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# The Journey from Security to Non-Security: SEC Director Comments on Mutability of Token Treatment

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06/19/2018

Emerging Companies + Venture Capital, Financial Institutions + Financial Services, Financial Technology, Financial Transactions, Investment Management, Mergers + Acquisitions, and Capital Markets

Client Alert

Many in the blockchain and cryptocurrency community were in a celebratory mood on June 14, 2018, following a landmark speech given by William Hinman, Director for the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the “SEC”).[1]

Director Hinman’s remarks addressed, head on, a key question that has long been vexing market participants and their lawyers—namely, whether present-day sales of Ether (“ETH”), the native token of the Ethereum blockchain, are sales of investment contracts and, hence, securities. Perhaps even more significant, however, was the analysis behind Director Hinman’s views on ETH—that the characteristics that cause a token to be classified as a security can change so that the same token or, one issued at a later time, may be reclassified as a non-security. While Director Hinman’s comments do not have the force of law, his speech provided much-needed direction for a market that has been hungry for regulatory guidance.

**Background on the Howey Investment Contract Analysis**

As the SEC previously has made clear, “[w]hether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction,”[2] and the SEC will apply the facts-and-circumstances test outlined in *SEC v. W.J. Howey Co*.[3] to determine whether a sale of tokens is a sale of securities.

The so-called *Howey* test, developed by the U.S. Supreme Court, is a four-pronged test to evaluate whether a particular instrument or scheme constitutes an “investment contract,” which is a type of security. Under *Howey*, an “investment contract” is said to exist where all of the following four factors are satisfied: (a) an investment of money; (b) is made in a common enterprise; (c) with an expectation of profits; (d) to be derived from the efforts of others.

Alluding to *Howey*, Director Hinman distinguished between digital assets representing a set of rights that grant a financial interest in a common enterprise—which are securities—and those digital assets sold only for purposes of acquiring a good or service from an operational and decentralized platform “where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts”[4]—which, in his view, likely are not securities.

Director Hinman reconfirmed that, irrespective of whether a token is labeled as a “utility token,” “[f]orm should be disregarded for substance”[5] and “the emphasis should be on economic realities underlying a transaction.”[6]

**Current Offers and Sales of ETH Are Not Securities Transactions**

Director Hinman's remarks were notable not just for their content, but also for their directness and clarity. Until Director Hinman's remarks, many in the blockchain community had been concerned about whether the SEC and its staff viewed ETH to be a security. This question was especially significant in light of the fact that many tokens and decentralized applications (dApps) run, or are intended to run, on Ethereum. If ETH were deemed to be a security issued, sold, or traded in violation of securities laws, many feared that this would threaten the viability and legality of all Ethereum-based projects.

Are present-day sales of ETH securities transactions? Director Hinman answered that question with a resounding no, stating, in pertinent part, that "putting aside the fundraising that accompanied the creation of Ether, . . . current offers and sales of Ether are not securities transactions."[7]

Director Hinman also emphasized the importance of decentralization in determining whether ETH, or any other token, should be considered a security, stating "[i]f the network on which the token or coin is to function is sufficiently decentralized—where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts—the assets may not represent an investment contract."[8]

**Securities Can Become Non-Securities**

Notably, Director Hinman's statements indicated that the analysis of whether a token is a security is "not static and does not strictly inhere to the instrument,"[9] and that decentralization could develop over time, even after an initial token sale launch. This means that, unlike records stored on a blockchain, a token's treatment under U.S. federal securities laws is potentially mutable.

This clarification was welcomed by some in the token sale space who had been concerned that initial token sales launched for capital raising purposes might result in future sales (including secondary market sales) of such tokens that would continue to be treated as sales of securities and, hence, be subject to continued regulation under U.S. federal securities laws.

For example, while Director Hinman suggested that, though initial sales of ETH in fundraising transactions for the Ethereum network may have been securities offerings, at this time, because the characteristics involving ETH have changed, offers and sales of ETH are no longer securities transactions in his view.

Similarly, certain tokens initially issued by blockchain startups pursuant to Simple Agreements for Future Tokens (or "SAFT") transactions conducted as private placements under U.S. securities laws may have the potential to ultimately become part of a decentralized token economy and no longer bear the hallmarks of securities.

**Factual Examination**

In his speech, Director Hinman emphasized two key areas for practitioners to examine when evaluating the treatment of a particular token as a security or non-security under U.S. federal securities laws. First, who are the parties involved? Second, what is the nature of the digital asset?

***Who Are the Parties Involved?***

When assessing whether a digital asset is offered as an investment contract, Hinman advised practitioners to "consider whether a third party—be it a person, entity or coordinated group of actors—drives the expectation of a return."[10]

He noted that this question "will always depend on the particular facts and circumstances," including several factors that Director Hinman included in an illustrative, although expressly "not exhaustive," list:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
4. Are purchasers "investing," that is, seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
5. Does application of the Securities Act of 1933's protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

***What Is the Nature of the Digital Asset?***

In addition, Director Hinman emphasized the relevance of "contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security."[11] Director Hinman further emphasized that the SEC staff "would look to the economic substance of the transaction, but then urged "promoters and their counsels [to] consider these, and other, possible features"[12]:

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. 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?
5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

Director Hinman noted that the list was not intended to be exhaustive and was "meant to prompt thinking by promoters and their counsel, and start the dialogue with the [SEC] staff—it is not meant to be a list of all necessary factors in a legal analysis."[13]

**Disclosure**

Director Hinman also reminded market participants that the "impetus of the Securities Act is to remove the information asymmetry between promoters and investors"[14] by prescribing adequate disclosure to address that asymmetry. A token seller's disclosure, therefore, becomes particularly important when a token purchaser relies on a token seller's efforts to develop an enterprise and, eventually, generate a return on investment for the token purchaser.

But, related to the mutability analysis described above, Director Hinman also noted that "[w]hen the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful."[15] Accordingly, as disclosure becomes less important later in the lifecycle of certain tokens, it becomes less important for purchasers to be afforded the protections of the federal securities laws.

**Key Takeaways**

Director Hinman's speech is significant in many ways.

First, using Bitcoin and Ether as its primary examples, Director Hinman clarified that tokens that are initially classified as securities can later be viewed as non-securities under certain circumstances. In particular, Director Hinman's speech indicated that subsequent sales (and resales) of certain tokens that were investment contracts and, therefore, "securities" when sold intitially for capital raising purposes may later be sold in transactions that are not classified as sales of "securities" if (a) the tokens would be used to purchase goods and services from a sufficiently decentralized platform and (b) purchasers would no longer reasonably expect a centralized person or group to carry out essential managerial or entrepreneurial efforts.

Second, it emphasized the importance of decentralization as a factor that is relevant not just to the federal securities law analysis, but also to the degree and necessity of ongoing disclosure requirements.

Third, as the SEC staff has stated before, an issuer cannot simply label a token as a "utility token" in an attempt to avoid the applicability of U.S. federal securities laws.

Fourth, consistent with prior guidance, sales of tokens for capital raising purposes will likely continue to be deemed securities offerings.

Fifth, there is certainly no one-size-fits-all structure or bright-line test for determining when a token is, is not, or ceases to be a security. Rather, token sellers, together with their legal counsel, will need to consider numerous factors to determine whether a token sale qualifies as a securities sale, including issues related to the manner of sale, purchaser intent, decentralization, and other relevant factors as articulated in *Howey* and subsequent U.S. federal securities law guidance.

Sixth, and likely welcomed by many token sellers and their legal counsel, Director Hinman signaled that the SEC staff intends to provide assistance and guidance to token sellers on the proper characterization of the sale of digital assets.

Finally, it is important to note that, although Director Hinman offered clarity on long-standing questions, there remain other pivotal issues that his speech did not address. First, the speech did not articulate whether and how the SEC might come to identify any practical distinctions between tokens classified as securities and non-security "utility" tokens, despite recent petitions to the SEC to establish safe harbors or otherwise promulgate guidance on this point. Second, it is not clear how an issuer whose token was initially offered as a security might, as a practical matter, exit such a framework, including whether purchasers who initially acquired digital tokens under the auspices of a securities offering may continue to demand the protections thereof even if at some point, sales of the token cease to constitute sales of securities. In addition to leaving these and other securities law-related questions open, Director Hinman's speech of course did not address, and should not distract market participants from the need to understand and comply with, other federal, state, and non-U.S. laws and regulations, including those related to money transmission, banking (including KYC/AML), commodities, and tax.

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[1] *See* Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.

[2] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

[3] 328 U.S. 293 (1946).

[4] *See supra* note 1.

[5] *See Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

[6] *See United Housing Found., Inc. v. Forman*,421 U.S. 837, 852-53 (1975).; *see also* Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order (Dec. 11, 2017), *available at* https://www.sec.gov/litigation/admin/2017/33-10445.pdf.

[7] *See supra* note 1.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.*