes the role of an Active Promoter ("AP"), which may include promoters, sponsors, and groups of affiliated parties, in creating value in the digital asset. It particularly focuses on whether a "purchaser reasonably expects to rely on the efforts of an AP" when purchasing a digital asset, and whether those efforts are "undeniably significant ones" as opposed to simply "ministerial."[45] In evaluating the role of an AP in this context, the SEC will focus on facts, such as whether the AP "is responsible for the development [and functionality] of the network" at issue and whether the "AP has a continuing managerial role in making decisions about or exercising judgment concerning the network." Notably, this analysis is similar to the reasoning in Henderson and Raskin's Bahamas Test, which looks to the managerial role of a third party in establishing and maintaining a token network.

- *Reasonable Expectation of Profits* — The framework offers a list of non-dispositive factors that may be used to determine whether a digital asset carries with it the expectation of profit. Of course, the framework suggests that if an asset conveys the "right[] to share in [an] enterprise's income," an expectation of profit is more likely,[46] echoing the reasoning in the DAO report, which pointed to the dividend-like feature of DAO tokens in classifying them as securities.

Continuing in the vein of the SEC's prior pronouncements, the framework also looks to how the digital asset is marketed, whether "the digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network," and whether "[t]he AP continues to expend funds from proceeds or operations to enhance the functionality or value of the network or digital asset." Such factors appear to focus on the more speculative aspects of issuances, such as if the use and value of the digital asset is connected to an undeveloped network, the success of which may likely be tied to the capital raised through the issuance itself.

*Other Relevant Considerations* — Importantly, the framework addresses the consumptive nature of the digital asset at issue, reasoning that if consumptive value is apparent, the asset is less likely to qualify as a security under the *Howey* test.[47] This assessment tracks the commentary of Van Valkenburgh and his contention that "if tokens are sought primarily for their use-value because they grant access to some tool or computing platform, then there is a poor case for expectation of profits."

To identify "use-value" in a token, the framework looks to a number of non-dispositive factors, such as whether the relevant network is "fully developed and operational" upon issuance of the token and whether "[h]olders of the [token] are immediately able to use it for its intended functionality on the network." Moreover, the framework attempts to distinguish between tokens issued for consumptive rather than speculative purposes. Here, it notes that a token is more likely consumptive if its "creation and structure are designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development of its network." To illuminate this consumptive model, the framework presents the example of a token offered by an online retailer, redeemable for merchandise. In highlighting the use-value of such token, the framework emphasizes that the token would be a non-transferable token, immediately redeemable within an established network. Under such a circumstance, the token would

[43] *Id.*

[44] Wells Response, *supra* note 17, at 17.

[45] The framework, *supra* note 41.

[46] *Id.*

[47] *Id.*

not carry the expectation of profit and would not, therefore, qualify as a security under *Howey*.

Finally, it should be noted that this framework memorializes Hinman's argument that digital assets, once deemed securities upon issuance, may cease to be securities over time. Specifically, the framework advises its users to consider whether:

- the efforts of an AP, including any successor AP, continue to be important to the value of an investment in the digital asset;
- the network on which the digital asset is to function operates in such a manner that purchasers would no longer reasonably expect an AP to carry out essential managerial or entrepreneurial efforts; and
- the efforts of an AP are no longer affecting the enterprise's success.

### *Applying the Framework*

The framework was released in conjunction with a formal no-action letter issued by the SEC to TurnKey Jet, Inc. ("TKJ").[48] In July 2019, the SEC issued another no-action letter to Pocketful of Quarters, Inc. ("Pocketful").[49] Although the SEC's reasoning in these no-action letters reflects back to earlier SEC guidance outside the cryptocurrency sphere,[50] the approach shines new light on the prospective application of the SEC's freshly minted framework on digital assets.

In the TKJ matter, TKJ alerted the Commission of its intent to issue tokens on a user platform to facilitate the procurement of chartered airline flights. In its letter to the Commission, TKJ made clear that consumers of these tokens would be "motivated . . . by a desire to obtain on-demand air charter services" and not by an expectation of future profits. Similarly, in the Pocketful matter, Pocketful requested no-action relief for its proposed issuance of a token that would allow buyers to spend value purchased or generated in one network-based game in another game on the network. Accordingly, TKJ and Pocketful maintained that these tokens would not be securities under the *Howey* framework. The Commission agreed, and identified several key attributes of both tokens that highlighted their consumptive utility and non-speculative nature. Specifically, the no-action letters noted:

- TKJ and Pocketful would not use any funds derived from the sale of the tokens to develop the associated token networks, which were to be fully operational upon any sale of the tokens;
- the tokens would be immediately usable for their intended purpose at the time they are sold;
- transfers of the tokens would be appropriately restricted within each respective network; and
- the tokens would be marketed in a manner that emphasized their functionality and not the potential for an increase in their market value.

The TKJ and Pocketful tokens have a fixed US dollar value, so it comes as little surprise that both tokens, which are simple payments or "stablecoin" tokens, would not be considered securities. Stablecoins are tokens that have their value pegged to that of a fiat or virtual currency or other asset.[51] They are an effective way of limiting the speculative potential of a token because they do not go up in value (or do so temporarily, or in limited amounts), meaning a purchaser cannot reasonably have the expectation of profit. Even so, the no-action letters remain significant, as they mark the SEC's first prospective determinations that certain token offerings are not securities — which should at least reassure potential issuers of similarly designed tokens intended for use on an existing network.

### *Enforcing the Message*

In addition to publishing the framework and issuing two no-action letters in 2019, the SEC has continued to take enforcement action against cryptocurrency industry participants to serve notice that "issuers cannot avoid the federal securities laws just by labeling their product a cryptocurrency or a digital tokens."[52] For example, in

[48] TurnKey Jet, Inc., SEC No-Action Letter (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.

[49] Pocketful of Quarters, Inc., SEC No-Action Letter (July 25, 2019), https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1.

[50] Cameron R. Kates and Shaun Musuka, *New SEC Token Guidance: This Is Howey Do It*, LATHAM & WATKINS LLP, GLOBAL FINTECH & PAYMENTS BLOG (April 10, 2019), https://www.fintechandpayments.com/2019/04/new-sec-token-guidance-this-is-howey-do-it/.

[51] Yellow Brick Road for Consumer Tokens, *supra* note 11.

[52] Press Release, SEC, SEC Halts Alleged $1.7 Billion Unregistered Digital Token Offering, (Oct. 11, 2019), https://www.sec.gov/news/press-release/2019-212.

August 2019, the SEC instituted and settled an action against SimplyVital Health, Inc. (“SimplyVital”) for conducting an unregistered securities offering that permitted sales to non-accredited US investors participating through known ICO pools — “groups of investors that pooled their money to collectively satisfy a token or coin issuer’s investment minimum and to take advantage of discounts offered to pre-sale investors.”[53] SimplyVital agreed to halt its public sale and return $6.3 million to investors who had bought SimplyVital’s “HLTH” token in a presale.[54] In its order, the SEC staff noted that it took into consideration SimplyVital’s cooperation once it was approached by the SEC staff.

In the same month, the SEC announced that it had initiated and settled an action (including a civil penalty) against ICO Rating for failing to disclose to market participants that it had received a total of $100,572 from the ICO issuers it purported to objectively evaluate. As a result, ICO Rating was fined a total of $268,998.[55] Finally, in October 2019, the SEC filed an emergency action to halt the sale of Telegram Group Inc.’s “Gram” token to the public in an unregistered securities offering.[56] The SEC alleges that Telegram issued a “Gram Purchase Agreement,” which is similar to a simple agreement for future tokens (“SAFT”) that provided purchasers the right to apply the investment amount to purchase Grams at a fixed price once issued upon the launch of Telegram’s “TON Network.”[57] Although Telegram has long acknowledged that the Gram Purchase Agreement is an investment contract subject to restricted transfers and resale, it has taken the position that the Grams purchased thereunder are not securities and may be freely traded upon issuance. The SEC disagrees, and in its complaint pointed to Telegram’s marketing materials as evidence that Gram purchasers have an expectation to profit directly from the efforts of Telegram to build the TON Network.[58] Although this case is in its infancy, it may bring clarity to the SEC’s view of SAFTs and similar arrangements that were historically used in ICOs and which we have criticized for a number of reasons.[59]

The flurry of enforcement actions has raised questions in the crypto-markets about whether any of the actions provide discernable lessons. The facts-and-circumstances nature of the securities law analysis makes deducing broad lessons regarding the substantive application of securities law to a range of digital assets difficult. However, from a procedural standpoint, one possible lesson is that entities that cooperate with the SEC (even following a violation) appear to achieve more favorable outcomes than those that pursue an adversarial approach. An example of this is the ongoing lawsuit between the SEC and Kik.[60] After the SEC privately notified Kik of its investigation into Kik’s September 2017 ICO, Kik publicly released its response,[61] a move seen by some as “throwing down the gauntlet.”[62] As a result, the SEC and Kik are now involved in litigation as the SEC seeks disgorgement of the $100 million that Kik raised during its ICO, the permanent enjoinment of Kik from engaging in similar courses of business, and the imposition of civil money penalties.[63]

In comparison, Nebulous, Inc., the developer of a decentralized cloud data storage network (Sia Network), reached a settlement after “cooperating fully”[64] with the SEC. As part of the settlement, Nebulous was ordered to pay a $225,000 penalty for conducting an exchange offer and an unregistered securities offering that raised $120,000.[65] The Sia Network features two tokens – Siafunds and Siacoins – and the penalty imposed on

[53] Stephen Wink, Cameron Kates, Shaun Musuka, & Deric Behar, *SEC’s Crypto Summer Continues*, LATHAM & WATKINS LLP, GLOBAL FINTECH & PAYMENTS BLOG (August 26, 2019), https://www.fintechandpayments.com/2019/08/secs-crypto-summer-continues/.

[54] *Id.*

[55] *Id.*

[56] Complaint, *SEC v. Telegram Group Inc.*, No. 19 Civ. 9439 (PKC) (S.D.N.Y. filed Oct. 11, 2019).

[57] *Id.*

[58] *Id.* ¶¶ 61-98.

[59] Yellow Brick Road for Consumer Tokens, *supra* note 11.

[60] Press Release, SEC, SEC Charges Issuer with Conducting $100 Million Unregistered ICO, (Jun. 4, 2019), https://www.sec.gov/news/press-release/2019-87.

[61] *See generally* Wells Response, *supra* note 17.

[62] Nikhilesh De, *The SEC Case Against Kik’s ICO Appears Strong, Experts Say*, COINDESK (Jun. 5, 2019), https://www.coindesk.com/the-sec-case-against-kiks-ico-appears-strong-experts-say.

[63] Complaint, *SEC v. Kik Interactive Inc.*, No. 19 Cv. 5244 (S.D.N.Y. filed June. 4, 2019).

[64] *Nebulous Enters into Settlement with SEC Regarding 2014 Offering of Sianotes and 2015 Conversion into Siafunds*, SIA, (Oct. 1, 2019) https://sia.tech/settlement2019.

[65] Daniel Kuhn, *Sia Reaches $225K SEC Settlement Over $120K Unregistered Token Sale*, COINDESK (Oct. 1, 2019), https://www.coindesk.com/sia-reaches-225k-sec-settlement-over-120k-unregistered-token-sale.

Nebulous by the SEC was only in relation to transactions involving Siafunds, which the SEC deemed to be securities. The SEC remained silent as to whether Siacoins constitute a security, and did not require them to be registered as such.[66] It appears that Siacoins may now be freely traded on the Sia Network, thus preserving the network's viability. If Siacoins were deemed to be a security, the Sia Network would likely have been rendered unusable because Siacoins could only be traded between accredited investors under an exemption from the securities law or in compliance with registration requirements.

## A FINAL LOOK

The SEC's framework for the application of *Howey* to digital assets is a welcome step toward clarity. While the TKJ and Pocketful no-action letters may have limited utility due to the straightforward analysis of the "reasonable expectation of profits" prong of *Howey* when applied to stablecoins or payment tokens, such letters demonstrate that, at the very least, a clear path exists for certain stablecoins or payment tokens to avoid securities regulation. In addition, such letters represent the first application of the SEC's most recent framework, which otherwise reinforces the idea that fundraising to build a network platform for a token remains the province of securities regulation. Furthermore, the framework makes clear that the role of the central enterprise or AP will remain a fundamental part of the SEC's inquiry at each stage of the network's evolution. Finally, the framework expands on Hinman's views on how a network may evolve toward sufficient decentralization, thus preserving the possibility of the transmutation of security tokens to consumer tokens.

Comparing how the SEC's framework measures up against the frameworks presented by Van Valkenburgh, Henderson and Raskin, and the TTA is an instructive exercise. The four frameworks are in agreement that decentralization is a necessary condition to reduce the type of information asymmetry that securities laws were designed to address. To measure decentralization, each framework inquires to what degree a project can function in the absence of managerial efforts undertaken by a centralized entity. Henderson and Raskin make this determination using the Bahamas Test, while the SEC, Van Valkenburgh, and the TTA do so by questioning whether an AP is present.

Although the SEC, Van Valkenburgh, and Henderson and Raskin agree that *Howey*'s "efforts of others" prong can be addressed via decentralization, the three frameworks diverge on the issue of how to deal with *Howey*'s "expectation of profits" prong. For Van Valkenburgh, the question is whether a token is functional (*i.e.*, has use-value). For Henderson and Raskin, the analysis focuses on whether the promoters of a project are taking substantial steps to create a project that has use beyond speculation. The SEC's framework eschews the Substantial Steps Test and instead looks at how a project is marketed and the token's functionality. Finally, the TTA focuses on the design of the token as a non-security instrument.

The SEC's framework leaves open a number of questions and reaffirms some problematic regulatory themes. Notably, how to evaluate when a platform becomes sufficiently decentralized is unclear. Moreover, the SEC's relentless focus on the marketing of digital assets regardless of design, as reflected in its framework, is likely to significantly impede entrepreneurs in establishing truly decentralized networks. Entrepreneurs are forced to operate within a world where the only way they can quickly and efficiently distribute tokens while avoiding securities status is by first establishing a decentralized network, but reaching decentralized status paradoxically requires tokens to be widely disseminated in the first place. This paradox is more apparent when compared to other jurisdictions that have successfully clarified how tokens can be designed, sold, and implemented on a network by focusing on the design of the token rather than how it is marketed or the status of the network. In the UK, for example, financial regulators employ a qualitative analysis that places digital assets into three categories tied to the use of the asset itself.[67] This approach has allowed for the sale and purchase of digital assets in the UK, including "utility" and "exchange" tokens, which do not fall within the UK's current regulatory regime.[68] Conversely, the SEC's shifting focus on marketing and functionality has created uncertainty and impeded similar innovation in the US market.

In a May 2019 speech, Commissioner Peirce highlighted this uncertainty in noting that "[t]he SEC has yet to provide guidance to the public or FINRA on any of the core questions" involving market participants in this area and characterized the formulation of the framework as "splashing lots of factors on the canvas

[66] Sia Blog Post, *supra* note 64.

[67] David Berman et al., *UK Cryptoassets Taskforce Publishes Its Final Report*, LATHAM & WATKINS CLIENT ALERT 2403 (Oct. 31, 2018), at 3, https://www.lw.com/thoughtLeadership/lw-UK-cryptoassets-taskforce-publishes-final-report.

[68] *Id.*

without any clear message."[69] Peirce challenged the SEC to "tackle the remaining legitimate legal questions in a way that does not throw merit-based obstacles in the way of socially beneficial innovation."[70] For Peirce, the SEC's continued silence on these key issues risks "push[ing] this innovation and any attendant economic growth into other jurisdictions that have done their work and provided clear guidelines for the market participants to follow."[71]

Issuers who both operate decentralized networks featuring tokens designed for consumption and sell such tokens in a manner designed to dissuade purchases for investment should be allowed to avoid the application of the securities laws to such token sales. This is especially true considering that other jurisdictions have been able to create pathways for consumer tokens that do not subject issuers to the compliance burden associated with traditional security issuances. Although sufficient decentralization is difficult to define precisely, the SEC can take potential steps to provide market participants with greater clarity. As Peirce discussed, while the SEC highlighted a number of factors to consider when judging whether a token-based network is sufficiently decentralized, clarity as to the appropriate weighting of such factors would be helpful to issuers.

The principle of mitigating information asymmetries that exist between issuers and investors, which both Hinman and Van Valkenburgh consider to be a fundamental driver of the need for regulation, should inform the weighting of the factors used to measure the sufficient decentralization of a network. As a result, the SEC should place greater emphasis on factors that have a clear nexus to the reduction of information asymmetries. For example, the decentralization of network development and maintenance, as well as distributed network governance, should be among the most heavily weighted factors. If such activity is truly decentralized, information asymmetries between network users and a powerful group that manages the network will be less likely. On the other hand, the SEC should give less weight to factors such as the existence of a secondary market for the token or its transferability. The mere existence of a secondary market should be distinguished from the *Gary Plastic*[72] context, where it became a fundamental part of the marketing scheme.[73] Of course, there are many commodities for which secondary markets exist, and their mere existence does not transmute those commodities into securities.

Many token-based networks are under development for which a large number of active market participants is critical to the success of the network. It is difficult to imagine a scenario in which such networks could achieve the critical mass of network participants necessary if such participants were restricted from exchanging their tokens in some way with other participants for other digital assets or tokens as a means to continually broaden the universe of token holders.

Clear guidance from the SEC regarding potential pathways for achieving sufficient decentralization will be essential to the development of tokens and networks. Currently, developers must be wary that the seeding of their network via token "airdrops" and other distributions to affiliates, strategic partners, vendors, and community members could be deemed to be a securities offering, given that the issuer may receive a direct benefit from such distributions.[74] However, due to the fact that airdrops do not involve an investment decision on the part of token recipients (they are free, after all), it is unclear why recipients require protection from the information asymmetries Hinman cited as the basis for applying the securities laws in this context. These distributions can be a vital step for many networks to achieve decentralization, as distributions often promote

[69] Speech, Hester M. Peirce, Comm'r, SEC, How We Howey (May 9, 2019), https://www.sec.gov/news/speech/peirce-how-we-howey-050919.

[70] *Id.*

[71] *Id.*

[72] *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce Fenner & Smith*, 756 F.2d 230 (2d Cir. 1985); *see also* Hinman Speech, *supra* note 11.

[73] Pocketful of Quarters, Inc. was granted a no-action letter by the SEC in July 2019. We note that Pocketful's incoming letter repeatedly emphasized that "it will not be possible for Quarters to trade in any secondary markets." No-Action Request from Cohen Wilson LLP to SEC, Div. of Corp. Fin. (Jul. 25, 2019), at 7-13, https://www.sec.gov/divisions/corpfin/cf-noaction/2019/pocketful-of-quarters-inc-072519-2a1-incoming.pdf. Although this was a prudent approach on Pocketful's part, such emphasis was unnecessary given that a secondary market only becomes relevant in the securities law analysis when it is a fundamental part of a token's marketing scheme. For Pocketful, this was not the case.

[74] *In re* Tomahawk Exploration LLC, Securities Act Release No. 10530, Exchange Act Release No. 83839 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf (order instituting administrative and cease-and-desist proceedings) (Aug. 14, 2018).

network activity, facilitate the implementation of governance procedures, enable network testing prior to full launch, and incentivize third-party development work.

In addition, this seed activity permits the nascent token economy of a network to grow, allowing forces beyond those of the initial promoter to begin to determine the value of the network. Accordingly, developers would greatly benefit from a bright line drawn between the capital formation period of these projects, when the securities laws would apply, and later periods, when token distributions may be made in pursuit of decentralization. This may well be the point at which the developers could leave for the Bahamas without disrupting the operation of the network.

Finally, the SEC should apply less weighting to whether purchasers might expect to receive potential gains based on the future value of the token. Well-designed token economies encourage the development of so-called "network effects," and such incentives should be encouraged as they will lead to further decentralization. The fact that a white paper[75] describes these economic incentives as part of the overall economic design of the network should not, in itself, cause the SEC to view the white paper as promoting the token sale as an investment. These types of design elements are notably distinct from actions taken by a central party to promote an increase in the value of the token.

Of course, courts and perhaps the legislature will eventually weigh in on these matters to further develop the law applicable to digital assets. In the meantime, further clarity from the SEC on the weighting of the framework factors would go a long way toward enabling rational and careful innovation in the cryptocurrency industry. ■

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[75] A white paper is a document published by a project, typically in connection with a token offering, informing investors and potential users about the project's token, protocol, and/or decentralized application.