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Teaching a New Dog Old Tricks: Why the Howey Test is Still the SEC's Best Friend When Examining Initial Coin Offerings

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**TEACHING A NEW DOG OLD TRICKS: WHY THE HOWEY TEST IS
STILL THE SEC’S BEST FRIEND WHEN EXAMINING INITIAL COIN
OFFERINGS**

*Laura Gritz**

This Recent Development examines the state of the law and opinions surrounding whether an initial coin offering (ICO) constitutes an offering of securities under federal securities laws. The SEC has taken the position that each offering will be analyzed on a case-by-case basis, looking at the facts and circumstances of each offering. The number of ICOs has been expanding at an exponential pace, leaving regulators scrambling to decide whether these tokens are within the jurisdiction of a specific regulator, such as the SEC if they are securities, and how to apply existing law to this new market. If the ICO token is a security, it must comply with the applicable securities laws. If the SEC determines that the token is not a security, the company does not need to register the ICO under those securities laws. Both the issuers and the regulators need to understand what is expected of each other in order to create an environment that does not stifle innovation, while sufficiently protecting investors.

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I. INTRODUCTION

“Initial coin offerings” (ICOs) are becoming an increasingly popular form of raising capital for up-and-coming and established companies alike.¹ A seemingly related variant of an initial public offering (IPO),² ICOs present a similar opportunity for investors to cash in on a new type of asset.³ In exchange for an initial investment, both private and public investors are hoping to catch the start of the next wave of innovation.⁴ Contributing to this craze is the skyrocketing price of digital currencies such as Bitcoin, which fuel the idea that ICOs and coin offerings might parallel the dot-com boom.⁵

Unlike an established company going public through an IPO, these companies are gathering contributions in the initial stages of

* J.D. Candidate, University of North Carolina School of Law, 2019. The author would like to thank Professor Thomas Lee Hazen for his insightful views and suggestions on this developing topic, Christian Ferlan, Joseph Hjelt, Jordan Luebke, Erin Larson, and the rest of the Journal of Law and Technology staff for their incredibly helpful edits and feedback.

¹ *Investor Bulletin: Initial Coin Offerings*, U.S. SEC. & EXCH. COMM’N (July 25, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings [hereinafter *Initial Coin Offerings*].

² *See generally Investor Bulletin: Investing in an IPO*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/investor/alerts/ipo-investorbulletin.pdf> (last visited Feb. 22, 2018) (giving an overview of considerations and information to help in IPO investing).

³ *See, e.g.,* Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, U.S. SEC. & EXCH. COMM’N (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11> (“The world’s social media platforms and financial markets are abuzz about cryptocurrencies and ‘initial coin offerings’ (ICOs). There are tales of fortunes made and dreamed to be made.”); Trevor N. Cadigan et al., *This Is What You Get When You Invest in an Initial Coin Offering*, BUS. INSIDER (Nov. 9, 2017), <http://www.businessinsider.com/ico-initial-coin-offering-explained-bitcoin-ethereum-2017-11>; Denis Baranov, *The New Blockchain Trend that Could Transform Business*, FORTUNE (Oct. 18, 2017), <http://fortune.com/2017/10/18/ico-cryptocurrency-coin-market-blockchain/>.

⁴ *See Initial Coin Offerings*, *supra* note 1; Clayton, *supra* note 3.

⁵ *See* Izabella Kaminska, *The Digital Currency Boom Echoes Dotcom Fever*, FINANCIAL TIMES (Sept. 8, 2017).

development and using the funds to create products.⁶ In contrast to an IPO, where purchasing stock represents ownership in the company, investors in an ICO receive digital tokens created and issued by that company that may not represent an ownership interest.⁷ “Promoters may tell purchasers that the capital raised from the sales will be used to fund development of a digital platform, software, or other projects and that the virtual tokens or coins may be used to access the platform, use the software, or otherwise participate in the project.”⁸ Currently, these offerings are largely unregulated, though their popularity is attracting the attention of the SEC and other federal regulators.⁹ This rising concern for investors is leading to increased scrutiny of ICOs. Investors and regulators alike seek to ensure that companies issuing tokens deemed to be securities are either registered under the securities laws or estopped from continuing their unauthorized “fundraising.”¹⁰

These coins can represent and accomplish a wide variety of products and functions. On one end of the spectrum, coins may be offered and purchased as an investment with the intent to make a profit.¹¹ Other investors purchase coins with the intent to use them for the purpose for which they were developed.¹² For example, consider a token that allows the investor access to a specific decentralized cloud storage program.¹³ Another ICO example is the creation of an app and token to allow users to interact in order to offset one user’s carbon emissions against the reduction in

⁶ *Initial Coin Offerings*, *supra* note 1.

⁷ *Id.*

⁸ *Id.*

⁹ *See, e.g., id.*; Clayton, *supra* note 3 (“I have asked the SEC’s Division of Enforcement to continue to police this area vigorously and recommend enforcement actions against those that conduct initial coin offerings in violation of the federal securities laws.”).

¹⁰ *See* Clayton, *supra* note 3.

¹¹ JUAN BATIZ-BENET, JESSE CLAYBURGH & MARCO SANTORI, *THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK* 9 (2017), <https://saftproject.com/static/SAFT-Project-Whitepaper.pdf>.

¹² *Id.*

¹³ Josiah Wilmoth, *ICO 101: Utility Tokens vs. Security Tokens*, STRATEGIC COIN, <http://strategiccoin.com/ico-101-utility-tokens-vs-security-tokens/> (last visited Mar. 26, 2018) [hereinafter Wilmoth, *ICO 101*].

another's.¹⁴ Ultimately, the investor's intentions and planned uses affect regulators' legal characterization of the coin.¹⁵

Much of the debate stems from attempts to characterize coins specifically with respect to whether the coins qualify as securities.¹⁶ Absent any objective bright-line test to guarantee the status of these coins under securities laws, many developers are running into difficulties provoked by this uncertainty.¹⁷ Even if the issuers decide that their offering is likely to become a security at a certain point, they may not know exactly when.¹⁸ ICOs usually occur during early stages of a company's development,¹⁹ and there is some debate as to whether the stage of development that the product is in can affect whether the federal securities laws will apply.²⁰ If securities laws do apply, there are corresponding registration requirements that will increase time and costs.²¹ This is a result that the issuers would like to avoid; however, the disclosures would increase oversight and transparency for investors.²² The SEC has expressly avoided any

¹⁴ *Frequently Asked Questions*, LIVING OFFSET, <https://www.livingoffset.io/faqs/index.html> (last visited Mar. 4, 2018).

¹⁵ *See generally* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, 117 SEC Docket No. 5, at 10–15 (July 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf> [hereinafter *The DAO*] (explaining how the categorization of the type of token is based on different factors depending on the facts and circumstances of each case).

¹⁶ *See, e.g.*, Clayton, *supra* note 3.

¹⁷ CARDOZO BLOCKCHAIN PROJECT, RESEARCH REPORT NO. 1, NOT SO FAST – RISKS RELATED TO THE USE OF A “SAFT” FOR TOKEN SALES 3–4 (2017), https://cardozo.yu.edu/sites/default/files/Cardozo%20Blockchain%20Project%20-%20Not%20So%20Fast%20-%20SAFT%20Response_final.pdf [hereinafter *CARDOZO*].

¹⁸ *See* BATIZ-BENET ET AL., *supra* note 11, at 15–16 (explaining how the authors believe that there is a strong likelihood that even if the token is a security before it becomes functional, once it becomes functional it no longer implicates securities laws).

¹⁹ *See id.* at 1.

²⁰ *Id.*

²¹ *See Fast Answers: Registration Under the Securities Act of 1933*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/fast-answers/answersregis33htm.html> (last modified Sept. 2, 2011) (providing a broad overview of the registration requirements).

²² *See id.*

definitive conclusions as to what types of ICOs fall within the definition of a security, explaining that it depends on the facts and circumstances of each case, likely due to the varying nature of each token.²³

To determine how the law may allow room for a token as a security, it is useful to first examine how the definition of a security may be applied to encompass ICOs. Within the definition of a security, among the enumerated list of items such as stocks, notes, and bonds, is the term “investment contract.”²⁴ In *SEC v. W.J. Howey Co.*, the Supreme Court created the predominant test to determine whether a particular product or issuance falls within the “investment contract” enumeration, and is thus a security.²⁵ The court defined the test of an investment contract as “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”²⁶ The SEC currently applies the *Howey* test to evaluate ICOs against which it has brought enforcement actions.²⁷

The *Howey* framework is the most suitable test for the SEC to apply in determining whether the ICO at issue is a security. Although one of the predominant concerns of relying on this test is that it does not create clear boundaries for the developers, case law and SEC guidance will begin to form those lines over time.²⁸ This subjective test is still the best option for maintaining enough flexibility to examine each unique token individually and on its own merits. It is important for the SEC to evaluate each offering on a case-by-case basis, as opposed to the comfort of a more objective and rigid rule with a clear, but in some cases inaccurate, application. Applying this test, it is likely that the SEC will find the majority of

²³ The DAO, *supra* note 15, at 17–18; *Initial Coin Offerings*, *supra* note 1.

²⁴ Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012).

²⁵ See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

²⁶ *Id.* at 301.

²⁷ *Munchee Inc.*, Securities Act Release No. 10445, 118 SEC Docket No. 5, at 2 (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

²⁸ See *The DAO*, *supra* note 15, at 1–2 (explaining that the report was issued in the public interest to advise those who may use similar means of capital raising as to how to best ensure compliance with the securities laws).

the ICO tokens to be securities.²⁹ Another factor for the SEC to weigh in its determination is the likelihood that the investor's initial contribution will result in an ultimate loss due to the failure of the product.³⁰ This consideration is called the risk capital test³¹ and will be discussed alongside the *Howey* test.³²

Part II of this Recent Development discusses the two primary types of coins to clarify what the deciding factors may be in determining whether a particular offering needs to be registered under the securities laws. Part III works through some key points defining what constitutes a security, considers why tokens are likely securities under the definition, and discusses some of the arguments taking the stance that a token is not a security. Part IV discusses why the subjective *Howey*³³ test is still the best tool that the SEC has to analyze these ICOs. This will allow the SEC to look past the issuer's surface label of the offering to determine whether they will be required to comply with federal securities laws.

II. TYPES OF COINS

There are two primary types of coins with two different functions.³⁴ Utility coins, as the name indicates, are meant to function for a specific purpose.³⁵ Most coins offered in an ICO are

²⁹ Daniel C. Zinman, James Q. Walker, Margaret Winterkorn Meyers & Whitney O'Byrne, *SEC Issues Warning to Lawyers on ICOs*, BLOOMBERG LAW (Feb. 23, 2018), <https://www.bna.com/sec-issues-warning-n57982089230/>.

³⁰ See *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 815 (1961).

³¹ *Id.*

³² In light of the complexity of this rapidly developing field, and in order to facilitate this work's analysis, this Recent Development will largely generalize characteristics of tokens. As such, the conclusions drawn are not intended to be all-encompassing, with respect to the hundreds of different types of coins and their purposes. Olga Kharif, *Initial Coin Offerings on Record Pace Even with Crackdown*, BLOOMBERG (Dec. 11, 2017, 12:40 PM), <https://www.bloomberg.com/news/articles/2017-12-11/initial-coin-offerings-on-record-pace-even-with-u-s-crackdown>; ICO Calendar, HYPE.CODES, <https://hype.codes/ico-calendar> (last visited Feb. 22, 2018). Rather, the discussions in this Recent Development consider that there are likely to be exceptions, and most statements will not apply fully to each token.

³³ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

³⁴ *BATIZ-BENET ET AL.*, *supra* note 11, at 3–4.

³⁵ *Id.*

purportedly utility coins as they have a specific use in mind outside of investment and offer no ownership rights in the company itself.³⁶ The other, less common, type of coin is security coins. Security coins are similar to stock in that they are purchased for investment and represent an interest in the company.³⁷ As has been common in this blossoming area, cryptocurrencies are subject to some definitional overlap. There is some indirect debate about whether cryptocurrencies,³⁸ such as Bitcoin, which function as a medium of exchange and payment, are a type of utility token or if they exist as their own category.³⁹ There is extensive literature on these virtual

³⁶ *Id.* at 1.

³⁷ Josiah Wilmoth, *The Difference Between Utility Tokens and Equity Tokens*, STRATEGIC COIN, <http://strategiccoin.com/difference-utility-tokens-equity-tokens/> (last visited Mar. 26, 2018) [hereinafter Wilmoth, *Difference Between*].

³⁸ The Financial Action Task Force defines “cryptocurrency” as:

a math-based, decentralised convertible virtual currency that is protected by cryptography.—i.e., it incorporates principles of cryptography to implement a distributed, decentralised, secure information economy. Cryptocurrency relies on public and private keys to transfer value from one person (individual or entity) to another, and must be cryptographically signed each time it is transferred. The safety, integrity and balance of cryptocurrency ledgers is ensured by a network of mutually distrustful parties (in Bitcoin, referred to as miners) who protect the network in exchange for the opportunity to obtain a randomly distributed fee (in Bitcoin, a small number of newly created bitcoins, called the “block reward” and in some cases, also transaction fees paid by users as a incentive for miners to include their transactions in the next block). Hundreds of cryptocurrency specifications have been defined, mostly derived from Bitcoin, which uses a proof of-work system to validate transactions and maintain the block chain.

FATF REPORT, VIRTUAL CURRENCIES, KEY DEFINITIONS AND POTENTIAL AML/CFT RISKS, FINANCIAL ACTION TASK FORCE 4 (June 2014), <http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>.

³⁹ Compare BATIZ-BENET ET AL., *supra* note 11, at 3, 9, with GUIDELINES FOR ENQUIRIES REGARDING THE REGULATORY FRAMEWORK FOR INITIAL COIN OFFERINGS (ICOs), SWISS FINANCIAL MARKET SUPERVISORY AUTHORITY 3 (Feb. 16, 2018) [hereinafter FINMA] (naming a list of three categories: Payment Tokens (synonymous with cryptocurrencies), Utility Tokens, Asset Tokens), and Matthew May, *What to Consider in an ICO*, FORBES (Nov. 21, 2017, 9:00 AM), <https://www.forbes.com/sites/forbesfinancecouncil/2017/11/21/what-to->

currencies,⁴⁰ and though they offer relevant and useful discussions, they are outside of the scope and have no bearing on the conclusions of this Recent Development.

A. *Utility Coins*

Utility coins are tokens purchased by investors for future use of an ecosystem or network of users being created by the developers.⁴¹ For example, investors may purchase a token that will allow them to have access to a certain application, and thus the value of the coin comes from the ability to partake in its use.⁴² These uses can range from a social-media type of user integration⁴³ to a more sophisticated platform that allows or requires users with the appropriate knowledge base to contribute to the underlying technology.⁴⁴ Utility tokens, unlike stock, often do not convey ownership rights in the underlying enterprise upon purchase.⁴⁵ As the Cardozo Blockchain Project explains:

[t]he contours between investment and utility tokens are not well-defined at this point, but utility tokens are generally designed to offer a consumptive or functional utility, as opposed to an inherent opportunity for profit. Many utility tokens are integral to the functioning of a blockchain-based platform that creates a decentralized network and can represent, for example, membership or licensing rights, staking mechanisms, or incentivization systems.⁴⁶

As an illustration of a utility token, a public statement by the SEC uses an example of a token to participate in a book of the month

consider-in-an-ico/#3bba95de5c44 (distinguishing between coin and token, with both being cryptocurrencies but the coin being similar to cash as it is spent and token being used for a “utility in a specific blockchain platform”).

⁴⁰ See, e.g., Mark Edwin Burge, *Apple Pay, Bitcoin, and Consumers: The ABCs of Future Public Payments Law*, 67 HASTINGS L.J. 1493 (2016).

⁴¹ BATIZ-BENET ET AL., *supra* note 11, at 3–4.

⁴² Wilmoth, *Difference Between*, *supra* note 37.

⁴³ See Munchee Inc., *supra* note 27 at 1–2 (explaining how the app was designed to allow users to post restaurant reviews and photos).

⁴⁴ See Tezos Contribution Terms, TEZOS 2, <https://www.tezos.ch/pages/contribution-terms.html#contribution-terms> (last visited Jan. 29, 2018) (requiring that the investor understand the intricacies of the blockchain system and plans to use the investment to participate in the network).

⁴⁵ Wilmoth, *Difference Between*, *supra* note 37.

⁴⁶ CARDOZO, *supra* note 17, at 2.

club.⁴⁷ It concludes that a “token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club’s operators to fund the future acquisition of books and facilitate the distribution of those books to token holders.”⁴⁸ This example is followed by the conclusion that even though simple participation tracking and integration may be an acceptable use, ICOs have taken this example to the next level by creating an entire functional network with an investment in a “yet-to-be-built publishing house with the authors, books and distribution networks all to come.”⁴⁹ The example is meant to highlight how many of these tokens are being created for use in a detailed network beyond a basic, single-use transaction.

B. *Security Coins*

Security, or equity coins, are those at the other end of the spectrum, and their issuance serves a function similar to the issuance of stock.⁵⁰ There may be ownership rights in a future system, and the incentive to invest will have been driven by the expectation of profit.⁵¹ Strategic Coin describes equity tokens as:

a subcategory of security tokens that represent ownership of an asset, such as debt or company stock. By employing blockchain technology and smart contracts, a startup could forgo a traditional initial public offering (IPO) and instead issue shares and voting rights over the blockchain. Additionally, a lender could create tokens that represent debt owned by the company, enabling loans to be bought and sold in a high-liquidity environment.⁵²

One of the first ICOs that the SEC investigated was The DAO, an organization that issued DAO Tokens which were ultimately held to be securities.⁵³ This security token has characteristics of stock and represents an interest in a company.⁵⁴ The investors contributed

⁴⁷ Clayton, *supra* note 3.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ Wilmoth, *Difference Between*, *supra* note 37.

⁵¹ *See id.*

⁵² *Id.*

⁵³ The DAO, *supra* note 15, at 1.

⁵⁴ *Id.* at 5–6.

funds in exchange for this new token.⁵⁵ The DAO planned to use the funds to invest in different projects, and profits were to be returned to the investors in a form comparable to dividends.⁵⁶ According to the SEC investigation report, the token offered the holder ownership and voting rights, and the promotional materials claimed that the owners would receive a return on their investment in the form of “rewards.”⁵⁷ There was also a functioning and efficient secondary marketplace on which to trade these tokens.⁵⁸ These stock-like characteristics led the SEC to classify DAO tokens as securities and issue an investigative report explaining their reasoning for doing so.⁵⁹

Security coins primarily fall within the scope of the securities classification, as it seems they are simply stocks or other investment tools in a different form.⁶⁰ The tokens with these straightforward properties will not be analyzed further in this Recent Development. Instead, the tokens with characteristics comprising both security coins and utility coins will be discussed. For example, utility coins may exhibit characteristics of a security when people invest in utility coins not for their use as a currency, but rather in the hope that the success of the created product will allow them to trade the token for a profit.⁶¹ These utility tokens with features of a security will be the focus of this Recent Development because these are the flexible and sometimes ambiguous characteristics that the majority of tokens will have.⁶²

⁵⁵ *Id.*

⁵⁶ *Id.* at 4–6.

⁵⁷ *Id.* at 5–6.

⁵⁸ *Id.* at 6.

⁵⁹ *Id.* at 1.

⁶⁰ Wilmoth, *ICO 101*, *supra* note 13.

⁶¹ See generally MUNCHEE INC., *supra* note 27, at 7–8 (explaining that the circumstances leading an investor to expect a profit from a token with utility contributed to the classification of the token as a security).

⁶² CARDOZO, *supra* note 17, at 2. The results of a study examining the rights that different utility tokens represent resulted in a finding that the majority offer access to an online platform. *Id.* The security features of these utility tokens will be discussed throughout this Recent Development, primarily concerning how they meet the *Howey* test factors.

III. WHY MOST UTILITY TOKENS ARE ALSO SECURITIES

A digital token is not among the listed items in the definition of a security.⁶³ Therefore, it would need to fall within the enumerated term “investment contract” to be considered a security.⁶⁴ To determine whether an investment contract exists, the favored analysis is the *Howey* test.⁶⁵ This test determines that an offering is an investment contract if there is (i) an investment of money, (ii) in a common enterprise, (iii) with an expectation of profits, (iv) solely from the efforts of others.⁶⁶

The ICOs discussed below all involve a capital contribution by investors.⁶⁷ Therefore the first *Howey* factor is satisfied. The ICOs will also be part of a common enterprise with multiple investors contributing capital to the development of the product; thus the second factor is also satisfied.⁶⁸ The third factor, whether there is an expectation of profits, is discussed first. Finally, the factor as to whether the expected profits come from the efforts of others will be addressed. After the factors in *Howey* are analyzed, the risk capital test is looked at as another useful consideration when weighing whether the token is an “investment contract” and thus a security.

A. *Expectation of Profits*

The *Howey* test looks at the intent of the investor to consider whether an individual investor or group of individuals likely had an

⁶³ Securities Act, Section 2(a)(1), 15 U.S.C. § 77b(a)(1) (2018).

⁶⁴ *Id.*; see also SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (creating a test to establish if an instrument is an “investment contract”).

⁶⁵ See *Howey*, 328 U.S. at 298–99 (holding that “an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.”).

⁶⁶ See *id.*

⁶⁷ *Initial Coin Offerings*, *supra* note 1 (explaining how investors purchase the tokens during the ICO).

⁶⁸ *Id.*

expectation of profit in the ICO.⁶⁹ Often, the sophistication and knowledge of the investor is a strong factor in weighing his or her intent.⁷⁰ The analysis considers both the groups of potential investors that the developers are targeting and the ultimate investor in the initial offering.⁷¹ For example, if the product is a new blockchain ecosystem designed to help facilitate transactions, avoiding the issues that plague many of the current systems, investors in the product should be tech savvy and have a demonstrated interest in using the product itself.⁷² When applying the *Howey* test to a product that is technical in nature, such as this system, there is likely an inference that individuals with no knowledge of the practical application of the technology will be investing primarily for profit.⁷³

The test also accounts for the actions of the company issuing the tokens.⁷⁴ If the issuer or issuing company targets investors with little to no background or experience in that specific product, it follows that the issuers assumed that those investors would invest with the expectation of profit instead of planning on using the product themselves.⁷⁵ Developers touting high returns is an equally clear sign investors may become involved principally for that purpose,

⁶⁹ *Munchee Inc.*, *supra* note 27, at 4, 6–7 (discussing how the investors could expect the value of the token to increase due both to their actions in participating in the ecosystem and the actions the company planned to take).

⁷⁰ *See Howey*, 328 U.S. at 299–300.

⁷¹ *See Teague v. Bakker*, 35 F.3d 978, 988 (4th Cir. 1994) (holding that a timeshare interest led to an expectation of profit from investors when the shares were advertised in a way to lead to that expectation).

⁷² *See TEZOS*, *supra* note 44, at 2–3 (requiring that the investor understand the intricacies of the blockchain system and plans to use the investment to participate in the network).

⁷³ *See Howey* at 299–300.

⁷⁴ *See Munchee Inc.*, *supra* note 27, at 5–6.

⁷⁵ *See Howey*, 328 U.S. at 299–300 (“They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment.”).

which will satisfy the third factor.⁷⁶ If the other *Howey* conditions are also satisfied, the ICO is a security, and the issuers are required to register under federal securities laws.⁷⁷

The Swiss Financial Market Supervisory Authority (FINMA), like many other regulators around the world, has been concerned with how best to approach ICOs.⁷⁸ FINMA released guidelines in February 2018 that provided a framework for determining whether an ICO token would be considered a security.⁷⁹ It took an approach that was similar to the expectation of profit prong in the *Howey* test, deciding that:

[u]tility tokens will not be treated as securities if their sole purpose is to confer digital access rights to an application or service and if the utility token can actually be used in this way at the point of issue. In these cases, the underlying function is to grant the access rights and the connection with capital markets, which is a typical feature of securities, is missing. If a utility token additionally or only has an investment purpose at the point of issue, FINMA will treat such tokens as securities (i.e. in the same way as asset tokens).⁸⁰

These guidelines acknowledge that using a utility coin only for its purpose does not implicate securities laws.⁸¹ The concern is that there are virtually no situations, at least from what the SEC has seen, where utility coins have been restricted in use to the extent necessary to meet this requirement.⁸² FINMA's statement—that if there is an additional investment purpose at the time of issue, the token will be treated as a security⁸³—encompasses the majority of these tokens. It is difficult to state that everyone who invested in an ICO solely had an expectation of use, with no investment agenda whatsoever. If

⁷⁶ See *Teague*, 35 F.3d at 989 (holding that a timeshare interest led to an expectation of profit from investors when the shares were advertised in a way to lead to that expectation).

⁷⁷ *Id.*

⁷⁸ See, e.g., FINMA, *supra* note 39; Annaliese Milano, *German Regulator Pledges 'Precise' Oversight of ICOs*, COINDESK (Feb. 22, 2018), <https://www.coindesk.com/german-regulator-pledges-precise-oversight-icos/>.

⁷⁹ FINMA, *supra* note 39.

⁸⁰ *Id.* at 5.

⁸¹ *Id.*

⁸² Zinman, *supra* note 29. The SEC chairman has noted that he has yet to see an ICO that is not a security. *Id.*

⁸³ FINMA, *supra* note 39, at 5.

read literally, a single purchaser who may have an inkling of an investment goal in the ICO, even if it is not the predominant factor, will cause the token to be treated as a security.⁸⁴ From the statements seen thus far, this conclusion is consistent with the SEC's findings.⁸⁵ The investment intent is taken into account in the expectation of profits prong of the *Howey* test and is now further established through a regulator's official acknowledgement.⁸⁶ These FINMA guidelines addressing ICOs may provide useful guidance to the SEC when the agency is creating appropriate regulations.

1. *Scarcity of the Product*

A consideration that has only garnered limited discussion is how the scarcity of the ultimate product affects the expectation of profit factor in the *Howey* analysis.⁸⁷ For example, some commentators say that one of the draws of investors and speculators to Bitcoin is the fact that there is a limited quantity that will be issued.⁸⁸ If there was an unlimited supply of Bitcoin, it is possible that the price would not be as inflated as it currently is.⁸⁹ Supply and demand are likely playing a factor in that value, among other market forces.⁹⁰ If the issuers of the ICO are aware of this fact, they could decide to artificially limit access to the product that the tokens represent in order to increase the price people are willing to pay for the token in

⁸⁴ *Id.*

⁸⁵ See generally Munchee Inc., *supra* note 27 (explaining how the investors' expectations of profits played a factor in the classification of the token as a security).

⁸⁶ FINMA, *supra* note 39, at 5.

⁸⁷ See Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 717 (2005).

⁸⁸ *Id.* (explaining how the issuers and initial investors of an IPO could manipulate the price of stocks upward through limiting the supply and increasing the desire to purchase); R.A., *New Money*, ECONOMIST (Mar. 17, 2014), <https://www.economist.com/blogs/freeexchange/2014/03/bitcoin>.

⁸⁹ R.A., *supra* note 88. The rapid price fluctuations of Bitcoin lend themselves to a conclusion that the prices are inflated at times, with a price of \$4,358 on October 1, 2017, an increase to \$19,458 on December 17, 2017, and then another rapid decrease to \$6,653 on February 5, 2018. *Bitcoin Charts*, WORLDCOININDEX, <https://www.worldcoinindex.com/coin/bitcoin> (last visited Mar. 4, 2018). That sharp fall was followed by another increase to \$11,679 on February 20, 2018. *Id.*

⁹⁰ R.A., *supra* note 88.

the secondary market.⁹¹ This limitation may be necessary if the ultimate product, drawing on the example of the blockchain ecosystem above, can only handle a certain amount of volume. If there is no such inherent limitation, and yet the ultimate access to tokens beyond just the initial ICO is limited, then one may conclude that decision as a strategy to create that inflated supply and demand.⁹² This is not inherently negative; it is simply an action that should be taken into consideration when using the *Howey* test to determine whether the issuers intended to create an expectation of profit.

Consider a limited-edition watch released in high demand. The watch could be used exactly for what it was made for, to tell time, but many individuals would likely purchase it with the intent to hold it as an investment that will increase in value. If the same watch was mass-manufactured, the potential value is unlikely to be as high, and there would be more purchasers intending to use it simply to wear and tell time.

The creators of Munchee Inc., and in turn MUN tokens, planned to use this supply and demand theory in practice.⁹³ Munchee Inc. is an app-based company that focuses on restaurant reviews.⁹⁴ The original function was to allow users to post reviews and photos of their meals.⁹⁵ Once Munchee decided to develop the app further, it decided to raise the funds with an ICO.⁹⁶ Ultimately, the SEC issued a cease and desist order against the company's ICO of MUN tokens stating that they were a security and thus needed to comply with the relevant securities laws.⁹⁷

One of the many factors the SEC took into consideration in its decision to classify MUN tokens as a security was the company's plan to increase the value of the token.⁹⁸ The whitepaper that Munchee issued described several different actions the company

⁹¹ *Id.*

⁹² Hurt, *supra* note 87, at 717.

⁹³ Munchee Inc., *supra* note 27, at 4–5.

⁹⁴ *Id.* at 1–2.

⁹⁵ *Id.* at 2.

⁹⁶ *Id.* at 2–3.

⁹⁷ *Id.* at 1–2.

⁹⁸ *Id.* at 8.

would take to increase the value of MUN tokens to benefit holders. One of those ideas included limiting circulation.⁹⁹ The company planned to “burn” tokens (take them out of circulation) periodically after receiving them as payment for certain actions, thereby restricting the number in use.¹⁰⁰ Munchee claimed that this “could potentially increase the appreciation of the remaining MUN tokens as the total supply in circulation reduces and as users would prefer holding their MUN tokens.”¹⁰¹

2. *Utility Coins as Memberships and the Secondary Market*

The Munchee promotional materials also discussed the plan to give access to a secondary exchange to allow the holders of MUN to partake in a market for the tokens.¹⁰² The value of utility tokens to the investors, beyond the use of the product alone, comes from the gain that they can realize by resale of the token on a secondary exchange.¹⁰³ This adds an element that would not ordinarily be present in a traditional product being purchased for use.¹⁰⁴ Utility tokens that are used to access a specific site or event may be comparable to a membership in a traditional sense.¹⁰⁵ However, even if investors do plan to use the token and the rights associated with

⁹⁹ *Id.* at 4–5.

¹⁰⁰ *Id.* at 1–2, 5.

¹⁰¹ *Id.* at 5.

¹⁰² *Id.*

¹⁰³ Clayton, *supra* note 3 (“It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. 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.”).

¹⁰⁴ For example, most daily products purchased do not have designated secondary markets used for efficient exchange like personal groceries, clothing, household items, etc. Nasdaq defines secondary market as “[t]he market in which securities are traded after they are initially offered in the primary market. Most trading occurs in the secondary market. The New York Stock Exchange, as well as all other stock exchanges and the bond markets, are secondary markets. Seasoned securities are traded in the secondary market.” *Secondary Market: Definition*, NASDAQ, <http://www.nasdaq.com/investing/glossary/s/secondary-market> (last visited Feb. 22, 2018).

¹⁰⁵ BATIZ-BENET ET AL., *supra* note 11, at 3 (mentioning “membership rights” as a utility token use).

them, in most situations, there is still an expectation of profit beyond a pure membership or purchase of a product.¹⁰⁶ As FINMA explained in its guidelines, even if the token is purchased with an intent to use it for its utility, if there is still an expectation or intent to obtain a profit, then they should be considered a security token.¹⁰⁷

These secondary markets bring opportunities into play that may not otherwise exist. The SEC has issued information about the difference in pricing between the IPO price paid by initial investors and the price that was paid on the secondary market once the shares were resold:

[t]here can be a large difference between the price of shares when purchased in an initial public offering (IPO) and the price for the same shares when they start trading in the secondary market (where previously issued stocks, bonds, and other securities are bought and sold) after the IPO.

The pricing disparities occur most often when an IPO is “hot” or appeals to many investors. When an IPO is “hot,” the demand for the securities far exceeds the supply of shares. The excess demand can only be completely satisfied once trading in the IPO shares begins. This imbalance between supply and demand generally causes the price of each share to rise dramatically in the first hours or days of trading. The price often falls after this initial flurry of trading subsides.¹⁰⁸

This economic observation also ties in the scarcity of the product and the impact it has on pricing, as discussed in the previous section.

There may also be some risk associated with the investment beyond what would come from the purchase of a standard, already operational membership. For example, as seen in a representative case, the Supreme Court of California determined that purchasing memberships to a country club before it was built, with the developers relying on the funding from the membership purchases

¹⁰⁶ Clayton, *supra* note 3 (“[C]ertain market professionals have attempted to highlight utility characteristics of their proposed initial coin offerings in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions appear to elevate form over substance. Merely calling a token a ‘utility’ token or structuring it to provide some utility does not prevent the token from being a security.”).

¹⁰⁷ FINMA, *supra* note 39, at 5.

¹⁰⁸ *Fast Answers: Initial Public Offerings, Pricing Differences*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/fast-answers/answersipopricing.htm> (last modified Sept. 6, 2011).

to continue construction, constituted a security because of the risk of the ultimate product not materializing.¹⁰⁹ The Court decided that the memberships were investment contracts because there was a risk of the country club never taking form, even though the ultimate benefit was just the use of the facilities.¹¹⁰ Although the Court used a state test called the risk capital test—discussed further below—its goal of investor protection is in the same spirit as the *Howey* test.¹¹¹ Because ICOs, without a fully functional product at the time of the offering, carry this same risk, regulation is needed in order to protect investors.¹¹²

Beyond this initial stage, once the country club is up and running, memberships can be purchased without that initial risk (setting aside the always-present possibility of the club going out of business). These types of memberships are not considered securities, so what is different about purchasing a token that allows the holder to have a similar type of “membership” or utility?¹¹³ The difference in many of these cases is that unlike memberships, the tokens are often liquid and sellable on a secondary exchange, potentially for a return on the initial investment.¹¹⁴ Many of the ICOs have tokens that can be transferred between parties, leading to an increased expectation of profit and making them look more like securities.¹¹⁵

Weighing all of these considerations, the expectations of profits prong is likely satisfied for most ICOs. Therefore, if the final *Howey*

¹⁰⁹ *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 815 (1961).

¹¹⁰ *Id.*

¹¹¹ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) (“If that test be 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 The statutory policy of affording *broad protection to investors* is not to be thwarted by unrealistic and irrelevant formulae.”) (emphasis added) (citations omitted).

¹¹² See *TEZOS*, *supra* note 44 (explaining that the investor is taking the risk that the project will not become functional); Clayton, *supra* note 3 (“I urge you to be guided by the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.”).

¹¹³ See *Golf Club of the Everglades, Inc.*, SEC No-Action Letter, 2000 WL 572489 (Apr. 27, 2000) (holding that the golf club interest was not a security).

¹¹⁴ See *Munchee Inc.*, *supra* note 27, at 5.

¹¹⁵ *Id.*

factor discussed next is also satisfied, the ICO at issue will be considered a security.

B. From the Efforts of Others

In response to the uncertainties surrounding the classification of ICO tokens, the Simple Agreement for Future Tokens (SAFT) Project was created with a goal of providing a framework that an ICO could apply and conform to in order to ensure compliance with any securities laws.¹¹⁶ This is purportedly achieved by first using a contract between the developers and the accredited investors, which the creators of SAFT concededly designate as a security that requires compliance with securities laws.¹¹⁷ The creators of SAFT next determined that once the product is fully developed, the resulting functional utility tokens will not fall under the securities definition and therefore would not need to follow federal securities laws.¹¹⁸ This conclusion was reached by looking at the “solely from the efforts of others” prong in the *Howey* test.¹¹⁹ The idea is that once a token becomes functional, its success and profits no longer rely on the efforts of others, but rather are predominantly influenced by market forces outside of any individual’s control.¹²⁰

The Cardozo Blockchain Project’s analysis of SAFT concluded that the suggested framework could have undesired implications.¹²¹ The Blockchain Project states that the framework could unnecessarily bring some pre-functionality tokens into the SEC purview, and could also keep tokens that should be securities, even though functional, improperly outside of regulations.¹²² Using this SAFT framework simplifies a complex issue, but potentially at the expense of accuracy.¹²³

The creators of the SAFT whitepaper believe that periodic updating of the already functional product is not sufficient to satisfy

¹¹⁶ BATIZ-BENET ET AL., *supra* note 11, at 1–2.

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 9.

¹¹⁹ *Id.* at 8–11.

¹²⁰ *Id.* at 9.

¹²¹ CARDOZO, *supra* note 17, at 5.

¹²² *Id.*

¹²³ *See id.*

the “from the efforts of others” prong.¹²⁴ Even if that conclusion is accepted, the token value can still be derived from the efforts of others by looking at the exchanges they may be traded on.¹²⁵ The tokens may even derive much of their value from the functioning of this exchange,¹²⁶ as will be evaluated below. This conclusion as to the value the exchange provides has been addressed in the SAFT whitepaper.¹²⁷ The authors explain “[w]hen a token purchaser resells a token on an exchange platform for more than the purchase price, it is not the exchange platform that created the price difference. To the contrary, the market is merely the venue where the token purchaser executes the sale.”¹²⁸ The whitepaper also cites cases determining that forward contracts from gold and silver did not meet the *Howey* test requirements “because profits to the coin buyer depended primarily upon the fluctuations of the gold market, not the managerial efforts of others.”¹²⁹ However valid these points may be, they do not adequately weigh the necessary influence of functioning markets in maintaining the value of something like a digital token.¹³⁰ In most cases, the markets are an essential tool in allowing the profits to be realized.¹³¹

Some commentators debate that gold and silver are different than tokens in that there is inherent value in these commodities, whereas a token is simply intangible code.¹³² An alternative conclusion is that it is the willingness and ability of others to give value in exchange for the precious metals that gives them their

¹²⁴ *Id.*; see BATIZ-BENET ET AL., *supra* note 11, at 11.

¹²⁵ BATIZ-BENET ET AL., *supra* note 11, at 10.

¹²⁶ *Fast Answers: Initial Public Offerings, Pricing Differences*, *supra* note 108.

¹²⁷ BATIZ-BENET ET AL., *supra* note 11, at 9–10.

¹²⁸ *Id.* at 10.

¹²⁹ *Id.* at 9.

¹³⁰ See generally Avtar Sehra, *ICOs and Economics of Lemon Markets*, MEDIUM (Aug. 23, 2017), <https://medium.com/@avtarsehra/icos-and-economics-of-lemon-markets-96638e86b3b2> (discussing how different factors will affect how a market will function fundamentally, which in return is likely to affect the token prices).

¹³¹ See *id.*

¹³² See Jacqui Frank & Kara Chin, *Economist Jim Rickards on Gold Versus Bitcoin — Intrinsic Value Is Meaningless for Both but the Bitcoin Prices Aren't Real*, BUS. INSIDER (Dec. 3, 2017, 11:14 AM), <http://www.businessinsider.com/economist-jim-rickards-bitcoin-versus-gold-price-manipulation-2017-12>.

worth.¹³³ The same can be said about digital tokens. Without an exchange platform to trade these tokens on, the value would be linked and limited to the effort that individuals would have to put into finding direct buyers.¹³⁴ This would severely hinder the feasibility of having free exchanges that properly reflect market value, and, in turn, profits could suffer.¹³⁵ Hence, the managerial efforts of others in keeping the exchange running smoothly in order to facilitate the buying and selling of tokens is essential to creating profits,¹³⁶ and if a token can be traded on an exchange, it would likely meet this fourth and final “from the efforts of others” aspect of the *Howey* test.

C. *The Risk Capital Test*

As discussed earlier, in *Silver Hills Country Club v. Sobieski*, the Supreme Court of California applied the risk capital test in determining whether solicitations for purchases of a country club membership, before the country club was built, and of which the capital would be used to build the club, constituted a security offering.¹³⁷ The court decided that the memberships did constitute a security under the risk capital test because the:

[p]etitioners [were] soliciting the risk capital with which to develop a business for profit. The purchaser’s risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.¹³⁸

Frequently, ICOs seek capital from investors in order to build their product.¹³⁹ Often, the investors are taking a risk in hopes that

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*; Brian Patrick Eha, *Bitcoin After the Mt. Gox Meltdown*, NEW YORKER (Feb. 25, 2014), <https://www.newyorker.com/business/currency/bitcoin-after-the-mt-gox-meltdown> (explaining how the hacking and subsequent loss of bitcoins from one of the largest exchanges of bitcoin of the time led to a decrease in the value of bitcoin.); *see also* R.A., *supra* note 88 (explaining how decreased confidence in exchanges could wreak havoc on the function and transferability of Bitcoin).

¹³⁶ Eha, *supra* note 135.

¹³⁷ *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 815 (1961).

¹³⁸ *Id.*

¹³⁹ *Initial Coin Offerings*, *supra* note 1.

the product will ultimately succeed, without a guarantee of recovering their investment.¹⁴⁰ It is likely that under both the risk capital test and the *Howey* test, this would constitute a security. Securities laws were enacted to protect investors, and a transaction such as a country club membership is a prime example of a situation that should require disclosures.¹⁴¹ This allows investors to make an informed decision about whether or not to participate in a particular investment opportunity.¹⁴² Even though their ultimate “profit” may not be monetary, they are still risking their capital with the expectation of an ultimate material benefit, in this case a membership at a constructed and functioning club.¹⁴³ Currently, the risk capital test is most commonly used by state courts,¹⁴⁴ but perhaps it would be a valuable tool for the SEC to use in determining whether a particular ICO is posing a risk to investors and thus, whether the ICO is likely to fall under one of the regulatory schemes.

The Cardozo Blockchain Project has addressed the risk capital test in its response to the SAFT Project whitepaper.¹⁴⁵ The authors explain how applying an analysis of the underlying risk of failure of a budding company or product would implicate scenarios beyond what securities laws are designed to regulate, using as examples

¹⁴⁰ *The Risk Capital Test – List of States*, SUSTAINABLE ECONOMIES LAW CENTER, http://www.theselc.org/which_states_apply_the_risk_capital_test_when_deciding_what_is_a_security (last visited Jan. 29, 2018) (summarizing *Silver Hills*, the test says that “[t]he court found that the investors were risking their capital in expectation of receiving the benefits of club membership, which was in the control of the issuers of the membership. Notably, the court stated the ‘act extends even to transactions where capital is placed without expectation of any material benefits.’”); *see also* TEZOS, *supra* note 44.

¹⁴¹ Richard A Mann et al., *Starting from Scratch: A Lawyer’s Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 830 (2004) (“The Securities Act has two basic objectives: (1) to provide investors with material information concerning securities offered for sale to the public and (2) to prohibit misrepresentation, deceit, and other fraudulent acts and unfair practices in the sale of securities generally, whether or not the securities are required to be registered.”); *Initial Coin Offerings*, *supra* note 1.

¹⁴² *See* sources cited *supra* note 141.

¹⁴³ *See generally* *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811 (1961) (applying the risk capital test).

¹⁴⁴ *Risk Capital Test*, *supra* note 140.

¹⁴⁵ CARDOZO, *supra* note 17, at 9–11.

crowdfunding for the creation of a new product or the preorder of a Tesla car.¹⁴⁶ What their response briefly mentions is how the risk capital test is not determinative, but rather only a factor taken into consideration when looking at the facts and circumstances.¹⁴⁷ The application of the risk capital test as a supporting factor instead of a determinative element helps abate their concern of too much inclusivity. The Project is concerned with a potential application of the risk capital test on its own.¹⁴⁸ However, it may be a useful consideration for the SEC in addition to the full application and analysis of the *Howey* test. Any use of the risk capital test should be another supplemental factor beyond the four *Howey* factors, as it is too broad of a test to apply individually.

IV. HOW THE SEC HAS ADDRESSED ICOs

Any tokens that do meet the four *Howey* test requirements are likely to be considered securities by federal regulators.¹⁴⁹ However, few decisions applying the *Howey* test exist, making it difficult to predict which factors are most determinative.¹⁵⁰ The SEC has recently issued public statements and investigative reports intended to make this analysis more transparent.¹⁵¹ One of the first investigations from the SEC into The DAO led the SEC to publish a report that they hoped would give guidance and considerations for future issuers.¹⁵² This insight provides a valuable look into the SEC's application of the *Howey* test; however, this one scenario is unlikely to provide enough for uniform application to other unique offerings. Until more factors are discussed by the SEC, there may be issuers without an example of an adequately parallel comparison to their own product.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 10–11.

¹⁴⁸ *Id.*

¹⁴⁹ See The DAO, *supra* note 15, at 11.

¹⁵⁰ Clayton, *supra* note 3 (“Investors should understand that to date no initial coin offerings have been registered with the SEC. The SEC also has not to date approved for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies.”).

¹⁵¹ See e.g., The DAO, *supra* note 15, at 1–2; Clayton, *supra* note 3.

¹⁵² The DAO, *supra* note 15, at 1–2.

This lack of a bright line standard as to what type of token requires SEC registration is likely to leave many issuers uncomfortable. The registration requirements are burdensome, costly, and time intensive.¹⁵³ Issuers would prefer to avoid having additional obligations resulting from their ICO falling within the scope of the federal securities laws.¹⁵⁴ However, avoidance of the registration requirements is likely to trigger SEC compliance actions.¹⁵⁵ The issuers need to weigh the cost of compliance with the chance that the SEC may decide that their ICO is outside of their purview. The issuers may take their chances and not register their ICO to save time and money.¹⁵⁶ However, if the gamble does not pay off it could end up costing them much more.¹⁵⁷ For example, in an emergency action against a fraudulent ICO touting the promise of exceptional profits:

[t]he SEC's complaint charge[d] [the issuers and others involved in the offering] with violating the anti-fraud provisions, and . . . the registration provision, of the U.S. federal securities laws. The complaint s[ought] permanent injunctions, disgorgement plus interest and penalties. [T]he SEC also s[ought] an officer-and-director bar and a bar from offering digital securities"¹⁵⁸

Despite the difficulties the test may present in token offerings with ambiguous characteristics, the subjective *Howey* test is still the appropriate analysis to apply due to the wide variety and functions of these tokens.¹⁵⁹ A new bright-line test is unlikely to account for the multitude of differences among the tokens, particularly because there will always be exceptions to a rigid rule due to the wide variety

¹⁵³ See Mann, *supra* note 141, for a walk-through of securities registration steps.

¹⁵⁴ *ICO Law and Compliance: Is Your ICO Subject to Regulation?*, DRAGLET, <https://www.draglet.com/ico-law-compliance> (last visited Feb. 22, 2018).

¹⁵⁵ See generally Munchee Inc., *supra* note 27, at 3–4 (enforcing a cease and desist once determining the offering was a security).

¹⁵⁶ See generally Mann et al., *supra* note 141 (providing an overview of the securities registration process).

¹⁵⁷ Press Release: SEC Emergency Action Halts ICO Scam, U.S. SEC. & EXCH. COMM'N (Dec. 4, 2017), <https://www.sec.gov/news/press-release/2017-219>; see also Munchee Inc., *supra* note 27, at 8–7 (ordering the return of the investors capital within hours of the issuance).

¹⁵⁸ SEC Emergency Action Halts ICO Scam, *supra* note 157.

¹⁵⁹ See The DAO, *supra* note 15, at 11.

and functions of the tokens. Despite this, there have been, and will continue to be, attempts to create a test that issuers can use to help alleviate some of the uncertainty.¹⁶⁰ There may be some applicable suggestions that result from this continued refining process; however, it seems unlikely that courts will create a more objective test that maintains the flexibility and personalization provided by the *Howey* approach.¹⁶¹ The flexibility the *Howey* factors offer is imperative for these fluid and unique offerings.

Developers may have a sense of whether their offering constitutes a security.¹⁶² Nonetheless, they could be trying to use this industry uncertainty to claim that they did not realize that it would be considered as such, thus explaining why they did not register.¹⁶³ Importantly, just because something is called a security does not mean that it is, and vice versa, despite what the issuers may claim.¹⁶⁴ The SEC will look beyond the issuer's decision regarding whether or not their token is a security to instead define the "economic reality."¹⁶⁵ The economic reality is what the underlying function and properties of the product resemble when compared to other devices, such as how it is similar to stock, and not just what it purports to be by label.¹⁶⁶ Despite SAFTs best intentions, the *Howey* test will likely still need to be applied in order to determine whether an ICO's designation is correct.

For instance, in a cease and desist order against Munchee Inc., the SEC worked through the *Howey* test to demonstrate that the

¹⁶⁰ See generally BATIZ-BENET ET AL., *supra* note 11, at 1 (explaining a new potential framework for ICOs).

¹⁶¹ See generally CARDOZO, *supra* note 17 (critiquing in part the rigid suggestion of a new framework for ICOs).

¹⁶² Jay Clayton, Opening Remarks at the Securities Regulation Institute (Jan. 22, 2018), <https://www.sec.gov/news/speech/speech-clayton-012218> (noting both that some lawyers may not take a stance on token characterization, and that investors are willing to take a chance by failing to comply with securities laws).

¹⁶³ *Id.*

¹⁶⁴ The DAO, *supra* note 15, at 11.

¹⁶⁵ *Id.*

¹⁶⁶ Public Statement: Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO, U.S. SEC. & EXCH. COMM'N (July 25, 2017), <https://www.sec.gov/news/public-statement/corpfen-enforcement-statement-report-investigation-dao>.

tokens were a security, even though Munchee claimed that they had run through the test themselves and determined the tokens were not.¹⁶⁷ The expectation of profit test was clearly met, with the SEC issuing a press release stating that:

[a]ccording to the [SEC's cease and desist] order, in the course of the offering, [Munchee Inc.] and other promoters emphasized that investors could expect that efforts by the company and others would lead to an increase in value of the tokens. The company also emphasized it would take steps to create and support a secondary market for the tokens. Because of these and other company activities, investors would have had a reasonable belief that their investment in tokens could generate a return on their investment.¹⁶⁸

These actions easily fit within the *Howey* framework, which is likely why the SEC took the stance that the ICO was a securities offering and ordered the company to return the funds to the 40 investors it had gathered, notably within the first couple hours of the offering.¹⁶⁹

Moreover, in the order, the SEC explained that

[e]ven if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security. Determining whether a transaction involves a security does not turn on labelling . . . but instead requires an assessment of “the economic realities underlying a transaction.”¹⁷⁰

The recently issued FINMA guidelines parallel some reflections of the SEC's statements on ICOs.¹⁷¹ The guidelines mention the need to take a flexible approach that looks at ICOs on a case-by-case basis.¹⁷² Like the SEC, FINMA states that “[it] will base its assessment on the underlying economic purpose of an ICO, most particularly when there are indications of an attempt to circumvent existing regulations.”¹⁷³

¹⁶⁷ Munchee Inc., *supra* note 27, at 3–4.

¹⁶⁸ SEC Press Release, Company Halts ICO After SEC Raises Registration Concerns, U.S. SEC. & EXCH. COMM’N (Dec. 11, 2017), <https://www.sec.gov/news/press-release/2017-227>.

¹⁶⁹ Munchee Inc., *supra* note 27, at 7–8.

¹⁷⁰ *Id.* at 9.

¹⁷¹ FINMA, *supra* note 39, at 5.

¹⁷² *Id.* at 2.

¹⁷³ *Id.*

V. CONCLUSION

The SEC has its hands full as the number of ICOs continues to rise.¹⁷⁴ With the community of developers and issuers wanting clear guidelines and investors wanting assurance that the tokens they are contributing to are following applicable laws, there may be increased pressure to come up with bright-line tests. Unfortunately, with the crackdown just beginning, courts have had insufficient time to issue enough opinions to provide a template for the parties involved.¹⁷⁵ The SEC has repeatedly said that they are going to look at each ICO on a case-by-case basis, and that is likely the best answer at the moment.¹⁷⁶ This wave of innovation needs a flexible approach, and at the same time needs a tough analysis to protect investors and the public from fraudulent or overly risky (at least without the known risks) offerings.¹⁷⁷ The proposed frameworks have their merits, but they would also likely create issues that otherwise would not exist with subjective examination.¹⁷⁸

With regulators discussing the need to create regulations specifically to address ICOs, this is an opportune time to cement the basic analysis of the *Howey* test as the universal test in ICO inquiries.¹⁷⁹ Though this initially would seem to create an insurmountable issue of scope for concerned issuers hoping for clear guidelines, this should not be a deterrent from having a factor-based regulation. Guidance will continue to be issued over time, and once the prominent players such as the federal regulators and courts are on board, the industry should begin to settle. Though the *Howey* factors will be applied in the same manner in each instance, the multitude of token characteristics should eventually be analyzed and weighed as to whether they classify the token as a security or not. This will provide valuable insight to new developers as they are

¹⁷⁴ Kharif, *supra* note 32.

¹⁷⁵ The first enforcement action was in December, 2017. Zinman et al., *supra* note 29.

¹⁷⁶ See, e.g., The DAO, *supra* note 15, at 17–18.

¹⁷⁷ See Clayton, *supra* note 3.

¹⁷⁸ See generally CARDOZO, *supra* note 17 (explaining the risks of a rigid framework like SAFT).

¹⁷⁹ See *supra* notes 151–52 and accompanying text.

considering how the SEC will weigh their tokens' qualities.¹⁸⁰ For the tokens that have unique characteristics that have not yet been addressed, the flexible framework will become a valuable tool instead of a hindrance.

There needs to be a balance of efficiency and accuracy, and the *Howey* test has proven capable thus far of accomplishing both. Once additional case law and decisions by the SEC are released, the ambiguity concerns should be relieved. For now, the developers need to take an honest look at the token to decide whether it could rationally be seen as a security, as that will be the side that the SEC's decisions will err on moving forward.¹⁸¹

¹⁸⁰ See *supra* notes 151–52 and accompanying text.

¹⁸¹ See Zinman et al., *supra* note 29.