Updates
January 11, 2018

# SEC Takes Aim at Initial Coin Offerings Again

In its most significant action since issuing the DAO Report in July 2017, the U.S. Securities and Exchange Commission (SEC) again took aim at initial coin offerings (ICOs) on December 11, 2017, when, through its new Enforcement Cyber Unit, the SEC entered into an administrative settlement with Munchee, Inc. (Munchee) (the Munchee Order), for conducting unregistered offers and sales of securities. Munchee, a blockchain-based food review service, agreed to halt its ICO and refund investor proceeds.

In an accompanying press release, Stephanie Avakian, co-director of the SEC's Enforcement Division, said the SEC "will continue to scrutinize the market vigilantly for improper offerings that seek to sell securities to the general public without the required registration or exemption." In a statement (Chairman's Statement or the Statement) issued the same day, SEC Chairman Jay Clayton asked the SEC's Enforcement Division to continue to police this area "vigorously" and to recommend action against those that conduct ICOs in violation of the federal securities laws.

Although Munchee's token was labeled a "utility token" that would allow purchasers to buy goods and service on the Munchee ecosystem, Munchee and other promoters emphasized that investors could expect that efforts by the company 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, the SEC found that the tokens were securities

As the SEC said in the DAO Report, a token can be a security based on the long-standing "facts and circumstances" test that includes assessing whether investor profits are to be derived from the managerial and entrepreneurial efforts of others. The Munchee case serves as a reminder that if tokens are found to be securities, their offering and sale in the United States must be registered or exempt from registration.

Not only does the Munchee case demonstrate that the staff of the Enforcement Division is continuing to focus on ICOs, it shows the SEC's increased attention to how the issuer markets and promotes the ICO to investors. The Munchee case and statements by senior SEC staff and Chairman Clayton reflect the SEC's continuing enforcement focus on the ICO market and its participants, and it likely portends future action in this area.

The SEC has made clear in the last year that digital token offerings will garner serious attention from the agency, and the Enforcement Division staff will continue to devote significant resources to policing the unregistered offers and sales of tokens that are found to be securities. In light of this, developers and sellers of token technologies should carefully review their practices with respect to token sales, including token attributes, marketing and advertisement, other public communications and the sale process. Numerous factors should be considered and discussed with experienced counsel when assessing these industry-wide practices against the federal securities laws and related SEC rules and SEC actions, guidance and statements. It is not sufficient to "follow the leader" here and do what others have done in this area.

The DAO Report

In the DAO Report, the SEC determined the DAO tokens were "securities" under the Securities Act of 1933 (Securities Act) after applying the *Howey* Test to evaluate whether the tokens were an investment contract and thus a "security." Under the *Howey* Test, an "investment contract" is (1) an investment of money (2) in a

common enterprise (3) with a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others.[1] The DAO Report thus confirmed the long-standing analytical framework used to gauge whether a digital coin or token is a "security."

The Munchee Order

In the second quarter of 2017, Munchee, a California startup, launched an iPhone application that allowed users to post photographs and review restaurant meals. On October 1, 2017, Munchee announced that it would hold a public sale of its token (MUN) in an ICO. Munchee posted a white paper (White Paper) on its website and provided links to the White Paper on other sites. Although the White Paper referenced the DAO Report and stated that Munchee had done a "*Howey* analysis" and that "as currently designed, the sale of MUN utility tokens does not pose a significant risk of implicating the federal securities laws," the SEC noted that the White Paper did not provide any such analysis (which, reading between the lines, probably meant the SEC staff thought whatever analysis was done was simply wrong).

Munchee's founders and others promoted the ICO on blogs, Facebook, Twitter and BitcoinTalk. The token sale began on October 31, 2017, with the goal to raise $15 million. The next day, the SEC contacted Munchee, and Munchee immediately stopped selling MUN tokens and refunded all proceeds. The Munchee Order confirms that whether a token is a "security" is not determined by the label the issuer gives it. The SEC will apply the *Howey* Test to determine whether a token is a "security" and the Munchee Order provides additional insight into how the SEC will apply the test.

First, the SEC noted that the White Paper contained statements about how the MUN tokens would **increase in value** and how MUN holders would be able to trade MUN tokens on **secondary markets**. Second, Munchee made a series of **marketing statements** to **specific audiences**—cryptocurrency investors *rather* than the restaurant industry and its likely customer base—relating to the future profit of buying and holding MUN tokens. In its marketing materials and in statements made by Munchee representatives in Facebook posts, YouTube videos and on podcasts, Munchee stated that MUN tokens would provide 199% gains, and that a $1,000 investment could create a $94,000 return.

Finally, in its White Paper, Munchee provided statements that the SEC believed would allow token purchasers to reasonably expect profits **from the efforts of others**. Specifically, the White Paper described how the value of MUN tokens would depend in part on the company's ability to develop the Munchee App and build an ecosystem for the MUN tokens, i.e., the expectation of profits for a MUN token purchaser was dependent on the skills and experience of Munchee's founders and employees.

Chairman Clayton's Statement

Chairman Clayton's statement echoed the analytical themes of the Munchee Order. He emphasized that a "utility token" can be a "security" if the marketing surrounding its issuance highlighted the potential for profits based on the managerial efforts of others and if it is designed to trade on a secondary market based on values that derive from the efforts of others. Chairman Clayton further noted that the analysis as to whether a token is a "security" is entirely dependent on the underlying facts. For instance, he noted, "a token that represents a participation interest in a book-of-the-month club may not implicate [the] 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" or such a token may implicate the securities laws if it is "more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come."

Applying the Lessons of the Munchee Order

1. **Growth and profit.** The SEC focused on Munchee's stated future development plans as potentially creating the impression that further efforts by the developer would materially enhance the value of a token, even a token that has current utility.
2. **The value of usefulness versus efforts for profit.** Like any good, a token may be valuable because its current utility is important to a user. Its retail price could rise or fall as it becomes widely adopted, as it allows users to develop new features, or as it falls out of popularity as better technologies are developed. On the other hand, a token whose current value is based on an enterprise's promised efforts to complete an unfinished product could be more likely to draw regulatory scrutiny.
3. **Marketing current utility versus future profit.** Any marketing efforts should focus on the current utility of a token and direct any marketing towards an audience that might appreciate the utility. In addition, definitive statements about future value should be expected to always draw the ire of the SEC.
4. **Practical use at the time of offering.** A utility token must be structured in a manner that avoids any elements of a security while also providing an existing practical application.[2] Demonstrating that a "utility token" has a practical use at the time of offering is one potential means an issuer has to create an economic reality in which the provision of money is to gain access to an existing feature set, rather than with an expectation of profit based on completion of that feature set by the promoter.

SEC's New Enforcement Division Cyber Unit

Not to be overlooked is the creation of the specialized unit within the SEC's Division of Enforcement that will focus its "substantial cyber-related expertise" on, among other things, policing distributed ledger technology and initial coin offerings. Created in September 2017, the unit is an important development illustrating that the SEC is focused on ICOs and blockchain technology, and it demonstrates the SEC's willingness to dedicate resources to pursue companies in this space.[3] So, it should come as no surprise that the latest action against Munchee was brought by this new Cyber Unit. It is reasonable to anticipate that the unit will continue to examine token offerings that have already happened and proposed token sales.

Implications of SEC's Attention on ICOs

Taken together, the DAO Report, the Munchee Order and the accompanying statements by Chairman Clayton and Ms. Ayakian highlight the attention the SEC is giving to ICOs and portend an increasing focus by the SEC on the ICO market and its participants. Technologists, inventors and entrepreneurs should carefully review their practices with respect to ICOs and consult with experienced counsel to analyze their individual practices against the evolving landscape of the SEC's actions, statements and rules. The regulator, both in the DAO Report and in Chairman Clayton's statement, has also emphasized the importance of seeking counsel and the role of gatekeepers. This is a complex area of law, and the role of and necessity for careful legal analysis are critical to those who wish to become active in pushing forward these revolutionary technologies.

If you have questions about how the Munchee Order or the Chairman's Statement might apply to you or your business, contact experienced counsel.

**ENDNOTES**

[1] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). An "investment contract" is just one kind of security, but the term is often considered when an arrangement does not fit within descriptions of the various other kinds of securities.

[2] Evaluating the economic realities of an underlying transaction is nothing new for the SEC and its utilization of the *Howey* Test. *See, e.g.*, Martin R. Kaiden, Exchange Act Release No. 41629, 1999 WL 507860 at *3 (July 20, 1999) (citing *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

[3] Speaking at a conference in 2017, SEC Chairman Jay Clayton reinforced the Cyber Unit's ICO mission and jurisdiction, noting that: "[I]n ICOs you are asking people for their money for you to take and use in a commercial endeavor with the prospect of increasing the value of that piece of the distributed ledger ... I see very little distinction — or any — between that and handing someone a piece of paper that says stock." John Reed Stark, International ICOs May Not Be Safe from the SEC, LAW360, Dec. 12, 2017 (quoting Chairman Clayton), https://www.law360.com/banking/articles/993855/international-icos-may-not-be-safe-from-the-sec.



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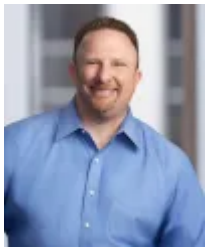


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