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Are Blockchain Utility Tokens Securities?

By **Douglas Pepe** (July 24, 2018, 12:39 PM EDT)

Douglas Pepe

A hot topic in the blockchain space is whether particular networks, cryptocurrencies or tokens constitute "securities" within the meaning of the Securities Act of 1933 (the "Securities Act") or the Securities Exchange Act of 1934 (the "Exchange Act").

Recent U.S. Securities and Exchange Commission regulatory efforts have focused on distributed autonomous organizations, fraudulent initial coin offerings, and other similar capital raising sales of crypto assets and tokens.[1] While this has provided some needed clarity on the SEC's approach to blockchain technology, much more clarity is needed. One key area that remains muddled is in the context of so-called "utility tokens." These are blockchain assets that are designed for, and have, a clear and intended use. Utility tokens raise an important and unsettled question for regulators, courts, blockchain developers and users alike: Are they really securities when they are actually used? This article lays out the background legal framework for analyzing this question.

The Howey Test

Section 2(a)(1) of the Securities Act and Section 3(a)(1) of the Exchange Act, in slightly different but essentially identical formulations, define a "security" to include "any note, stock, treasury stock, security future, bond, debenture, ... investment contract, ... [or any] instrument commonly known as a 'security.'"[2]

In the seminal case of SEC v. W.J. Howey Co.,[3] the U.S. Supreme Court defined the term "investment contract" to include "any 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 a promoter or third party." This test, known as the Howey test, has become the fulcrum in analyzing the question whether blockchain assets and tokens are securities.

The DAO Report

The SEC's first substantive application of the Howey test in the blockchain space came with the July 25, 2017, Report of Investigation Pursuant to Section 21(a) of The Securities Exchange Act of 1934: The DAO. In the DAO report, the SEC Division of Enforcement extensively analyzed the question whether token interests in "The DAO" constituted securities within the meaning of U.S. law.[4]

The DAO was a new kind of organization, called a “distributed autonomous organization” or “DAO.” The DAO was created by a company called Slock.it “with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund ‘projects.’”[5] The DAO’s founders marketed and promoted DAO tokens to investors as investments in a decentralized enterprise.[6] Investors exchanged ETH, the token used to perform transactions on the Ethereum blockchain, for DAO tokens. The ETH was pooled and was to be used to fund blockchain projects. Investors in DAO tokens had ownership interests, and possessed limited voting rights “akin to those of a corporate shareholder.”[7] DAO token holders “stood to share in the anticipated earnings from [DAO] projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ... that supported secondary trading in the DAO Tokens.”[8]

Under these facts, the division concluded that DAO tokens were “investment contracts” under a Howey analysis, and that the public offer and sale of those securities to investors required registration or an applicable exemption.[9]

Utility Tokens: Square Pegs and Round Holes

The DAO report revealed a clear SEC enforcement focus on “virtual organizations or capital raising entities that use distributed ledger or blockchain technology *to facilitate capital raising and/or investment* and the related offer and sale of securities.”[10] Subsequent enforcement actions targeting initial coin offerings and other forms of public capital raising have borne this out.[11]

Easy cases make easy law. Applying federal securities laws to the public offering of interests in an organization designed to make and distribute profits to investors through deployment of the capital raised (as in the DAO report) — or to the marketing and sale of investments to raise capital (as in recent enforcement actions) — is a relatively straightforward application of settled principles to new circumstances. Where the end and aim of a token sale is to raise funds for a product that does not yet have a use, and purchasers are led to expect profits from the efforts of a promoter, it is not a stretch to say this is the sale of a security. That is the essence of Howey.

The easy cases, however, still leave much work to be done. Many of the most important and promising blockchain projects involve crypto assets and tokens that are designed for — and have — a real use, separate and apart from their prospects as speculative investments. These are the hard cases, and they do not fit neatly into a Howey analysis. They are the square pegs facing a regulatory round hole.

The Ethereum Example

Ethereum is the most prominent example. At its most basic level, Ethereum can be described as a global, blockchain-based computer that runs decentralized programs and applications.[12] Performing computations has a cost (measured in “gas”), and that cost is paid for with ether, or ETH. ETH, therefore, has clear utility: It is the thing you use to run programs on the Ethereum computer. ETH serves much the same function as an arcade game token, only instead of buying the right to play a basic game for pleasure, you can use ETH to run sophisticated applications on a trustless, decentralized network.

In a recent speech posted on the SEC’s website, William Hinman, director of the SEC’s Division of Corporate Finance, concluded that “current offers and sales of Ether are *not* securities transactions.”[13] This was a critical statement for users of the Ethereum blockchain. Hinman’s clear guidance with respect to Ethereum came at a pivotal time in the development and adoption of this important blockchain project.

ETH Is Not Alone

For other less established blockchain projects not mentioned by name, however, keen interest lies in Hinman's analysis in reaching that conclusion. That is because Hinman placed limited emphasis on ether's actual utility. His analysis of ETH was based almost exclusively on the notion that the Ethereum network is currently "decentralized."[14] For many utility token projects, this approach raises more questions than it answers.

Centralization

The first question is: Why does centralization even matter? The word centralization appears nowhere in Howey, and the degree of it bears little apparent connection to the essence of the question, "What is a security?" To use the arcade analogy again, arcade tokens are often sold in a centralized way (at the arcade's cash register, for example). No one would suggest this makes arcade tokens securities, no matter how big the arcade and no matter how many people the tokens are sold to. Utility tokens are not materially different. Focusing on centralization also raises a host of other issues in the blockchain context. Is a project with 10 developers sufficiently decentralized, or is 100 required? Is open source code sufficiently decentralized if it can be forked by a single developer or group of developers proposing a better solution to a problem? What does decentralization mean in the context of different consensus algorithms like proof of work and proof of stake? Regulators are not even asking those questions, let alone answering them.

Profit Seeking Motive

If centralization is not the ultimate touchstone, then what is? Whether investors have a profit seeking motive is one possibility. This at least has some basis in the Howey test. Howey involved land sales with service contracts that gave the promoter "full and complete" possession of the land to grow citrus crops. The promoter retained "full discretion and authority" to harvest the crops, and investors had "no right of entry to market the crop" themselves.[15] At harvest, crops were pooled with those of other investors, and investors received an aliquot share of net profits from the enterprise.[16] The Supreme Court emphasized that investors were "attracted by the expectation of substantial profits."[17] They had "no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment."[18]

Profit seeking, however, does not get to the heart of the issue on its own. People invest in things — from collectibles to commodities to currencies (and everything in between) — all the time in order to profit from a sale in the future. None of these things are securities. The original buyers of the 1952 Mickey Mantle rookie cards, for example, may have purchased with a firm — and prescient — conviction that the cards would increase in value. That does not make baseball cards securities. Nor does it mean Topps should have registered with the SEC before selling the Mantle rookie at stores across America.

Capital Raising

Raising money through a public offering is yet another option. That, too, cuts too wide a swath because companies regularly raise funds in public sales that no one would consider to be securities offerings. Take movie theaters as an example. They conduct daily public offerings for seats at the 5:30 showtime; this does not make movie tickets securities.

What about public sales in order to raise capital for future development? That doesn't quite work, either. Software companies routinely sell products in early developmental stages and use the proceeds of those sales to fund further upgrades and functionality. Does this make the software a security? The answer is, of course not. The analysis should be no different for blockchain projects. Ethereum, for example, did not launch with a fully developed protocol. It has been built and developed over time, and continues to be developed.[19] Like many similar projects, the developers of Ethereum raised funds by selling ETH to the public.[20] Those funds continue to be used to build out Ethereum's features.[21] That fact does not mean it is a security, any more than Microsoft Windows is a security.

Things That Get Used Are Products, Not Securities

The examples above highlight a deeper, more fundamental question in play with direct relevance to utility tokens: Is something really a security when you use it?

The Supreme Court addressed this issue in United Housing v. Forman.[22] Forman involved the question "whether shares of stock entitling a purchaser to lease an apartment in [a large apartment cooperative in New York] are 'securities' within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934."[23] The owner/operator of the complex raised funds for a portion of the construction costs through the sale of stock entitling purchasers to occupy apartments, with ongoing operating and mortgage costs to be paid from rents.[24] When the owner sought to increase rents, stockholders sued, claiming violations of the federal securities laws and other statutes.[25]

The Supreme Court held that the stockholders' interests in the cooperative were not "securities" despite the fact that they were called shares of "stock" (an enumerated item in both the Securities Act and the Exchange Act).[26] In reaching this conclusion, the Supreme Court expressly distinguished between investments motivated "solely by the prospects of a return on [the] investment" on the one hand, and purchases "motivated by a desire to use or consume the item purchased" on the other.[27]

The Supreme Court's distinction should be the beginning and the end of the question whether utility tokens are securities. That is because securities, at their core, are solely profit-seeking investments. Apple stock, for example, is clearly a security. It has no use, apart from generating a return (or at least hopefully generating a return, from the perspective of Apple stockholders). The citrus grove interests in Howey were the same. Investors bought into a fractional share of the profits of a citrus enterprise and were motivated "solely" by the prospect of a return on investment, not to use the land they bought.[28]

Utility tokens are different. Their defining feature is their use. Things that people use are not securities; they are products. They do not lose this essential character merely because they are sold, or based on the manner in which they are sold. Nor do they lose it because some purchasers think they can hold and sell in the future to another prospective user at a profit.

Take Ethereum as an example again. Some purchasers may buy ETH in order to perform transactions on the Ethereum blockchain today. Other purchasers may buy it in order to hold it and sell it in the future, speculating that the price will rise because demand will increase. But for both of these categories of purchasers, the value proposition is the potential usefulness of ETH, either in the original purchaser's hands or in the hands of a subsequent purchaser. What distinguishes ETH from a security is not that Ethereum is decentralized, it is that it is intended to be used, and actually has a use. Speculative profits are secondary to that use.

Where Is the Line?

In his Yahoo speech, Hinman "recognize[d] that the Supreme Court has acknowledged that if someone is purchasing an asset for consumption only, it is likely not a security."[29] This inverts the analysis in Forman and Howey. Forman did not mandate that every purchaser have a motive to use a product for it to be outside the scope of the securities laws. Howey held that one of the key factors in determining whether something is within the securities laws is whether investors are "solely" motivated by the prospects of a return.[30] When purchasers have a motive to use a product — or even a mixed motive to use or sell it at a profit to someone else who may value it more — Forman supplies the answer, not Howey.

That is not to say that merely calling something a "utility token" will remove it from the reach of the securities laws. The relevant metric is not what a blockchain token is called, but rather what it actually is. Considering Howey and Forman in tandem leads to a clear line of demarcation. A blockchain token that has actual utility at the time it is sold is not a security. A token that has no use and is sold to raise capital, promising purchasers a return on investment through the deployment of that capital, is.[31]

Conclusion

Recent SEC pronouncements and enforcement actions have provided helpful guidance to practitioners and developers in the blockchain space. Whether particular utility tokens are "securities" remains unsettled, and raises a host of unanswered questions. A regulatory desire to protect the public from fraud and deception is a laudable. This does not mean the federal securities laws are the right vehicle to accomplish that objective. The distinction drawn in Howey and Forman can provide a useful metric in resolving this important issue. Ultimately, where and how the line is drawn will be up to courts to decide.

Douglas J. Pepe is a partner at Joseph Hage Aaronson LLC.

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[1] See SEC, 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; SEC Website, Initial Coin Offerings (ICOs), available at https://www.sec.gov/ICO.

[2] SEC v. Edwards, 540 U.S. 389, 393 (2004).

[3] 328 U.S. 293, 301 (1966).

[4] DAO Report at 1.

[5] Id. at 1.

[6] Id. at 4-5.

[7] Id. at 5, 15.

[8] Id. at 1.

[9] Id. at 11-16.

[10] Id. at 2 (emphasis added). See also id. at 11 ("Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology").

[11] See, e.g., Complaint, SEC v. Sharma, et ano., No. 1:18-cv-02909-DLC (S.D.N.Y. Apr. 2, 2018) (ECF No. 1); Preliminary Injunction and Order, SEC v. Titanium Blockchain Infrastructure Servs. Inc., No. CV18-4315-DSF (JPRx) (C. D. Cal.) (ECF No. 48).

[12] See, e.g., A Next-Generation Smart Contract and Decentralized Application Platform (Ethereum White Paper), available at https://github.com/ethereum/wiki/wiki/White-Paper.

[13] See William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018) ("Hinman Yahoo Speech"), available at https://www.sec.gov/news/speech/speech-hinman-061418#_ftnref12 (emphasis added).

[14] See id. (concluding that ETH is not a security "based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure").

[15] Howey, 328 U.S. at 296.

[16] Id. at 296, 299-300.

[17] Id. at 296.

[18] Id. at 300.

[19] See, e.g., https://github.com/ethereum/wiki/wiki/Releases.

[20] See Vitalik Buterin, Launching the Ethereum Sale (July 22, 2014), available at https://blog.ethereum.org/2014/07/22/launching-the-ether-sale/.

[21] See id. (discussing the creation of "two endowment pools, each 0.099x the initial quantity of ether sold, that will be allocated in the first case to early contributors to the project and in the second case to a long-term endowment to our non-profit foundation"). See also https://www.ethereum.org/foundation("The Ethereum Foundation's mission is to promote and support Ethereum platform and base lawyer research, development and education.").

[22] United Hous. Found. Inc. v. Forman, 421 U.S. 837 (1975).

[23] Id. at 840.

[24] Id. at 842-844.

[25] Id. at 845.

[26] Id. at 849.

[27] Id. at 852-53.

[28] See Howey, 328 U.S. at 300.

[29] See Hinman Yahoo Speech.

[30] See Howey, 328 U.S. at 300.

[31] This line is completely consistent with SEC enforcement actions involving capital raising vehicles couched as “utility tokens.” See, e.g., Consent Order, In re: Munchee Inc., SEC File No. 3-18304 (Dec. 11, 2017) (public offering of newly-created token promising future utility in $15 million capital raise is an offering of securities).