Blogs
November 13, 2018
Asset Management ADVocate

2018 Recap: Tokens, Coins, Cryptocurrencies, and Other Digital Assets under the Federal Securities Laws

This post continues my recap of where things stand regarding the treatment of tokens, coins, cryptocurrencies, and other digital assets under the federal securities laws. My prior post discussed actions and statements made by the SEC in 2017. This post reviews significant enforcement actions and statements this year prior to the recent Coburn enforcement action.

Director Hinman's Remarks

In June 2018, William Hinman, Director of the SEC's Division of Corporation Finance, presented public remarks regarding the application of federal securities laws to digital assets. Director Hinman outlined the framework the SEC staff uses to evaluate whether a given token sale should be considered a securities offering. His speech considered whether "a digital asset that was originally offered in a securities offering [could] ever be later sold in a manner that does not constitute an offering of a security?" He suggested the answer was "likely no" when "the digital asset represents a set of rights that gives the holder a financial interest in an enterprise," as was the case with The DAO. The answer could be a "qualified yes," however, "where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created," referring to bitcoin and ether as examples. Hinman described promoters selling tokens or coins to raise money to develop networks on which the digital assets will operate, rather than selling shares, issuing notes, or obtaining bank financing. Hinman noted that in many cases, the economic substance is the same as a conventional securities offering, *i.e.*, funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument. In such cases, Hinman said that it may be appropriate to apply the *Howey Test* to determine if the digital asset is a security. Hinman highlighted that while the transaction in *Howey* was recorded as a real estate sale, it also included a service contract to cultivate and harvest the oranges, which meant that the investors were relying on the efforts of a Howey Co. affiliate for a return. Hinman emphasized that regardless of whether something is called a "token" or a "coin," the analysis often turns on *how an asset is sold* -- "as part of an investment; to non-users; by promoters to develop the enterprise" -- which may cause investors to have a *reasonable expectation of profits* based on the efforts of others. Hinman analogized certain sales of tokens to the underlying facts in *Gary Plastic Packaging v. Merrill Lynch*, in which the U.S. Court of Appeals for the Second Circuit held that a transaction may be subject to the federal securities laws even if the instrument being sold would ordinarily not be a security, based on the manner of their sale and the promises associated with such sale. In *Gary Plastic*, the Court found that, despite the fact that conventional certificates of deposit (CDs) issued by a bank are not securities under the federal securities laws, they were securities when sold pursuant to the program because they were sold in a manner that satisfied the *Howey Test*. Merrill Lynch sold the CDs through a program that promised retail investors that it would make available fully insured CDs, maintain a secondary market for the CDs by enabling investors to sell the CDs back to Merrill Lynch at prevailing market rates, provide credit reports on the issuers, and make new CDs available frequently. The Court found that the CDs represented a joint effort by the issuers of the CDs and Merrill Lynch and that the CDs were investment contracts because investors expected to receive profits through the extra services provided by Merrill Lynch. Applying the same reasoning to tokens, Hinman stated that while tokens themselves (which he notes are, after all, "simply code") may not be securities, "how [tokens are] being sold and the reasonable expectations of purchasers" are central to the securities law determination. In sum, he emphasized that, in the context of a token sale that involves an investment contract, the application of the securities laws and especially its disclosure requirements is appropriate.

Token Lot

In September, in the its first case charging an unregistered broker-dealer for selling digital securities, the SEC announced that TokenLot, LLC, a self-described "ICO Superstore," and its owners settled charges that they acted as unregistered broker-dealers. The SEC's announcement stated that TokenLot and its owners used TokenLot's website to receive investors' purchase orders for digital tokens during initial coin offerings (ICOs) and to engage in secondary trading for investors. While the announcement stated that TokenLot handled more than 200 different digital tokens, which the SEC found included securities, the SEC order did not specify which digital assets it determined to be securities or describe the basis for its determination.

Takeaways

The DAO Report, Munchee, Chairman Clayton's remarks, Director Hinman's remarks, TokenLot, Coburn and other SEC actions, and comments by the SEC staff have clarified the basic analytical framework the SEC will use to determine whether a digital asset is an investment contract or is otherwise a security. What is clear, in particular, is that the SEC will determine whether a digital asset is a "security" based on the relevant facts and circumstances and that it will consider the broader public policy purposes of the securities laws in doing so. However, while the SEC continues to fill in interpretive gaps through informal remarks and enforcement actions, it has not yet provided comprehensive or formal guidance with respect to this rapidly evolving asset class and marketplace. As a result, conducting activity in this market remains subject to substantial regulatory uncertainty and risk, and careful legal analysis should be undertaken before doing so.

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