METAMORPHOSIS: DIGITAL ASSETS AND THE U.S. SECURITIES LAWS

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By: Anthony R.G. Nolan, Eden L. Rohrer, Robert M. Crea, Kimmi H. Pham

"When Gregor Samsa woke up one morning from unsettling dreams, he found himself changed in his bed into a monstrous vermin."
- Franz Kafka, *The Metamorphosis*

In the past year, the U.S. Securities Exchange Commission ("SEC") and Chairman Jay Clayton have repeatedly cautioned the cryptocurrency and initial coin offering ("ICO") industries about the securities law implications for digital assets. On February 6, 2018, in testimony before the Senate Banking Committee, Chairman Clayton notably asserted that "[e]very ICO I've seen is 'a security.'" [1]

Such guidance and statements have led many industry participants to ask whether Ether — the second most prominent cryptocurrency after Bitcoin — might be a security in light of the Ethereum Foundation's initial fundraising and promotional efforts in creating Ether, as well as their ongoing curation activities. [2] The question has been of great importance to many participants in the cryptocurrency and ICO markets in the last several months.

On June 14, 2018, William Hinman, the SEC's Director of the Division of Corporation Finance, delivered a speech entitled *Digital Asset Transactions: When Howey Met Gary (Plastic)* (the "Hinman Speech"), in which he stated that, putting aside the fundraising that accompanied the creation of Ether, "current offers and sales of Ether are not securities transactions." (emphasis added). This statement was based on a novel theory of evolving decentralization that may very well have significant ramifications for cryptocurrency and ICO markets. The Hinman Speech also provides guidance for how the Division of Corporation Finance might evaluate whether a given digital asset constitutes a security.

This article discusses the context and implications for Director Hinman's conclusions surrounding Ether. It also analyzes the specific factors he suggests weighing in determining whether a given digital asset is a security.

THE CONSEQUENCES OF DEEMING ETHER A SECURITY

Were Ether to be deemed a security, the consequences would be profound and immediate for many industry participants. For example, issuers and resellers of Ether arguably could be subject to enforcement actions under the Securities Act of 1933 (as amended, the "Securities Act"), which makes it illegal to sell or offer to sell securities unless a registration statement is filed with the SEC or the offering or sale falls under an available exemption from the registration requirements of the Securities Act. [3] Furthermore, cryptocurrency exchanges that host trading in Ether would need to register as a national securities exchanges or alternative trading systems

("ATS"). [4] Since no cryptocurrency exchange is yet registered, trading activities in Ether could be significantly hindered or cease altogether. Such an interruption would likely affect ICO fundraising, as Ether is a prominent currency of denomination for many ICOs. Private fund managers trading in Ether could be subject to registration as investment advisers under the Investment Advisers Act of 1940 or analogous state regulatory regimes.

Additionally, the SEC has the power to investigate violations of the law and to make criminal referrals to the U.S. Department of Justice. [5] The SEC's enforcement powers reach to "any person," including natural persons, in violation of the law. [6] Additionally, private rights of action sounding under federal and state laws also could be brought.

SEC AND CFTC JURISDICTIONAL QUESTIONS

Whether Ether constitutes a security also implicates which regulatory agencies would have jurisdiction over investor protection and cryptocurrency exchanges. On February 6, 2018, each of SEC Chairman Clayton and Chairman J. Christopher Giancarlo of the U.S. Commodity Futures Trading Commission ("CFTC") testified before the U.S. Senate Banking committee on the subject of cross-agency coordination with respect to virtual currencies. [7] During that testimony, Chairman Clayton acknowledged that only the SEC could exercise jurisdiction over a cryptocurrency exchange that is hosting securities trading. Chairman Giancarlo acknowledged that, even if a cryptocurrency exchange hosted trading in virtual currencies deemed to be commodities, the CFTC's regulatory jurisdiction does not extend to spot commodity trading although it does have authority to police fraud and manipulation in spot markets. [8] It thus remains unclear what agency, if any, would be the principal regulator for exchanges hosting trading in virtual currencies that are spot commodities.

As background, the CFTC asserted jurisdiction over virtual currencies in 2015, prior to the broad distribution of Ether. [9] In a preliminary order issued on March 7, 2018, a federal district court supported the CFTC's assertion of jurisdiction, but that order applied to virtual currencies generally and not to Ether specifically. [10]

The question of which agency has jurisdictional authority over cryptocurrency and ICO exchanges is one that also impacts investor protection. On March 7, 2018, the SEC's Divisions of Enforcement and Trading and Markets released a *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* cautioning investors that many such exchanges are not registered as a national securities exchange or as an ATS. The statement specifically called into question the trading protocols, the integrity of such exchanges, pricing transparency, and fairness to users. While the statement specifically targeted exchanges of ICOs, the concerns expressed also could apply to many exchanges for traditional cryptocurrencies.

Following this statement, many observers speculated as to whether the SEC might exercise jurisdiction over traditional cryptocurrency exchanges — almost all of which trade Ether — on a finding that Ether is a security. Former CFTC Chairman Gary Gensler, who served under President Barack Obama, weighed into the question of whether Ether might be a security on April 24, 2018, at the "Business of Blockchain" conference sponsored by the MIT Technology Review. [11]

Mr. Gensler acknowledged the commonly held view that Bitcoin likely is not a security because it came into existence through autonomous mining efforts rather than being sold into existence as an "incentive in validating a distributed platform" characteristic of many ICOs. Regarding Ether, however, former Chairman Gensler opined that "there's a strong case" that it is a security based on the initial sale and the central role of the Ethereum

Foundation as a developer of the Ethereum network. Noting that his remarks represented only his own views as a private citizen, Mr. Gensler also said that he thought it would be a "multi-year process" for the SEC to come to a ruling on whether Ether might be a security. No doubt to the relief of many, the Hinman Speech, although not a ruling, came much sooner.

SEC DIRECTOR WILLIAM HINMAN – ETHER IS NOT *PRESENTLY* A SECURITY

The Hinman Speech may provide insight into how the SEC views virtual currencies (i.e., not just ICOs) under the securities laws. Director Hinman posited "[c]an a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security" and answered with a "qualified 'yes.'" Most prominently, the Hinman Speech concludes that even though Ether might have been a security when the Ethereum Foundation initially sold Ether in 2014, Ether no longer is a security and has morphed into something else as the Ethereum network has become decentralized over time. [12]

Director Hinman also provided some guidance about what decentralization process may be sufficient to remove a token from being considered a security under the *Howey* test:

If 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. Moreover, when 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.

Director Hinman did not elaborate on what specific facts or case law he weighed in concluding that the Ethereum network has become decentralized or how the process of decentralization somehow transmogrified Ether from being a security into something else. He reasoned "that the analysis of whether something is a security is not static and does not strictly inhere to the instrument" citing as examples assets that could be packaged and sold in an investment strategy, contract, fund, or trust. To some extent, this conclusion appears to have been a prudential one on the basis that "applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value."

Director Hinman's remarks on decentralization have several important implications:

- ***What is Ether if not a Security?*** – If the SEC staff does not view Ether as a security, then it would appear that Ether may in fact be a virtual currency subject to the CFTC's anti-fraud jurisdiction as a spot commodity.
- ***Jurisdiction over Cryptocurrency Exchanges*** – The SEC staff would appear not to be looking to use Ether as a basis for asserting broad jurisdiction over existing cryptocurrency and ICO exchanges. Given the CFTC's lack of jurisdiction over commodity spot markets, questions thus remain as to what agency, if any, will address the SEC's publicly stated concerns on the quality, transparency, and fairness of existing exchanges. If no federal agency asserts jurisdiction, will jurisdiction be left to the individual states?
- ***Implications for ICOs*** – The theory that decentralization of a digital asset network over time might alter the digital assets' original securities characterization also might prove beneficial to some producers of

virtual currencies and ICOs that have been working through the tricky issues of how to remediate offerings that may have violated securities laws.

- ***Maybe the SAFT Isn't Dead Yet*** – Director Hinman's theory of decentralization as a means to morph a security into a non-security also might restore some credibility to the "simple agreement for future tokens" or "SAFT" as a technique to insulate tokens from being deemed securities. As background, the SAFT has been a commonly used instrument over the past year to fundraise for the development of digital asset platforms. The theory behind the SAFT is that the SAFT itself would be deemed to be a security issued pursuant to Rule 506(c) of Regulation D of the Securities Act but that the digital assets would be issued only once the platform is functional, such that the digital assets themselves would be deemed a "utility" and not a security. By not being securities, such digital assets arguably could trade on secondary market platforms free from the restrictions of the securities laws. [13]

  The Cardozo Blockchain Initiative, a group of academics and legal practitioners organized under the auspices of Cardozo Law School, publicly criticized the SAFT approach in November 2017 in a paper entitled *Not So Fast - Risks Related to the Use of "SAFT" for Token Sales*. The SAFT also appears to have come under regulatory criticism following the SEC's December 2017 enforcement action in *In re Munchee Inc.*, which involved the sale of tokens pursuant to a pre-sale instrument akin to the SAFT. [14] Following news accounts of a broad dissemination of subpoenas earlier this year by the SEC to token sponsors and their advisers, a number of prominent crypto news editorials further challenged the SAFT approach. [15]

  If the process of decentralization can effectively change a security into something else, then the SEC staff may be open to viewing the digital assets issued subsequent to the SAFT as distinct from the securities posture of the SAFT.

POTENTIAL NO-ACTION RELIEF

The Hinman Speech acknowledges that the question of whether a particular digital asset involves the sale of a security is a "fact-sensitive legal analysis" and, importantly, indicates that the SEC staff "stand[s] prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use." This statement is accompanied by a footnote wherein Director Hinman acknowledges that his speech should not be regarded as an opinion "on the legality or appropriateness of a SAFT . . . it is clear I believe a token once offered in a security offering can, depending on the circumstances, later be offered in a non-securities transaction."

The SEC's Division of Corporation Finance is one of several SEC divisions that reviews and considers no-action relief. Although the Division of Corporation Finance has yet to provide no-action relief in the cryptocurrency or ICO space, we are hopeful that Director Hinman's statement indicates that additional guidance, particularly with respect to the SAFT, may be forthcoming. Given Director Hinman's expressed willingness to provide no-action guidance, future token sponsors would be well-advised to consider obtaining no-action relief in areas where there is uncertainty over the application of federal securities laws.

Additionally, no-action relief may be a consideration for issuers who offered unregistered securities and are now seeking guidance on the difficult decision of whether to offer remediation. Those issuers may be able to demonstrate, based on the status of their platforms, that their virtual currencies should no longer be considered securities. We would caution, though, that such no-action relief would not necessarily preclude the possibility of private rights of action.

INFLUENTIAL FACTORS IN DETERMINING WHETHER DIGITAL ASSETS IMPLICATE SECURITIES LAWS

The Hinman Speech indicates that a key determination for whether a digital asset is a security depends on whether a third party drives the expectation of a return — in other words, the third and fourth prongs of the *Howey* test. Courts often break the *Howey* test (as expounded over the years) into four elements to determine whether (i) there exists an investment of money, (ii) there exists a common enterprise, (iii) there is a reasonable expectation of profits, and (iv) the profits come from the entrepreneurial or managerial efforts of third parties. [16]

Regarding the third and fourth prongs of *Howey*, Director Hinman provides a list of illustrative, non-exhaustive factors that indicate how the Division of Corporation Finance might consider the issue. We address each in turn:

Hinman Factor	Implications Under *Howey*
1. Prominent and Central Developer: 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?	A person or group playing a prominent role in the creation, sale, development, maintenance, and promotion of a digital asset network weighs in favor of a positive finding under the fourth prong of *Howey*.
2. Developer Incentive and Influence: 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?	Ongoing retention by a developer of digital assets, especially if publicly known, could mean a developer is incentivized to influence the digital asset network or that other purchasers might reasonably conclude that the developer would have an influential impact on the value of the digital asset. Such perceptions could contribute to a positive finding under the fourth prong of *Howey*. On this issue, we would note that retention of a stake or interest might not be limited to actual ownership of digital assets but could also be construed as the ability to exercise influence or control over the governance of a network.

3. Excess Fundraising: 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?	Raising money beyond what is necessary to build a digital asset network can indicate a need for the promoter to have proceeds from which it can continue to undertake efforts to increase a network's value. Such circumstances indicate that the network might in fact be a common enterprise subject to ongoing central authority, which weighs in favor of positive findings under the second and fourth prongs of *Howey*.
4. Investment Value: Are purchasers “investing,” that is, are they 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?	Many ICOs were specifically marketed as investments and promised substantial returns. Similarly, many ICOs were structured to provide value through scarcity and the digital assets were sold to early purchasers with discounts. These facts weigh significantly in favor of a positive finding under the third prong of *Howey*.
5. Are SEC Protections Necessary?: Does application of the Securities Act 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?	These prudential, policy-based questions are independent of a *Howey* analysis and may be the trickiest to answer when contemplating a digital asset network. We could imagine a scenario where an investor could make an investment decision based on knowing the development plans of a prominent digital asset network curator.
6. Other Persons in Control: Do persons or entities other than the promoter exercise governance rights or meaningful influence?	One might be able to exercise control over a digital asset network without necessarily owning a significant portion of digital assets on that network. In such case, a positive finding under the fourth element of *Howey* is more likely.

Further, on the question of whether a digital asset might be deemed a consumptive utility or a security, Director Hinman provided the following factors that the SEC staff might consider. We address each in turn:

Hinman Factor	Implications Under *Howey*
1. Utility or Investment?: Is token creation commensurate with meeting the needs of	An emphasis on speculation weighs heavily in favor of a positive finding of the third prong of *Howey*. Chairman

users or, rather, with feeding speculation?	Clayton previously has asserted that an emphasis on potential secondary market trading is “especially troubling,” noting that the sale of tokens based on the potential for purchasers to profit by reselling tokens on a secondary market “are key hallmarks of a security and a securities offering.” [17]
2. Price Setting: Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?	Where a promoter maintains the ability to influence the secondary market price, the greater the risk becomes of a positive finding under either the third or fourth prong of *Howey*.
3. Consumptive or Speculative Intent?: 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 intent, as opposed to their investment intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?	This factor touches on several issues, including the potential for speculation, terms of sale and token structure. As to terms of sale, we would note that the SEC might find the existence of a security notwithstanding investor representations to the contrary of consumptive intent, particularly if there are other circumstances surrounding the token structure and manner of offering that weigh in favor of positive findings under the third and fourth prongs of *Howey*.
4. Token Design and Use: 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?	Similar to factor #3, tokens tied to incremental use cases or with built-in degrading features are less likely to be used for speculation. Such tokens would less likely support a positive finding under the third prong of *Howey*.
5. Availability to the Public: Is the asset marketed and distributed to potential users or the general public?	A broad and indiscriminate distribution to the public, as opposed to a targeted distribution to potential digital asset network users, suggests that purchasers may be speculators, thus weighing in favor of a positive finding under the third prong of *Howey*.
6. Asset Distribution: Are the assets	The more broadly distributed digital assets are on a

dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?	network, the less likely the digital asset network would appear to be subject to central control of a digital asset network or authority. We would caution, however, against conflating ownership of digital assets with control of a digital asset network. Depending on the governance structure of a given digital asset network, one might be able to control a network with little to no ownership of the digital assets issued with respect to the network.
7. Network Maturity: Is the application fully functioning or in early stages of development?	Digital assets sold with respect to a network in its early stages of development may more likely be deemed securities for several reasons. The network looks more like an investment in a common enterprise (i.e., the second prong of *Howey*) captive to the management and curation of third parties to make the network fully functional (i.e., fourth prong of *Howey*).

CONCLUSION

The Hinman Speech provides welcome common-sense advice for prospective participants in digital token offerings. However this advice also raises many questions about the regulatory posture of virtual currencies and ICOs, particularly with respect to decentralization, that may require industry participants to seek further interpretive guidance or no-action relief. While Director Hinman caveated that his speech represented his personal views and not those of the SEC, we believe they provide a barometer of the views of the SEC staff. In an environment of frequent and unsettling change, the character of digital assets may itself see future unexpected metamorphoses. Federal district courts are now evaluating through class action litigation some of the same issues discussed in the Hinman Speech and may come to different conclusions. In the meantime, the Hinman Speech provides helpful guidance that sponsors of new digital asset networks and ICOs should consider in consultation with securities counsel.

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Notes:

[1] *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing and Urban Affairs*, 115th Cong. (Feb. 6, 2018) (testimony of Jay Clayton, Chairman, SEC).

[2] *See* Ether Product Purchase Agreement (July 21, 2014), https://GitHub.com/ethereum/ethereum.org/tree/master/public/pdf (last visited June 18, 2018).

[3] 15 U.S.C. § 77a.

[4] SEC Exchange Act Rel. No. 81207, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (July 25, 2017) at 16, https://www.sec.gov/litigation/investreport/34-81207.pdf.

[5] 15 U.S.C. § 77t(a).

[6] 15 U.S.C. §§ 77h-1(g), 77t(d).

[7] *See* SEC Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC (Feb. 6, 2018); Written Testimony of Chairman J. Christopher Giancarlo before the Senate Banking Committee (Feb. 6, 2018) (the "Giancarlo Statement").

[8] *See* Giancarlo Statement ("In 2015, the CFTC determined that virtual currencies, such as Bitcoin, met the definition of 'commodity' under the [Commodity Exchange Act]. Nevertheless, the CFTC does NOT have regulatory jurisdiction under the CEA over markets or platforms conducting cash or 'spot' transactions in virtual currencies or other commodities or over participants on such platforms."). A spot commodity is a commodity available for delivery within 28 days, as opposed to a contract for delivery at a future date.

[9] *See* In re Coinflip, Inc., Dkt. No. 15-29 (CFTC Sept. 17, 2015), http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf.

[10] *See* CFTC v. Cabbagetech et al., 18-CV-361 (EDNY Mar. 6, 2018) (available here).

[11] The full text of former Chairman Gensler's comments can be found here.

[12] To clarify some of the confusion we have seen in the press, Director Hinman concluded that current offers and sales of Ether are not securities transactions. Director Hinman did not broadly conclude that offers and sales of ICO tokens created and sold pursuant to smart contracts on the Ethereum platform are not securities transactions.

[13] For the theoretical underpinnings of the SAFT, *see The SAFT Project: Toward a Compliant Token Sale Framework* (Oct. 2, 2017), https://saftproject.com/static/SAFT-Project-Whitepaper.pdf.

[14] *In the Matter of Munchee Inc.,* Securities Act Rel. No. 10455 (December 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf.

[15] *See, e.g.*, Aaron Kaplan, SEC Subpoenas Show the SAFT Approach to Token Sales is a Bad Idea. VENTUREBEAT (Mar. 3, 2018), https://venturebeat.com/2018/03/03/sec-subpoenas-show-the-saft-approach-to-token-sales-is-a-bad-idea/; Howard Marks, The Days of SAFT Are Over, HACKERNOON (Mar. 29, 2018), https://hackernoon.com/the-days-of-saft-are-over-febe31dbb04; Brady Dale, What if the SEC is Going After the SAFT?, COINDESK (Mar. 6, 2018), https://www.coindesk.com/sec-going-saft/.

[16] *See* SEC v. Edwards, 540 U.S. 389, 393 (2004); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); *see also* United Housing Found., Inc. v. Forman, 421 U.S. 837, 852-53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.")

[17] *Id.*

KEY CONTACTS

ANTHONY R.G. NOLAN
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM

EDEN L. ROHRER
PARTNER

NEW YORK
+1.212.536.4022
EDEN.ROHRER@KLGATES.COM