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Corporate Practice

Your Utility Token May be a Security: SEC Staff Members' Remarks on Cryptocurrency

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On January 22 and 23, 2018, key members of the SEC Staff and the SEC's Chairman commented on cryptocurrency matters at the Northwestern University Pritzker School of Law's 45th Annual Securities Regulation Institute in Coronado, California. At the Institute, the SEC Staff and the SEC Chairman expressed their own views, and not the views of other members of the SEC Staff or the other Commissioners. What follows are high-level notes on some of these remarks. Based on the Staff's remarks, issuers should not assume their token is not a security merely because the issuer has called the token a utility token, especially where the token's value in a secondary market is emphasized in marketing. Further, there is a focus on the extent to which lawyers and other professionals must use judgment and serve as gatekeepers when advising cryptocurrency issuers.

Utility Tokens

William Hinman, Director of the Division of Corporation Finance at the SEC, noted that issuers often try to distinguish utility tokens on the basis that the tokens are not collective investment vehicles, but instead allow a purchaser to buy a good or service. He notes that the importance of the underlying good or service is often very limited and almost secondary in the marketing materials. Rather, the marketing materials tend to focus on potential appreciation in the secondary market. In this regard, the marketing materials tend to include significant discussion of the things the issuers will do to promote secondary activity. Hinman says the SEC is taking enforcement action in these situations. He indicated that many of these tokens are not a utility to be used in a closed system. In analyzing whether a utility token is a security, Hinman points out that the Staff looks at the relative value of the good or service as opposed to the appreciation based on efforts of others. He notes that the Staff also looks at how the issuer treats the secondary market and whether there is a closed system that does not allow for secondary trading, or that allows for only limited secondary trading outside of the closed system.

Given these remarks and recent enforcement activity by the SEC, cryptocurrency issuers should carefully review both the structure and marketing of their token. While some in the cryptocurrency community will be disappointed to hear Hinman's interpretation on the appropriate treatment of utility tokens, the remarks leave open a door for the creation of a true non-security token within a closed system that does not focus on the secondary market or a potential increase in value based on the efforts of others.

Gatekeepers

In his remarks at the Institute, SEC Chairman Jay Clayton emphasized that gatekeepers, such as lawyers, must act responsibly with respect to ICOs and "can do better" than what he has been seeing. He notes that gatekeepers should bring judgment and skepticism. Chairman Clayton is disturbed to see lawyers structuring products with the features of a security and providing legal advice around ICOs that look similar to an IPO, but then claiming that the crypto product is not a security and proceeding with the offering without the protections of a securities offering. Chairman Clayton indicated that he has instructed the Staff to be on high alert for this issue.

Given these remarks and other recent remarks by the SEC Chairman, both in-house and external lawyers should exercise caution in providing advice regarding ICOs.

Mainstreet

Chairman Clayton is most concerned about investors who will be materially impacted, possibly for their whole lives, by the loss of a $10,000 – $50,000 investment.

Given Chairman Clayton's remarks, entities issuing cryptocurrency should consider their target market and understand that there may be extra scrutiny from the SEC to the extent that less-sophisticated investors or investors with fewer resources are harmed, or may potentially be harmed, by a loss of investment in the cryptocurrency.

SEC Consultation

Hinman indicated that the SEC is willing to meet with companies to discuss token issues in more depth and is involved in ongoing discussions with some potential issuers regarding structuring compliant offerings.

Potential cryptocurrency issuers should consider consulting with the SEC regarding their proposed structure and how they will conduct a compliant issuance well in advance of launching or marketing their offering.

Name Changes

Chairman Clayton flagged what he called a problematic practice, in which a public company with no operating history in blockchain begins to dabble in blockchain, changes its name to be blockchain-oriented and then offers securities to investors without the appropriate disclosures. He indicated that the SEC is looking closely at public companies that shift to capitalize on blockchain and provide inadequate disclosure to investors.

Shelley Parratt, Deputy Director of the Division of Corporation Finance at the SEC, also discussed public companies emphasizing their work in the crypto area by adding ‘blockchain’ or ‘cryptocurrency’ to their name and changing their business description. The Staff is watching press reports and Forms 8-K where companies are changing their names. She noted that there is nothing wrong with a company reinventing itself, but there are important disclosure requirements. Parratt indicated that, to the extent such a name change is a fundamental change to the company, and therefore alters the total mix of info about the company, companies engaged in offerings should be mindful that all offering material, including the prospectus on file for the offering, is complete and accurate. She encourages issuers and practitioners to reacquaint themselves with Item 501(b)(1) of Reg. S-K. Parratt noted that if a company’s name indicates a line of business in which it is not engaged, or engaged only to a limited extent, the company should include information that eliminates any confusion.

These remarks follow the SEC’s recent suspensions of trading of certain companies with blockchain- or crypto-oriented names. Although these comments are directly applicable to only a limited number of companies, they may suggest some broader lessons. First, any public company with a name out of line with its actual business should consider whether it needs to include additional disclosure to clarify. Second, any public company engaging in cryptocurrency activity should consider whether its disclosure around that activity is accurate and complete.

Moving Forward

In sum, any issuer claiming their token is a utility token should tread cautiously in both the technical structure and marketing of their token. While comments by the SEC Staff and the SEC Chairman do not constitute law, the cryptocurrency community’s assessment of which cryptocurrencies are securities should take into account these views. These recent remarks encourage accurate and complete disclosure as well as a careful securities analysis for cryptocurrency offerings.

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