

Blockchain & Cryptocurrency Regulation

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Not in Kansas anymore: The current state of consumer token regulation in the United States

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Developing a framework for consumer tokens

The digital asset sector continues to evolve at a rapid pace. As SEC Commissioner Hester Peirce put it, the sector is “about as nimble as it gets.”¹ In 2021, we have witnessed the explosion of decentralized finance, yield farming, and governance tokens. Non-custodial decentralized exchanges continue to experience substantial growth, with total exchange volume peaking at over \$150 billion in Q2 2021. Non-fungible tokens (NFTs) went from crypto curiosity in 2020 to mainstream in 2021, with sales for individual NFTs and lines of collectibles smashing records each consecutive month. Besides their popularity as collectibles, NFTs have also taken hold in the blockchain-based gaming, metaverse and virtual worlds, and as collateral for borrowing and backing stablecoins

As the US Securities and Exchange Commission (the SEC) continues to pursue enforcement actions with respect to token offerings (while scrupulously avoiding giving regulatory guidance), the question on the minds of many entrepreneurs and their counsel is what the parameters are for the issuance and sale in the United States of “consumer” or “utility” tokens – those designed for use by consumers on a distributed platform and not intended to constitute securities.² While there appears to be a viable regulatory path to the issuance of consumer tokens that would not necessarily be viewed as “securities” subject to SEC oversight, the framework continues to suffer from a lack of definite regulatory parameters and bright line definitions. In this chapter, we discuss the legal issues surrounding such issuances under the US federal commodities and securities laws.

This chapter serves as an update to the previous edition and reflects our most current and up-to-date thinking and analysis regarding the development of consumer token sales.

Existing frameworks

The securities law framework

The SEC’s approach to whether a digital asset sold in a token sale would be a security derives from its application of the test set forth in *SEC v. W.J. Howey Co.* (the *Howey Test*).³ The *Howey Test* determines whether an asset constitutes an “investment contract,” one of the enumerated types of instruments defined in the securities laws.⁴ 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.⁵ 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.⁶ 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 (DAO) tokens, a digital asset, was an unregistered securities offering undertaken without a valid exemption from Section 5 of the Securities Act of 1933 (the Securities Act). 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.

In its first enforcement action relating to the sale of digital assets, on December 11, 2017, the SEC issued an order instituting cease-and-desist proceedings to halt Munchee Inc.'s sale of tokens (the *Munchee* Order), having concluded that the sale was an unregistered securities offering. A key lesson of the *Munchee* Order was that despite the utility design features of the MUN Tokens, the manner in which the digital assets were offered to prospective investors, and the presence of investment intent on the part of participating investors, constituted material factors for the SEC in determining that the offering was a securities offering subject to the US federal securities laws.⁷

Following the *Munchee* Order, in a June 2018 speech, William Hinman, Director of the SEC's Division of Corporation Finance at the time, emphasized that digital assets need not always be securities. Rather, in addition to the underlying rights associated with such assets, he reiterated that 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.*,⁸ in which the Court found that an offering of a certificate of deposit, which in and of itself is not a security, was subject to US federal securities laws because marketing efforts relating to the certificates centered on the establishment of a secondary market and the opportunity for purchasers to profit from the enterprise. In the case of nascent token platforms and networks, digital tokens sold in an offering by promoters to "develop the enterprise" will most often constitute securities because the value of the token will primarily derive from the entrepreneurial efforts of the enterprise's promoters. Nevertheless, Director Hinman noted that transactions involving digital assets on a sufficiently decentralized network do not otherwise have the indicia of securities transactions and do not give rise to the public policy concern of informational asymmetries between an investor and issuer, and thus may not trigger the application of US federal securities laws. Director Hinman reiterated these ideas in a May 2019 speech, stating that a potential pathway exists for a token that was once a security to transmute into a non-security.

In April 2019, the SEC staff issued a "Framework for 'Investment Contract' Analysis of Digital Assets" (the Framework) to assist market participants to assess whether a digital asset constitutes an investment contract.⁹ In addition, the SEC staff also released two no-action letters relating to token offerings in 2019. The first (the Turnkey Letter) was in response to a proposed token offering by TurnKey Jet, Inc. (Turnkey Jet), an air carrier and air taxi service, and the second (the PoQ Letter) was in response to Pocketful of Quarters, Inc.'s (PoQ) proposed token offering.¹⁰ Together, the Turnkey Letter, PoQ Letter and Framework emphasize that the analysis of whether a utility token constitutes an investment contract typically hinges on the third and fourth prongs of the *Howey* Test; in particular, whether the investors have an expectation of profits that will be derived from the managerial efforts of others. The Framework now serves as the principal source of guidance for analyzing whether a digital asset falls within the definition of a security.

To evaluate "reliance on the efforts of others," the Framework introduces the concept of an Active Participant (AP), defined as "a promoter, sponsor, or other third party . . . [that]

provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts.” Determining the existence of an AP necessarily requires an analysis of each party’s role in developing, maintaining or governing the network. The presence of an AP means it is more likely that profits are being derived from the efforts of others.

To analyze “reasonable expectation of profit,” the Framework bases its evaluation on whether an asset conveys the “right to share in [an] enterprise’s income.” This factor should be unsurprising to issuers, as it derives from 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 guidance also looks to how the digital asset is marketed, whether “the digital asset is offered broadly” (e.g., via secondary markets) “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 where 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. In addition, the Framework looks to whether the AP will receive or retain any of the digital assets, and the nature of purchasers’ expectations with respect to the role of the AP and the ongoing viability of the digital asset itself.

In June 2019, the SEC sued Kik Interactive Inc. (Kik) for allegedly conducting an illegal \$100 million securities offering of Kik’s digital token, Kin.¹¹ In its complaint, the SEC alleged that Kik marketed Kin to investors as an investment opportunity, offered and sold Kin before it had any utility, retained a proportion of the tokens for Kik and promised investors that Kin would be listed on secondary markets. For the SEC, such features meant the Kin offering was a securities transaction and should have complied with registration requirements as prescribed by the securities laws.¹² In a press release,¹³ Kik responded to the SEC’s suit, citing similar arguments as those raised in its Wells submission¹⁴ in December 2018. Specifically, Kik argued that the SEC’s complaint is based on “flawed legal theory” and expands the *Howey* Test beyond its prescribed limits. In support of this position, Kik claimed that “the complaint assumes, incorrectly, that any discussion of a potential increase in value of an asset is the same as offering or promising profits solely from the efforts of another; that having aligned incentives is the same as creating a ‘common enterprise’; and that any contributions by a seller or promoter are necessarily the [‘essential[’] managerial or entrepreneurial efforts required to create an investment contract.”¹⁵ Of course, in addition to proving instructive, the resolution of this case and these issues could provide useful judicial precedent.

In June 2020, a year after commencing the Kik lawsuit, the SEC announced a settlement with Telegram Group Inc. (Telegram) over charges that Telegram had violated securities laws when it offered and sold its unregistered “Grams” token in exchange for \$1.7 billion from 175 initial purchasers.¹⁶ The Telegram fact pattern is strikingly similar to Kik’s, in that both are operators of messenger applications that sought to introduce a token into their messenger service by selling pre-functional tokens to initial purchasers and using the funds to develop their respective networks.¹⁷ Prior to the settlement, the Court in the Southern District of New York had sided with the SEC in March 2020 and granted an injunction prohibiting Telegram from delivering Grams to the initial purchasers. The Court held that Telegram’s scheme constituted an investment contract, requiring either registration or an applicable exemption

in order to comply with securities laws. As part of the settlement with the SEC, Telegram returned \$1.2 billion to the initial purchasers and paid an \$18.5 million penalty.

Some commentators had hoped Telegram's case would provide further clarity on the path tokens should take to not constitute securities. Unfortunately, those hopes were not met, but the Court provided a brief hint of what might be, noting:

“Cryptocurrencies (sometimes called tokens or digital assets) are a lawful means of storing or transferring value and may fluctuate in value as any commodity would. In the abstract, an investment of money in a cryptocurrency utilized by members of a decentralized community connected via blockchain technology, which itself is administered by this community of users rather than by a common enterprise, is not likely to be deemed a security under the familiar test laid out in [*Howey*]. The SEC, for example, does not contend that Bitcoins transferred on the Bitcoin blockchain are securities.”¹⁸

Token safe harbor proposal

In a February 2020 speech, Commissioner Peirce proposed a token safe harbor, which would provide network developers with a three-year grace period to achieve sufficient decentralization for their network following the issuance of unregistered tokens.¹⁹ On April 13, 2021, she reissued²⁰ the proposal as Token Safe Harbor Proposal 2.0 (Proposal 2.0), in light of feedback received since the original release from the crypto community, securities lawyers, and members of the public.

The original Safe Harbor Proposal, as well as Proposal 2.0, provide a time-limited exemption for token-based projects that seek to raise capital to develop decentralized networks. Proposal 2.0 would also allow fledgling networks to operate unburdened by the onerous registration provisions of the US federal securities laws until they reached network maturity (defined as either decentralization or token functionality). Provided that certain standards and disclosure requirements are met, a three-year grace period would be granted to allow token developers to pursue “sufficient” decentralization of their network from the time of the first token sale. As a result, purchasers of the token would no longer reasonably expect that the value of their tokens was being driven by a person or group via managerial or entrepreneurial efforts.

Although the Proposals were floated by a single SEC Commissioner, they are nevertheless a positive development for such a discussion to be taking place, and would provide token holders with greater protection and transparency if adopted. Unfortunately, however, there has been little enthusiasm from Commissioner Peirce's fellow Commissioners and other regulators for establishing a safe harbor such as Proposal 2.0.

A note on custody (SEC)

For centralized exchanges and broker-dealers acting as custodians of digital asset securities, the SEC staff issued a joint statement²¹ with the Financial Industry Regulatory Authority on July 8, 2019, highlighting the importance of compliance with Rule 15c3-3 under the Securities Exchange Act of 1934 (the Customer Protection Rule). The Joint Statement emphasized how digital asset securities, as opposed to traditional securities, are particularly susceptible to being lost due to cyberfraud, cybertheft, loss of a private key, or a faulty blockchain transaction.

In addition, the SEC issued a related statement²² on December 23, 2020 (“Custody of Digital Asset Securities by Special Purpose Broker-Dealers”) clarifying its position on how broker-

dealers can establish possession or control of digital assets in compliance with the Customer Protection Rule to mitigate the risk of the loss or theft. Digital asset securities, according to the Custody Statement, do not provide customers the protections offered by traditional securities infrastructure. The SEC stated that the traditional infrastructure “contains checks and controls that can be used to verify proprietary and customer holdings of traditional securities by broker-dealers, as well as processes designed to ensure that both parties to a transfer of traditional securities agree to the terms of the transfer.” The Custody Statement lays out the minimum measures that broker-dealers must take to comply with the Customer Protection Rule when acting as custodians of digital asset securities. The guiding principle behind the measures is to mitigate the risk of the loss or theft of digital asset securities and the impact such an event would have on broker-dealers, their customers and counterparties, and other market participants.

The commodities law framework

The US Commodity Futures Trading Commission (the CFTC) regulates futures, options on futures, and swaps (*i.e.*, derivatives) on commodities (including crypto-assets) (collectively, Commodity Interests). While the CFTC does not have general regulatory jurisdiction and oversight with respect to spot crypto-asset markets, the CFTC does retain general enforcement authority to police against manipulation and fraud in the spot commodities markets (including spot crypto-asset markets).²³ 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).²⁴ Since 2015, the CFTC has been active in bringing enforcement actions when virtual currency enterprises run afoul of regulatory requirements²⁵ and in the enforcement against fraud and manipulation in the virtual currency “spot” markets.²⁶

In addition to transactions in Commodity Interests, the CFTC also regulates commodity transactions with retail customers that are entered into or offered on a leveraged, margined or financed basis as if they were futures contracts (the Retail Leveraged Rules). However, if a transaction results in “actual delivery” of the relevant commodity within 28 days, such leveraged transaction will not be subject to regulation as a futures contract. Crypto-asset markets have exhibited increasing use of leverage and margin for the trading of crypto-assets, and the application of the Retail Leveraged Rules to transactions in crypto-assets has been an area of CFTC regulatory and enforcement emphasis. The CFTC has finalized interpretive guidance (the Guidance) on what constitutes “actual delivery” in the context of crypto-assets that serve as a medium of exchange (*i.e.*, virtual currency),²⁷ providing two primary factors for what would constitute “actual delivery” for purposes of the Retail Leveraged Rules: first, the purchaser must have possession and control over the virtual currency; and second, the purchaser must be able to use the virtual currency in commerce.

A note on custody (CFTC)

On October 21, 2020, the CFTC’s Division of Swap Dealer and Intermediary Oversight issued CFTC Staff Letter No. 20-34,²⁸ clarifying its views on the acceptance, holding, and reporting of virtual currency (*e.g.*, Bitcoin or Ether) in segregated accounts by futures commission merchants (FCMs) and the development of appropriate risk management programs in relation thereto. Specifically, the Advisory related to virtual currencies deposited by customers with FCMs in connection with physically delivered futures contracts or swaps. Due to the “custodian risk” associated with holding virtual currency as segregated funds, the Advisory lays out specific guidance for FCMs on virtual asset acceptance and custody, and their responsibility to implement appropriate policies, procedures, and oversight programs.

Pre-functional consumer token sales²⁹

It is generally understood that sales of tokens to fund an AP's development of a token-based network are highly likely to constitute investment contracts, regardless of the form of instrument evidencing the sale. That is, the efforts of the AP 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, financing instruments – most prominently, the Simple Agreement for Future Tokens (the SAFT)³⁰ and other similar token presale instruments – were designed. The SAFT is a presale instrument in which the sale of the SAFT is explicitly a securities transaction that is usually sold in compliance with an exemption from registration (*i.e.*, Regulation D) that promises the later delivery of the underlying token upon launch of the network. While such instruments attempted to solve the securities law issues with presales by delaying delivery of the token until after the network is functional, they raised other significant concerns.³¹

Securities law issues

While the token presale instruments may postpone delivery until after the utility token is functional, they 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 structuring the token presale as an investment opportunity, these instruments arguably imply that the underlying token is being purchased for investment rather than consumptive purposes. As a general matter, such instruments are generally sold under an exemption from registration to accredited investors who may have to represent that they are purchasing for investment purposes.³²

SAFTs raise another related concern. As settlement of these instruments generally contemplates delivery of the token at network launch,³³ the delivery of tokens to SAFT holders generally occurred at the same time as broader distribution to the community via airdrop or similar method. This potentially also implicates the tokens being distributed to the community as securities because under the logic of *Gary Plastic* and the *Munchee* Order, the settlement of these instruments is not directed solely to consumers and thus could make the delivery of all tokens a securities transaction, not a consumer token launch.³⁴

Recent examples of the unintended consequences of using token presale instruments can be seen in the SEC's actions against Kik and Telegram.³⁵ Kik and Telegram each offered and sold pre-functional tokens to accredited investors in private placements pursuant to Regulation D via token presale agreements. Despite this, the SEC's view was that the private nature of the sales of tokens under the token presale instruments was vitiated because these sales were part of schemes that involved token sales to the public and thus constituted a single plan of financing that did not qualify for the private placement exemption from registration under US securities laws. In its Kik complaint, the SEC noted that "Kik sold the Kin as part of a single plan of financing, for the same general purpose, at about the same time, without creating different classes of Kin[.]"³⁶ Similarly, in halting the delivery of Telegram tokens to the initial purchasers, the Court found that "the delivery of Grams to the Initial Purchasers, who would resell them into the public market, represents a near certain risk of future harm, namely the completion of a public distribution of a security without a registration statement."³⁷

Commodities law issues

Beyond the securities law concerns, the SAFT, and other similar token presale instruments, also raise commodities law concerns. Because cryptocurrencies are commodities,³⁸ a

presale of consumer tokens through an instrument that provides the right to receive tokens in the future, or confers 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.³⁹ 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,⁴⁰ but provided such forward contract also qualifies as a commercial merchandising transaction (the Non-Financial Forward Contract Exclusion).⁴¹ 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."⁴² The CFTC has expressly stated that hedge funds, acting in their capacity as investors, are not commercial market participants.⁴³ As such, token presale instruments are 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 many token presale agreements are (and continue to be) largely marketed to investors and not commercial market participants,⁴⁴ such investors would not be eligible for the Non-Financial Forward Contract Exclusion.

(b) *Commodity options*

More recent versions of token 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,⁴⁵ 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).⁴⁶ In order to qualify as a trade option and benefit from the Trade Option Exemption,⁴⁷ 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 eligible contract participant (ECP)⁴⁸ 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 token 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, token presale investors are unlikely to qualify for the Trade Option Exemption.

(c) *Hybrid Instrument Exemption*

Furthermore, since token 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.”⁴⁹ 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).⁵⁰

While token presale instruments may, in theory, be capable of qualifying for the Hybrid Instrument Exemption, because they are often primarily marketed to investors who themselves are solely or in large part motivated to purchase such instruments in order to receive the underlying commodity (*i.e.*, the token), such instruments will often fail to satisfy the requirements of the Marketing Condition of the Hybrid Instrument Exemption.⁵¹

(d) *Retail leveraged transactions*

Further still, under certain structures, network participants who are also functionally retail investors may wish to receive a token. Network participants may receive such tokens through the financing of a third party or the network platform itself. The recently issued Guidance with respect to Retail Leveraged Rules has clarified uncertainty over what delivery actually means in this context and stresses meaningful possession and control and the ability to use such token in commerce. In certain instances, neither utility nor control is practicable within a 28-day timeline. As a result, such token presale structures may be regulated as futures contracts.

(e) *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, or in the case of Retail Leveraged Rules, subject to regulation as a futures contract. In particular, in order to trade over-the-counter, swaps must be entered into between ECPs.⁵² 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. As a result, the contract could be rescinded 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,⁵³ 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 token 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 decentralization (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-favored nation” (MFN) 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.⁵⁴ Eventually, as the pathway for consumer token sales becomes clearer, 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 preferred from a commodities law perspective for several reasons. 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 not clearly a swap under the CEA and subject to CFTC regulation. Currently, no regulatory certainty exists as to the treatment of preferred stock and convertible promissory note structures with token participation rights, and it is unclear whether such participation rights would constitute swaps (or not) subject to CFTC jurisdiction. There is no strike price or final price differential that creates market risk that the CFTC would necessarily be incentivized to regulate in the commodity options market. Such token participation rights seek to reduce economic risk and loss attributable

to other token presale agreements. They afford the investor an MFN pricing provision to purchase the token at spot price, which is likely to reduce an investor's risk of loss. Accordingly, for the reasons set forth above, we believe such structures reduce regulatory risk of CFTC intervention, which is inherent in predecessor token presale instruments.

Furthermore, 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.⁵⁵

Of course, while each instrument would need to be analyzed on its own merits, we believe these alternate structures have great promise for addressing commodities law issues. At a minimum, they significantly mitigate the regulatory risks of the SAFT and other similar presale token structures; and at best may offer a clear path to avoid characterization as a swap subject to CFTC jurisdiction.

Importantly, even if these preferred stock and promissory note structures are not completely exempt from regulation as a swap, certain token projects and network participants may qualify for the Trade Option Exemption, giving further relief from CFTC regulatory requirements.

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.

Please note that in collaboration with ConsenSys, we have offered up a convertible note tool that we believe addresses the concerns raised in this chapter.⁵⁶

Enabling true consumer token sales

Once a platform and token protocol have been developed, the question remains whether a viable consumer token sale may be accomplished. The Framework identifies a number of factors centering around two main inquiries to help distinguish when digital assets transactions may be characterized as securities transactions.⁵⁷ First, the Framework emphasizes the necessity of the AP for the continued success of the enterprise. Second, the Framework emphasizes the expectations held by network participants with regard to the AP and the token. Critical in this inquiry is the nature of the marketing of the consumer token and its platform, and the nature of the purchasers.

We believe we can draw two concrete takeaways from the Framework and relevant legal decisions that bear upon this analysis. First, tokens offered in a manner intended to appeal to an investor's investment intent are more likely to trigger the application of the securities laws. Second, when the token-based network has developed to an extent that the

value of the tokens can no longer be perceived to be dependent upon the entrepreneurial or managerial efforts of such network's APs, token trading on that network may not be considered securities transactions. To date, Bitcoin and Ether are the only tokens that the SEC has explicitly confirmed meet this level of sufficient decentralization.

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 decentralized nature of their use.⁵⁸ 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.”⁵⁹ Two seminal cases provide guidance on this prong for instruments traded in well-developed markets such as Bitcoin and Ether.⁶⁰ 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 an AP. 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, decentralized market where the spot price is determined by ordinary market forces.

What is the role of the AP? Decentralized networks

As discussed above, the SEC's nascent regulatory framework for consumer tokens appears to be focused on a threshold question derived from the fourth prong of the *Howey* Test: Is the token-based network sufficiently decentralized/independent of the entrepreneurial efforts of the AP? 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 decentralized, no AP 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. The Framework states it is more likely that a token purchaser is relying on the efforts of others if “[a]n AP is responsible for the development, improvement (or enhancement), operation, or promotion of the network, particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.” 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 decentralized. 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. The Framework states that reasonable expectation of profit is more likely to be present if “[t]he AP continues to expend funds from proceeds or operations to enhance the functionality or value of the network or digital asset.” This further supports the use of traditional financing instruments, coupled with economic rights in future token offerings. Issuers utilizing 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 Framework also indicated that a token-based network's governance structure will be considered when determining whether such network is decentralized.⁶¹ In its most simple form, a decentralized governance structure would provide token holders the ability to directly determine matters relevant to the network's development. Reliance on the efforts of others is more likely to be deemed present if an AP has a continuing managerial role in network governance, including exercising judgment concerning the network or the characteristics and rights that the digital asset represents. The sufficient decentralization argument is strengthened if the AP can avoid playing a lead role in making decisions regarding governance issues, code and protocol updates, and how third parties participate in the validation of transactions that occur with respect to the digital asset.

(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.⁶² The Framework also recognizes this principle, noting that token "[p]rice appreciation resulting solely from external market forces impacting the supply and demand for an underlying asset generally is not considered "profit" under the *Howey* test." Filecoin⁶³ is an apt example of a robust economic structure that helps ensure market forces drive token values independent of the AP'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.⁶⁴ 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.⁶⁵ There are numerous token-based networks and token economy models that similarly promote the development of a robust economic structure. The success of most decentralized token-based marketplaces, whether for data storage, digital assets in virtual worlds, 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 AP, though distinct, is the question of whether the token-based network is "fully functioning or in the early stages of development."⁶⁶

A common feature of many early token sales was that they were commenced before the consumer could actually utilize 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.”⁶⁷ Although it remains difficult to assign weighting to the factors presented in the Framework, network functionality appears to be a factor that has significant bearing. As such, 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, then SEC Chairman Jay Clayton testified before the US Senate Committee on Banking, Housing, and Urban Affairs, in part sharing his particular concern for token issuers and emphasizing the secondary market trading potential of the tokens offered for sale.⁶⁸ 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.⁶⁹ Accordingly, the Framework states that if the AP promises to arrange trading of the digital asset on a secondary market, this means the token purchasers reasonably rely on the AP for liquidity, strongly supporting 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 does 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 realize 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 arising out of ongoing innovation in blockchain technology provides 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. The purchaser's tokens could be unlocked initially only in the event they were utilized 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 token offering.

Director Hinman appears to have suggested as much in his enumerated factors.⁷⁰

(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.⁷¹ Ultimate control over dilutive issuances is also a factor in network governance, which may impact the analysis above regarding the decentralization of a given network.

(d) *Token retention*

To date, a common feature of token offerings 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.⁷² The Framework states that token retention by an AP cuts towards reliance on the efforts of others given that token "[p]urchasers would reasonably expect the AP to undertake efforts to promote its own

interests” by taking actions that enhance the value of the digital asset. 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[.]”⁷³

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) *Virtual currency peg/stablecoins*

Another means of limiting the speculative potential in the purchase and sale of consumer tokens could be the adoption of token structures that initially peg the value of the consumer token to fiat or virtual currency, also known as a “stablecoin.” The Framework highlights that tokens designed and marketed as virtual currencies are less likely to be considered securities under the *Howey* Test if the token can be used to pay for goods or services without first having to convert it to fiat currency or another token. In addition, the token must operate as a store of value that can be saved, retrieved, and exchanged for something of value at a later time. In the Turnkey Jet matter, the company alerted the SEC of its intent to issue “tokenized jet cards” (tokens) on a user platform facilitating the procurement of chartered airline flights. In its letter to the SEC, Turnkey Jet made clear that consumers of these tokens would be “motivated . . . by a desire to obtain on-demand air charter services,” not by an expectation of future profits. Accordingly, Turnkey Jet maintained that these tokens would not be securities under the *Howey* framework. The SEC agreed, and identified several key attributes of the Turnkey Jet tokens that highlighted their consumptive utility and non-speculative nature. Specifically, the Turnkey Letter noted that Turnkey Jet’s tokens would be immediately usable, have a fixed value of one USD per token and would be marketed in a manner that emphasized their functionality and not the potential for an increase in their market value. Similarly, in issuing the PoQ Letter, the SEC noted that PoQ’s token having a fixed price factored into its considerations.⁷⁴

As an alternative, in the case of an early-stage marketplace, an issuer could incentivize sellers to advertise their products or services in both the network’s native virtual currency/token, as well as, for example, Ether, with the price of the goods or services being determined by the market price of Ether. The transaction could then be consummated in the native token of the network. This structure could have the effect of deterring speculative purchases at the time of an issuer’s consumer token sale because the price of the token would presumably face downward pressure to remain in line with the exchange rate with the virtual currency peg. As a result, a virtual currency peg could result in the price of a given consumer token being primarily influenced by individuals or events beyond the token issuer’s control and may therefore be viewed favorably by the SEC.⁷⁵ Once a larger and more functional network was operational with APs, these incentivizing schemes could be removed to allow for free market activity.

We would note that stablecoins may be swaps subject to CFTC regulation. Such structure would need to be carefully considered under commodities laws.

(f) *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 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, utilization 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 and achieving decentralization

Based on the foregoing considerations, 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 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 decentralized and functional network on which consumer tokens can be utilized necessitates that issuers first seed network activity by issuing consumer tokens in transactions that do not trigger the application of the 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 of 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 AP 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.⁷⁶

Nonetheless, issuers need to be aware that the SEC takes the view that the securities laws apply to airdrops of tokens, even though no money or digital currency funds are 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.⁷⁷ 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.⁷⁸ 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.

Although sufficient decentralization is difficult to define precisely, there are potential steps that the SEC can take to provide market participants with greater clarity. The SEC has highlighted a number of factors to consider when inquiring whether a token-based network is sufficiently decentralized. Of course, as noted by Commissioner Peirce,⁷⁹ it would be helpful if the SEC could provide clarity as to the appropriate weighting of such factors. One of the primary goals of securities law is to protect investors through the mitigation of information asymmetries that exist between issuers and investors. We propose that this principle should inform the weighting of the factors used to measure the sufficient decentralization of a network. As a result, there should be less emphasis on factors that penalize tokens simply because they bear similarity to securities in their marketing, and 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 network governance should be factors that are amongst the most heavily weighted. If such activity is truly decentralized, the less likely it is for there to be information asymmetries between network users and a powerful central group that manages the network.

On the other hand, the SEC should give less weight to factors such as a token's transferability or the existence of secondary markets for it. As discussed, a commodity does not become a security simply because there are secondary markets on which it is traded. It is critical to the success of certain token-based networks to have a large number of active market participants. If users on such networks were restricted from exchanging in some way their tokens with other potential participants, it is unlikely that the network could reach the necessary critical mass.

Furthermore, the SEC should provide clear guidance regarding potential pathways for achieving sufficient decentralization. Under the current regulatory framework, developers need to 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. However, these parties are unlikely to require protection from the information asymmetries securities laws are designed to guard against and these distributions are a vital step for many networks to be able to achieve decentralization. Such distributions often promote 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 network's value. As a result, this activity directly addresses several of the factors identified in the Framework and can strengthen the case that a particular network is decentralized.

New SEC Chairman may mean new rules for crypto

On August 3, 2021, Gary Gensler, the newly appointed Chairman of the SEC, gave a speech⁸⁰ on the digital asset industry. The speech offered some indication of what he expects the SEC to focus on in this area but did not provide concrete guidance for industry participants looking for clarity on regulatory uncertainties. He did, however, make clear that he believes "we just don't have enough investor protection in crypto" and that the SEC will play a more active role in regulating the industry. Mr. Gensler, therefore, is particularly focused on the investor protection pillar of the SEC's mission.

In his speech, he took a broad view of the securities laws and spoke of digital asset innovation primarily through the lens of consumer and market protection. Mr. Gensler was also clear that he believes the mandate of the SEC and other regulators is far-reaching, asserting that “we have taken and will continue to take our authorities as far as they go.” According to Mr. Gensler, the *Howey* Test is only one of the ways the SEC determines whether a digital asset must comply with the securities laws.

Mr. Gensler also echoed former SEC Chairman Jay Clayton’s views when Mr. Clayton testified in 2018 that “to the extent that digital assets like [initial coin offerings, or ICOs] are securities—and I believe every ICO I have seen is a security—we have jurisdiction, and our federal securities laws apply.” Whether this view includes more modern iterations of token distributions that do not include a public sale remains to be seen.

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 over 85 years old, and the seminal case, *Howey*, is more than 70 years old. While age is not in itself sufficient to discount governing law (after all, the US Constitution is now over 230 years old), digital assets present unique questions that our current laws do not always appear equipped to answer. 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 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.

* * *

Endnotes

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5. *See Howey* at 301.
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15. Kik Response Article.
16. *Telegram to Return \$1.2 Billion to Investors and Pay \$18.5 Million Penalty to Settle SEC Charges*, Sec. & Exch. Comm’n (June 26, 2020), <https://www.sec.gov/news/press-release/2020-146>; *SEC v. Telegram Group Inc.*, No. 19 Civ. 9439 (PKC) (S.D.N.Y. filed Mar. 20, 2020).
17. *SEC v. Kik Interactive Inc.*, No. 19-cv-5244 (S.D.N.Y. filed June 4, 2019); *SEC v. Telegram Group Inc.*, No. 19 Civ. 9439 (PKC) (S.D.N.Y. filed Mar. 20, 2020).
18. *SEC v. Telegram Group Inc.*, No. 19 Civ. 9439 (PKC) at 2 (S.D.N.Y. filed Mar. 20, 2020).
19. See Hester M. Peirce, Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020), <https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06>.
20. See Hester M. Peirce, Commissioner, Sec. & Exch. Comm’n, Token Safe Harbor Proposal 2.0 (Apr. 13, 2021), https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0?utm_medium=email&utm_source=govdelivery.
21. See Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities (July 8, 2019), <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities>.
22. See Custody of Digital Asset Securities by Special Purpose Broker-Dealers (Dec. 23, 2020), <https://www.sec.gov/rules/policy/2020/34-90788.pdf>.
23. 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>; Statement of Commissioner Dawn D. Stump on the CFTC’s Regulatory Authority Applicable to Digital Assets (Aug. 23, 2021), https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement082321?utm_source=govdelivery.
24. Timothy Massad, Chairman, Commodity Futures Trading Comm’n, Testimony of Chairman Timothy Massad before the US Senate Committee on Agriculture, Nutrition, and Forestry (Dec. 10, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6> [hereinafter 2014 Massad Senate Testimony].

25. 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>.
26. *See, e.g.*, CFTC Release PR7938-19, CFTC Charges Company and its Principal in \$147 Million Fraudulent Bitcoin Trading Scheme (June 18, 2019), <https://www.cftc.gov/PressRoom/PressReleases/7938-19>; CFTC Release PR7839-18, CFTC Orders Former Virtual Currency Trader to Pay More than \$1.1 Million for Fraudulent Bitcoin and Litecoin Scheme (Nov. 9, 2018), <https://www.cftc.gov/PressRoom/PressReleases/7839-18>; CFTC Release PR7813-18, CFTC Charges Two Defendants with Fraudulent Solicitation, Impersonation of a CFTC Investigator, and Forging CFTC Documents, All in Attempt to Steal Bitcoin (Sept. 28, 2018), <https://www.cftc.gov/PressRoom/PressReleases/7813-18>; 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 (Apr. 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>.
27. Retail Commodity Transactions Involving Certain Digital Assets, 85 Fed. Reg. 37,734 (June 24, 2020), <https://www.govinfo.gov/content/pkg/FR-2020-06-24/pdf/2020-11827.pdf>.
28. *See* Accepting Virtual Currencies from Customers into Segregation (Oct. 21, 2021), <https://www.cftc.gov/csl/20-34/download>.
29. The following discussion of consumer token presales only seeks to address fundraising instruments utilized for pure consumer token issuances and not instruments utilized 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.
30. *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].
31. 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.
32. *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.”
33. 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 publicized product launch.” Simple Agreement for Future Tokens, <https://saftproject.com/static/Form-of-SAFT-for-token-pre-sale.docx> (last visited July 29, 2018).
 34. 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 decentralized in the interim such that the “efforts” prong of the *Howey* Test was no longer satisfied.
 35. *See SEC v. Kik Interactive Inc.*, No. 19-cv-5244 (S.D.N.Y. filed June 4, 2019); *SEC v. Telegram Group Inc.*, No. 19 Civ. 9439 (PKC) (S.D.N.Y. filed Mar. 20, 2020).
 36. *SEC v. Kik Interactive Inc.*, No. 19-cv-5244 (S.D.N.Y. filed June 4, 2019).
 37. *SEC v. Telegram Group Inc.*, No. 19 Civ. 9439 (PKC) at 43 (S.D.N.Y. filed Mar. 20, 2020).
 38. *See, e.g.*, 2014 Massad Senate Testimony.
 39. *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 \$10 million; or \$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).
 40. Both the CEA and CFTC regulations thereunder have long recognized 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).
 41. 17 C.F.R. § 34.3(a).
 42. Both the CEA and CFTC regulations thereunder have long recognized 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).

43. *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].
44. 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.
45. 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.

46. *See id.*; *supra* text accompanying note 16.
47. 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”).
48. *See* 17 C.F.R. § 32.3(c).
49. *See* 17 C.F.R. § 32.3(a).
50. Under Section 2(f) of the CEA, a hybrid instrument is “predominantly a security” and exempt from the provisions of the CEA if:
 1. the hybrid instrument issuer receives payment in full of the hybrid instrument’s purchase price, substantially contemporaneously with delivery of the hybrid instrument;

2. 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;
 3. the hybrid instrument issuer is not subject by the instrument's terms to mark-to-market margining requirements; and
 4. 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).
51. 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.
 52. *See supra* text accompanying note 29; 7 U.S.C. § 2(e).
 53. 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 utilizing 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>.
 54. 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.
 55. 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.
 56. *See* Latham & Watkins, Token Presale Agreements and the ConsenSys Automated Convertible Note (May 22, 2019), <https://www.lw.com/thoughtLeadership/token-presale-agreements-consensys-automated-convertible-note>.
 57. *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>.
 58. *See* Hinman Speech.
 59. *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).

60. 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.
61. *See id.*
62. *See supra* text accompanying note 46.
63. Please note that we have chosen Filecoin in this example in part because we have no connection to its activities.
64. Protocol Labs, FILECOIN: A DECENTRALIZED STORAGE NETWORK (Aug. 14, 2017), <https://filecoin.io/filecoin.pdf>.
65. CoinList, FILECOIN TOKEN SALE ECONOMICS, https://coinlist.co/assets/index/filecoin_index/Filecoin-Sale-Economics-e3f703f8cd5f644aecd7ae3860ce932064ce014dd60de115d67ff1e9047ffa8e.pdf (last visited July 26, 2018).
66. 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>.
67. Hinman Speech.
68. 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.")
69. *See Gary Plastic* at 240–241.
70. *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?"
71. *See id.* ("Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?").
 72. *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?").
 73. *Id.*
 74. Pocketful of Quarters, Inc., SEC No-Action Letter (July 25, 2019), <https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1>.
 75. *See* Hinman Speech ("Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?").
 76. *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?").
 77. Simplystocks.com, SEC No-Action Letter (Feb. 4, 1999).
 78. SEC Staff Legal Bulletin No. 4 (Sept. 16, 1997), <https://www.sec.gov/interps/legal/slbcf4.txt>.
 79. Hester M. Peirce, How We Howey (May 9, 2019), <https://www.sec.gov/news/speech/peirce-how-we-howey-050919>.
 80. *See* Gary Gensler, Chairman, Sec. & Exch. Comm'n, Remarks Before the Aspen Security Forum (Aug. 3, 2021), https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03?utm_medium=email&utm_source=govdelivery.

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