

2017 Recap: Tokens, Coins, Cryptocurrencies, and Other Digital Assets under the Federal Securities Laws - Facts and Circumstances

The Securities and Exchange Commission's ("SEC") recent [action against a digital trading platform](#) illustrates the continued uncertainty surrounding the treatment of tokens, coins, cryptocurrencies, and other digital assets under the federal securities laws. Senior SEC officials have expressed concern that a significant amount of activity in this industry may not comply with federal securities laws and increasing SEC enforcement activity evinces these concerns. This set of posts offers a recap of the SEC's previous enforcement actions and statements, providing a reminder to market participants that there is not yet any formal, comprehensive guidance on the reach of federal securities laws in this area. As a result, whether the SEC or a court determines that a particular token, coin, cryptocurrency or digital asset is a security remains a case-by-case, facts and circumstances analysis.

The DAO Report

In July 2017, in response to the SEC's finding of the increasing use of distributed ledger technology or blockchain-enabled means to offer and sell instruments such as tokens, the SEC issued the "[Report of Investigation Pursuant to 21\(a\) of the Securities Exchange Act of 1934: The DAO](#)" to "stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale." The DAO Report confirmed that, unless properly conducted, selling tokens that are securities may violate federal securities laws. The DAO Report confirmed the SEC would use a long-standing analytical framework from the 1946 U.S. Supreme Court case [SEC v. W.J. Howey Co.](#) to determine the DAO tokens were an "investment contract" and, therefore, "securities" (the "*Howey Test*"). In *Howey*, the Supreme Court found that the sale by Howey Co., a hotel operator, of interests in a nearby citrus grove along with a service contract obligating an affiliated service company to harvest and market the oranges on the purchaser's behalf and deliver the purchaser's share of the grove's profits, amounted to the sale of an investment contract. Under the *Howey Test*, an arrangement is an investment contract and thus a security if each of four elements are satisfied: (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. The DAO Report further cautioned that whether a transaction involves a security "will depend on the facts and circumstances, including the economic reality of the transaction."

Munchee, Inc. and Chairman Clayton's Statement

A few months later, in December 2017, the SEC settled [an enforcement action against Munchee Inc.](#), a token issuer, for issuing unregistered securities. The tokens in the Munchee Order ("MUN") were intended for use in an application to advertise, review and buy meals from restaurants, although "no one was able to buy any good or service with MUN" at the time of their sale. Although MUN was labeled a "utility token," Munchee had marketed that investors could expect that its efforts would lead to an increase in the tokens' value and that it would take steps to create and support a secondary market for MUN. Further, Munchee directed its marketing to virtual currency investors rather than likely users of MUN. The SEC based its determination that MUN were investment contracts under the *Howey Test*, particularly the "reasonable expectation of profits" prong, on these

facts, among others. On the same day the Munchee Order was released, Jay Clayton, the Chairman of the SEC, stated that "by and large, the structure of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws." My next post will review the more nuanced views expressed by the staff members of the SEC in 2018 and the expanding range of enforcement cases.

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