The SEC Says That (Some) Crypto Tokens Are Not Securities (Finally)!

By Herrick K. Lidstone, Jr., Burns, Figa & Will, P.C.
Greenwood Village, Colorado

Any discussion of digital assets as securities is fraught with confusion and a lack of clarity. In the 24 months prior to writing this, the law and approach to and acceptance of cryptocurrency ("a digital unit of exchange that is not backed by a government-issued legal tender") has changed dramatically. With the advent of cryptocurrency and blockchain, many industries have begun using cryptocurrencies to enhance their services and fund their ventures. The increase in the use of digital assets has brought new questions to the fore. Among these questions is whether a digital asset qualifies as an "investment contract," thus triggering regulation by state and federal securities administrators. In 2019, digital assets have a number of applications beyond the traditional "investment contract," causing the industry to wonder: when does a digital asset fall outside the scope of securities regulation? Recently the federal Securities and Exchange Commission (the "SEC") has given us some guidance.

***Investment Contracts and* Howey.**

Under the Securities Act of 1933 (the "1933 Act"), the SEC regulates the offer and sale of securities. Several times now, the SEC has determined that cyptocurrency (also described as "digital assets") constitutes an "investment contract" (initially defined in *SEC v. W.J. Howey Co.*[1]) under certain circumstances. As a result, where digital assets were investment contracts, the 1933 Act would subject the offer and sale to SEC registration and disclosure requirements.

Howey found that the offer and sale of orange trees by a farmer constituted an investment contract by virtue of the purchaser's expectation of profits based on the efforts of the grove managers.[2] The test established in *Howey* states that an "investment contract" exists where there is:

(i) an investment of money,
(ii) in a common enterprise,
(iii) in which the investor is led to expect profits,
(iv) derived from the efforts of the promoter or one or more other third parties.[3]

Howey has remained the prevailing standard for determining whether a business relationship constitutes a security since it was established in 1946 and is the test applied to digital

[1] Digital assets are not among the securities enumerated in the statutory definition of "security" in the 1933 Act or the 1934 Act, or in state law. However, digital assets have been found to be investment contracts and, because investment contracts are included in the definition of a security, digital assets carry the potential for being subject to securities laws. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946).

[2] *Id.* In the offer and sale of the trees to investors, the farmer included a service agreement for the care of the trees and the harvesting and sale of the oranges.

[3] *Id.* at 301.

assets.[4] The SEC first applied the *Howey* test to digital assets in July 2017 when the SEC issued an investigatory report under the Securities and Exchange Act of 1934 (the "1934 Act"), deciding that DAO tokens (tokens issued by Decentralized Autonomous Organization[5]) were securities.[6] The DAO tokens were promoted with the promise of a return on investment and the investor profits were to be derived from the managerial efforts of the DAO. Relying on the *Howey* test, the SEC report determined that the tokens were securities under the 1933 Act and the 1934 Act. Since then, the SEC has applied Howey to issues of digital asset enforcement a number of times.

SEC Launches FinHub

In October 2018, in an effort by the SEC to work with tech developers regarding compliance with federal securities requirements, the SEC launched the "Strategic Hub for Innovation and Financial Technology ("FinHub")[7] to provide a way for technologists and their advisers to engage with the SEC staff on these issues. In a statement accompanying the launch of FinHub, SEC Chairman Jay Clayton said:

> The FinHub provides a central point of focus for our efforts to monitor and engage on innovations in the securities markets that hold promise, but which also require a flexible, prompt, regulatory response to execute our mission.

In April 2019, FinHub released guidance for companies looking to deal in digital assets while maintaining compliance with securities laws. The guidance, "Frameworks for 'Investment Contract' Analysis of Digital Assets," [8] ("Framework") focuses on the application of the *Howey* test

---

[4] Bitcoin, Etherium, and other virtual currencies have also been determined to be commodities under the Commodity Exchange Act. See 7 U.S.C. § 1, *et seq*.

[5] "DAO" is a Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain; the holders of DAO Tokens stood to share in the anticipated earnings from these 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 ("Platforms") that supported secondary trading in the DAO Tokens. SEC, Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the 1934 Act: The DAO (2017), avail. at https://www.sec.gov/litigation/investreport/34-81207.pdf.

[6] SEC., Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the 1934 Act: The DAO (2017), avail. at https://www.sec.gov/litigation/investreport/34-81207.pdf.

[7] FinHub website states, "as financial technologies, methods of capital formation, market structures, and investor interfaces continue to evolve, FinHub will play an important role in facilitating the SEC's active engagement with innovators, developers, and entrepreneurs. In addition to being a resource for information about the SEC's views and actions in the FinTech space, FinHub is also a forum for engaging with SEC staff." SEC, https://www.sec.gov/finhub (last visited July 8, 2019).

[8] SEC, Statement on "Framework for 'Investment Contract' Analysis of Digital Assets" (Apr. 3, 2019) https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets. This is expected to be updated from time-to-time as the law and circumstances warrant.

to digital assets in order to determine whether a digital asset, in its particular use, is a security.[9] The Framework states that the offer and sale of a digital asset will typically satisfy the first two prongs of the *Howey* test; making the distinguishing factors the reasonable expectation of profits derived from the efforts of others.

Does the Purchaser Have a Reasonable Expectation of Profits? The Framework provides that the stronger the presence of the following characteristics, the more likely it is that the purchaser of the digital asset has a "reasonable expectation of profits":

- The holder of the digital asset has rights to share in the enterprise's income or profits;
- The digital asset is transferable on or through a secondary market;
- The digital asset is offered broadly;
- Purchaser reasonably would expect that the issuer's efforts will result in capital appreciation;
- Little apparent correlation between the purchase/offering price of the digital asset and the market price of the particular goods or services; and
- The issuer expends funds from the proceeds of the sale of the digital asset to enhance the functionality or value of the network or digital asset.

Is that "Reasonable Expectation of Profits" Derived from the Efforts of Others? The Framework also indicates that the stronger the presence of the following characteristics, the more likely it is that the purchaser of the digital asset has "relied on the efforts of others":

- The issuer is responsible for the development, improvement (or enhancement), operation or promotion of the network;
- Essential tasks are performed by the issuer;
- The issuer creates or supports a market for, or the price of, the digital asset;
- Purchaser would reasonably expect the issuer to undertake efforts to promote its own interests and enhance the value of the network or the digital assets.

Digital assets that possess these characteristics are most likely to be classified as a security and subject to federal and state securities regulation. Three recent cases are illustrative of these factors and how the SEC applies them to digital assets.

Gladius Network L.L.C.—GLA Tokens are Securities

[9] The SEC has applied the *Howey* test to multiple digital assets in the past. See *United States v. Zaslavskiy*, No. 17 CR 647 (E.D.N.Y. Sep. 11, 2018); *SEC v. Blockvest, LLC*, No.: 18CV2287-GPB(BLM) (S. D. Cal. Feb. 14, 2019) (a hotly litigated case where the SEC initially failed to obtain a preliminary injunction against the promoter, Reginald Buddy Ringgold III, for the sale of digital assets, but succeeded on rehearing); *CarrierEQ Inc.*, Release No. 10575, Admin. Proc. File No. 3-18898 (Nov. 16, 2018); *Munchee Inc.*, Release No. 10445, Admin Proc. File No. 3-18304 (Dec. 11, 2017); *Paragon Coin, Inc.*, Release No. 10574, Admin. Proc. File No. 3-18897 (Nov. 16, 2018); *Tomahawk Exploration LLC*, Release No. 10530, Admin. Proc. File No. 3-18641 (Aug. 14, 2018).

In *Gladius Network LLC*, the SEC found that the GLA tokens at issue were, in fact, securities.[10] The GLA tokens were to serve as the *sole* "currency" for the services offered within the Gladius network and enable the delivery of content to servers renting out their bandwidth to Gladius customers. The SEC found the GLA tokens to be securities because the sales effort for the GLA tokens consisted of factors that created a 'reasonable expectation of profits', including:

- Broad-based marketing, well beyond Gladius' existing network of subscribers;
- Prospect of increasing value – Gladius claimed, "as more websites join [the Gladius network], the value of the token should rise with demand."
- Intention to list the GLA tokens on secondary "digital asset trading platforms" and consideration of making the GLA tokens available on other exchanges; and
- Intention to use a significant portion of the proceeds from its offering of the GLA tokens for continuing development of its platform.

In the *Gladius* settlement, the SEC did not impose any fines or penalties because of Gladius's cooperation with the SEC.[11] However, the settlement did require that Gladius: (i) make a rescission offer to the purchasers of the GLA tokens; (ii) file a registration statement under the 1934 Act for the GLA tokens; and (iii) meet the periodic reporting requirements under Section 13(a) of the 1934 Act.

Turnkey Jet, Inc.—Digital Tokens for Air-Charter Services are Not Securities

Until recently, the SEC had yet to find a digital asset that was not an investment contract and therefore not subject to federal securities regulation. However, in April 2019 the SEC found that digital tokens to be issued by Turnkey Jet, Inc. were not a security and therefore not subject to federal securities regulation.

Turnkey, a private air charter service, found that dealing with credit cards and wire transfers for payment, resulted in significant delays and inefficiencies which, according to the initial request letter, "can prevent the customer from traveling."[12] To minimize these problems, Turnkey proposed to create a digital asset program for "prepaid on-demand air charter services" which would allow settlement via blockchain to decrease the settlement time and to improve "the efficiencies of paying for, and obtaining, air charter services for both consumers and Turnkey." According to the initial letter requesting a no-action position from the SEC staff, consumers would be able to obtain the air charter services and leave on their trip much faster than under the current system of checks, wire transfers or cash payments for these large transactions. Turnkey cited the reduction in financial transaction costs and the efficiency of delivery as primary advantages for utilizing digital assets.

[10] *Gladius Network L.L.C.*, Release No. 10608, Admin. Proc. File No. 3-19004 (Feb. 20, 2019).

[11] *Id.*

[12] Letter from James Prescott Curry, Esq., to Division of Corporation Finance, SEC (Apr. 2, 2019) (on file with the SEC).

Based on the representations made by Turnkey in the initial letter, the SEC issued its no-action letter stating that Turnkey could sell its token without registration under the 1933 Act and the 1934 Exchange Act.[13] In reaching that conclusion, the SEC cited the following reasons:

- Turnkey will not use the funds from token sales to develop the Turnkey Platform, Network, or App, and each aspect of the platform will be *fully developed* and operational at the time any tokens are sold;
- The tokens will be immediately usable for purchasing air charter services at the time they are sold;
- Turnkey restricts transfers of tokens to Turnkey Wallets only, and will not allow transfers to external wallets;
- Turnkey will sell tokens at a price of one USD per token throughout the life of the Platform, and each token will represent a Turnkey obligation to supply air charter services at a value of one USD per token;
- If Turnkey offers to repurchase tokens, it will only do so at a discount to the face value of the tokens (one USD per token) that the holder seeks to resell to Turnkey, unless a court within the United States orders Turnkey to liquidate the tokens; and
- The token is marketed in a manner that emphasizes the functionality of the token, and not the potential for the increase in token value.

The factors listed in the *Turnkey* no action letter, combined with the *Howey* test, establish a laundry list of guidelines for avoiding 1933 Act registration requirements. Most importantly, prospective issuers of digital assets should consider offering (1) purely consumptive use digital assets, (2) limited marketing emphasizing functionality of the token and excluding claims for increasing value, (3) a fully functioning platform prior to the sale of the digital assets, and (4) restrictions on transfers to wallets external to the issuer's platform.

Pocketful of Quarters, Inc.—Q2 Tokens for Playing Video Games are Not Securities

On July 25, 2019, the SEC Division of Corporation Finance issued a second no action letter finding, in circumstances similar to *Turnkey*, that the issuance of digital coins would not constitute the offer and sale of securities. Like *Turnkey,* this no action letter, *Pocketful of Quarters, Inc.*,[14] also dealt with a fully-developed network that was actually financed by an earlier sale of securities – Q2 Tokens for which Pocketful of Quarters, Inc. ("PoQ") had (in April 2019) filed a Form D under Rule 506(b) for a "simple agreement for future equity" ("SAFE")[15] reflecting the intention to raise an indefinite amount of proceeds and as to which $181,000 had by then been raised.

---

[13] SEC No Action Letter, Response of the Division of Corporation Finance, Turnkey Jet, Inc., (Apr. 2, 2019) available at https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.

[14] SEC No Action Letter, Response of the Division of Corporation Finance, Pocketful of Quarters, Inc. (July 25, 2019) available at https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1.

[15] Available at https://www.sec.gov/Archives/edgar/data/1741667/000174166719000002/xslFormDX01/primary_doc.xml.

The subject of the July 25, 2019 no action letter, "Quarters", were a sixth grader's[16] solution to "prevent the loss of value [of video game tokens] resulting from in-game currency fragmentation, improve player experience, and enhance gameplay behavior" by creating a token that could be used across videogame platforms. When in circulation, these tokens ("Quarters") could be used in a number of approved video game platforms. Among other requirements, the SEC no action letter noted that:

- Funds from the sale of Quarters would not be used to build the platform for the use of the Quarters,
- The Quarters would not be sold until the platform was constructed and therefore the Quarters would be immediately usable,
- Gamers will only be able to transfer Quarters from their "Quarters Hot Wallets" for gameplay to game developers with approved accounts,
- Quarters would be made available to gamers in unlimited quantities at a fixed price, and
- PoQ would market and sell Quarters to gamers solely for consumptive use as a means of accessing and interesting with participating games.

Like *Turnkey*, there would be no likelihood that the Quarters would appreciate in value or be used outside the gaming platform. Like *Turnkey*, the SEC concluded that the Quarters were not securities subject to federal regulation. Unlike *Turnkey*, the *Pocketful of Quarters* no action letter in part relied on the fact that PoQ also agreed to impose "know your customer" rules and anti-money laundering requirements.

The Chuck-E-Cheese Test

The findings in the *Turnkey Jets* and *Pocketful of Quarters* no-action letters are essentially a real-life example of the "Chuck E. Cheese Test" that the SEC's Jonathan Ingram suggested in September 2018.[17] Mr. Ingram, Deputy Chief Counsel for the S.E.C.'s Division of Corporation Finance, told the D.C. Bar Association that digital assets that can pass a "Chuck E. Cheese" test are likely to be exempt from securities regulation. Mr. Ingram described the "Chuck E. Cheese" test as requiring a closed, fully-functional business ecosystem that issues digital assets through an Initial Coin Offering ("ICO"), where holders can use the digital assets within the ecosystem, but the digital assets have limited value beyond that ecosystem. Mr. Ingram stated that digital assets lacking a consumptive nature similar to a Chuck E. Cheese token, are more likely to require registration with the SEC.

Closed system transactions, and digital assets issued for a purely consumption purpose, such as those of Turnkey Jets, will likely avoid a classification as an "investment contract." However, as with the orange groves in *Howey* and, more recently, the certificates of deposit in

[16] See biography at https://www.pocketfulofquarters.com/invest.

[17] Lydia Beyoud, Chuck E. Cheese' Test May Tell SEC If Crypto Token a Security (Dec. 12, 2018 1:08 PM), https://news.bloomberglaw.com/securities-law/chuck-e-cheese-test-may-tell-sec-if-crypto-token-a-security (subscription only). Mr. Ingram utilized an analogy to Chuck E. Cheese – a children's play place where people exchange money for game tokens and use them within the Chuck E. Cheese "ecosystem," but the tokens have virtually no value outside of a Chuck E. Cheese establishment – to illustrate a digital asset that falls outside the scope of a security.

Gary Plastic,[18] even items that are not inherently securities can be transformed into securities through the marketing, offer, and sale of the item.

The SEC's Division of Corporation Finance has suggested that digital assets may initially be "investment contracts", but their networks and decentralized structure could evolve to a point where, eventually, they no longer constitute securities.[19] The guidelines issued in *Howey*, the Framework, and the *Turnkey Jets* and *Pocketful of Quarters* no-action letters, will also provide guidance for companies looking to recategorize its digital assets.

Ultimately, the *Howey* analysis remains important to the issuance of digital assets, even those being issued for consumptive purposes. ICOs need to be analyzed carefully if the issuer hopes to avoid application of the securities laws, either at the initial issuance or when looking to recategorize at a later date. The SEC has noted on several accounts that the evaluation of a digital asset is not static. Rather, asset traders must balance the *Howey* test, the Framework, and the decisional guidance from cases like *Gladius, Turnkey,* and *Pocketful of Quarters*, before concluding its analysis of a digital asset. This conclusion should not be a surprise to any securities lawyer. Corporate finance transactions should generally be viewed as securities transactions and implemented in the customary manner, whether such instruments are represented by tokens on a blockchain or otherwise.

Further Clarification Is Likely Forthcoming

There is hope for further clarification of the digital asset's relationship as securities. The SEC has pursued legal action against Kik Interactive, Inc., arguing that Kik conducted an illegal sale of securities when it issued its ICO in 2017.[20] Kik, a Canadian social media company, claims that it issued the ICO so the resulting tokens, known as Kin, could be used across its social media platform. On the contrary, the SEC argues that Kik issued its ICO in an attempt to raise funds to keep the company afloat. The SEC claims that Kik intended to use the proceeds as funding for the development of its platform. Robert Cohen, chief of the Enforcement Division's Cyber Unit, stated that "Kik told investors they could expect profits from its effort to create a digital ecosystem."[21] Such motivations would likely indicate a reasonable expectation of profits from the efforts of others, thus triggering SEC regulation.

---

[18] In *Gary Plastic*, the court found that the existence of a secondary market for the certificates of deposit being offered and the expectation of the purchasers for investment profits was a critical part of an issuer's marketing efforts for what was otherwise not a security – thus resulting in the offering of the asset being subject to securities regulation. Here, the Second Circuit held that transactions in instruments that themselves are not securities can still be subject to the securities laws when such instruments constitute an "investment contract." *Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*, 756 F.2d 230, 240 (2d Cir. 1985).

[19] William Hinman, Director, Division of Corporation Finance, Remarks at The Yahoo Finance All Markets Summit: Crypto, Digital Asset Transactions: When Howey Met Gary (Plastic) ¶ 15 (June 14, 2018).

[20] *SEC v. Kik Interactive, Inc.*, No. 19-cv-5244, 2019 WL 2365305 (S.D.N.Y. June 4, 2019).

[21] Press Release, SEC Charges Issuer with Conducting $100 Million Unregistered ICO (June 4, 2019) (On file with author).

Kik has vowed to fight the allegations, in hopes of forcing the court to grant the industry more guidance by setting legal precedent regarding digital assets as securities. The case is likely to result in further progress in the way the SEC regulates digital coins.

Regulation A Compliance – The "*Blockstack*" Regulation A Offering

On July 11, 2019, Blockstack PBC filed an offering circular pursuant to Regulation A[22] for the offer of up to 180,333,333 Stacks Tokens at $0.30 per token. The offering circular stated that Blockstack would "use the proceeds of this offering, net of any federal and state income taxes, in conjunction with the proceeds from [certain] private sales . . . for working capital and other general corporate purposes, including but not limited to development of the Stacks Tokens and the Blockstack network and Stacks blockchain, payment of salaries, hiring employees and consultants, supporting the application ecosystem, and organizing and hosting educational and developer events."

The Stacks Tokens were clearly an "investment contract" under the *Howey* and *Gladius* tests, and Blockstack recognized that in the offering circular. However, the offering circular also noted that the Stacks Tokens were intended to be "flexible" and (consistent with the Framework) that the Stacks Tokens may not be securities in the future. As stated in the offering circular:

> For the foreseeable future, Blockstack anticipates treating the Stacks Tokens as securities based on our view that the tokens are "investment contracts" . . . [and are] securities under the laws of certain foreign jurisdictions. However, the board of directors of Blockstack PBC will be responsible for regularly considering and ultimately determining whether the Stacks Tokens no longer constitute securities issued by us under the federal and state securities laws of the United States. . . . At the present time, based on the guidance cited above, we expect this determination to turn on whether the Blockstack network is sufficiently decentralized; this will, in turn, depend on whether purchasers of Stacks Tokens reasonably expect Blockstack to carry out essential managerial or entrepreneurial efforts, and whether Blockstack retains a degree of power over the governance of the network such that its material non-public information may be of special relevance to the future of the Blockstack network, as compared to other network participants. Under current guidance, Blockstack would expect to take the position that if the answers to these questions are that purchasers do not have that expectation, and Blockstack does not have that power, the Stacks Tokens will no longer constitute a security. The board of directors of Blockstack PBC may also assess other criteria for making this determination, including any criteria based on additional guidance we receive from U.S. regulators.
>
> . . . In the event that the board of directors of Blockstack PBC determines that the Stacks Tokens are no longer a security, Blockstack will make a public announcement of its determination at least six months prior to taking any actions based on this determination, such as filing an exit report on Form 1-Z terminating its reporting obligations with respect to the Stacks Tokens under Regulation A. At that time, we anticipate that we will cease to have any reporting or disclosure obligations under federal or state securities laws. Holders of the Stacks Tokens will have no consent or comment rights with respect to this decision.

---

[22] SEC File Number 024-11033, filed pursuant to Rule 253(g)(2). See https://stackstoken.com/static/offering-circular-20190711.pdf.

Colorado's Securities Act

In Colorado, the 2019 General Assembly adopted Senate Bill 19-023 which provides limited exemptions from the securities registration and securities broker-dealer and salesperson licensing requirements for persons dealing in digital tokens. The Bill, adding § 11-51-308.7 to the Colorado Securities Act, defines "digital token" as "a digital unit with specified characteristics, secured through a decentralized ledger or database, exchangeable for goods or services, and capable of being traded or transferred between persons without an intermediary or custodian of value." Senate Bill 19-023 is effective August 2, 2019, and is reflective of the efforts of a number of states to move the discussion forward.

Conclusion

Determining whether cryptocurrency is a security and how to comply with applicable laws is a continuing area of development in federal and state securities regulation.

Ultimately, however, where federal law applies, federal Securities Act of 1933, the *Howey* test, and the actions by the SEC will control the development, offer, and sale of digital tokens.