

Cryptocurrency 'security' questions clarified by SEC

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In a June speech, William Hinman, director of the Securities and Exchange Commission's Division of Corporate Finance, began to place additional definition around the debate over whether digital assets, including tokens, are securities. Until that speech, much commentary had focused on statements repeated by SEC officials that digital assets distributed in initial coin offerings are almost always securities in the commission's view, with the possible exception of widely disseminated cryptocurrencies like bitcoin. Hinman's remarks set out the view that, in their initial phases, tokens are more likely to constitute securities under the U.S. Supreme Court's *Howey* test, but in limited circumstances may, over time, shed enough of the characteristics of securities to lose that designation. *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946).

Under the rubric Hinman laid out, the new hallmark of success for a token project may become the point at which a project's tokens are so widely used and supported that they function without any centralized efforts and lose their securities status.

Hinman's Framework

Consistent with past comments from Hinman and other SEC staff, Hinman stated that most, if not all, sales of digital assets in initial coin offerings he has seen satisfy *Howey's* "investment contract" test and should be treated as securities.

The clarification came in Hinman's next explanation: that tokens that start out as securities can later change their characteristics such that they no longer would be securities. He explained, "[i]f the network on which the token or coin is to function is sufficiently decentralized — where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts — the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede."

In other words, issuers may structure their token platforms in a manner that initially requires significant setup and investment, but, if the network and tokens eventually become self-sustaining, the tokens can lose their status as securities.

Having drawn this distinction between more and less mature projects, Hinman then laid out a variety of non-exhaustive questions relevant to the analysis of which side of the line a particular project (or a particular project at a particular time)



New York Times News Service

SEC Chairman Jay Clayton testifies at a Banking Committee on virtual currencies earlier this year.

would fall:

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
5. Is the asset marketed and distributed to potential users or the general public?
6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
7. Is the application fully functioning or in early stages of development?

Ultimately, Hinman says, "we would look to the economic substance of the transaction" to determine the standing of a given token project.

Clayton Confirms

It appears that Hinman's view is not a one-off. Testifying before the Committee on Financial Services of the U.S. House of Representatives, SEC Chairman Jay Clayton referred to Hinman's June 2018 remarks saying, "[o]ur Corporation Finance Division director recently further outlined the approach staff takes to evaluate whether a dig-

ital asset is a security.'

Clayton's reference suggests that Hinman's framework is not merely his personal view, but rather an approach taken by the staff as a whole.

Moving Forward

For platforms designed to run independently after a certain point — or that can be adapted to do so — tokens that the SEC would previously consider securities may transition and become non-securities tokens. The factors laid out by Hinman establish a useful baseline for predicting where the SEC will draw the line, with project participants on notice that they will need to comply with securities laws until platforms are "sufficiently decentralized."

But numerous issues still remain. The concept of being "sufficiently decentralized" has not yet been tested, and some reports draw into question just how decentralized certain cryptocurrency ecosystems truly are. Recently, for instance, reports indicated that the Zcash Foundation paid money to a developer to prevent a fork of the protocol. Likewise, earlier this year, a report prepared by researchers at Cornell indicated that neither ether nor bitcoin was as decentralized as initially thought. This issue will likely be tested in the months and years to come. Further, projects may need to add new disclosures around the transition from securities tokens to non-securities tokens, including that the protections of the securities law may, at some point, cease to apply. And, in addition, some commentators have surmised that this new framework may breathe new life into the movement for the use of Simple Agreement for Future Tokens, or SAFTs; however, no SEC official has formally endorsed SAFTs and Hinman's prepared remarks expressly disavowed any view on whether any particular SAFT passed muster, noting that each case is reviewed on its particular economic substance and advising those with questions to contact the SEC.

In all, these and other questions will continue to be debated. And, as the market develops its understanding of the mix of factors that will safely render a token a non-security, any potential distributor of tokens should work closely with counsel to ensure its tokens comply with applicable legal requirements.

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