

Stradley Ronon Stevens & Young, LLP  
2005 Market Street  
Suite 2600  
Philadelphia, PA 19103-7018  
215.564.8000 Telephone  
215.564.8120 Facsimile  
www.stradley.com

With other offices in:  
Washington, D.C.  
New York  
New Jersey  
Illinois  
Delaware

## I'll Have What Ether's Having – Top SEC Official Educates Crypto Audience on Federal Securities Law Basics and Ether Passes the Test

In a keenly anticipated speech from a key official at the Securities and Exchange Commission (SEC) last week, a global audience heard several important messages about the SEC staff's approach to regulating cryptocurrency, and in particular Ether, under the federal securities laws.<sup>1</sup>

First, and perhaps of greatest interest in the short term, is the message that Ether, like Bitcoin, is not a security, at least in its present form and when sold in the secondary market.

Second, the status of a cryptocurrency under the federal securities laws is not static, nor does it strictly inhere to the instrument itself. A cryptocurrency token may be part of a securities offering when first issued, and not sold as a security later on when the platform is operational and the network is decentralized. On the other hand, the same "non-security" token could be packaged in a trust by a promoter and sold as part of a new security.

Third, in applying the famous "*Howey* test" – the test formulated by the Supreme Court in 1946 to determine whether an instrument is the type of security known as an investment contract – to cryptocurrency tokens, the most important criterion will be how much purchasers of the token are expecting profits in reliance on the efforts of third party promoters of the token, rather than relying on the functionality of the token itself.

The cryptocurrency markets greeted these pronouncements from William Hinman, the Director of the SEC's Division of Corporate Finance, with exuberance, and the price of Ether rose nine percent. Nonetheless, while the words were welcome, a few notes of caution are in order from beneath the sound bites:

First, Mr. Hinman does not speak for the Commission, as a footnote to the speech states. It can be expected, of course, that his words were vetted within the agency, but the Commission is not bound by them. The speech indicated that the SEC is prepared to provide formal guidance in the future based on specific facts.

Second, the SEC appears to be holding fast to the view that initial coin offerings are presumptively securities offerings subject to regulation by the SEC. The "not a security" statement regarding Ether is limited to current secondary market sales.

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

Copyright © 2018  
Stradley Ronon Stevens & Young, LLP  
All rights reserved.

<sup>1</sup> Remarks at the Yahoo Finance All Markets Summit: Crypto: "Digital Asset Transactions: When *Howey* Met Gary (Plastic)," William Hinman, Director, Division of Corporation Finance, San Francisco, CA (June 14, 2018), available at <https://www.sec.gov/news/speech/speech-hinman-061418>.

Third, the speech reflects a confirmation, in Mr. Hinman's view at least, that the SEC's existing framework is fully up to the task of being applied to cryptocurrency. In other words, the wine may be new, but the old bottles are still sound, and the SEC is likely to use them.

Caveats aside, the speech is well worth reading, and there are a number of significant takeaways that can reasonably be drawn to enhance the industry's understanding of the SEC's thinking on the subject.

## 1. Ask the Right Question

Questions about the status of Ether and other cryptocurrencies are often phrased as "is it a security?" A variation on the question is whether a digital asset offered as a security can, over time, become something other than a security.

According to Mr. Hinman, the better question is, "Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security?" Phrasing the question in this manner focuses the analysis not on the digital asset itself, but on the circumstances surrounding the digital asset and the manner in which it is sold.

As to the answers, here are Mr. Hinman's:

- Where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise, the answer is "likely no" – that is, the digital asset is still offered as a security.
- 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, the answer is "a qualified yes" – that is, the digital asset is no longer being offered as a security.

## 2. Labeling Is Not Determinative

Calling a transaction an initial coin offering, or "ICO," or a sale of a "token," will not take it out of the purview of the U.S. securities laws. This is not news – substance over form is the cornerstone of the traditional "security" analysis. But it bears mentioning here, as Mr. Hinman made the point three times in his speech. "Let me emphasize an earlier point: simply labeling a digital asset a 'utility token' does not turn the asset into something that is not a security."

## 3. Back to Basics – a Primer on the "Howey" Test

Before addressing Ether, Mr. Hinman took the opportunity to give his audience a plain English primer on the "Howey" test, including its basic elements and the facts upon which it was forged.<sup>2</sup> While admitting that a discussion of the federal securities laws fundamentals applicable to digital transactions might be dryer than a discussion of the promise of blockchain technology itself, he viewed the former as a necessary first step. "[F]ocus on the application of the federal securities laws to digital asset transactions – that is how tokens and coins are being issued, distributed and sold – ... is critical to the broader acceptance and use of these novel instruments."

### a. Components of the Test

A security is being offered (in the form of an investment contract) where there is:

- an investment of money
- in a common enterprise
- with an expectation of profit derived from the efforts of others.

### b. The Facts in Howey – Sale of "Orange Groves"

The SEC sued the Howey parties (W. J. Howey Company and Howey-in-the-Hills Service, Inc.) to enjoin them from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and

<sup>2</sup> See *SEC v. Howey Co.*, 328 U.S. 293 (1946).

nonexempt securities – units of a citrus grove development, coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor – in violation of the Securities Act of 1933. As described in the speech, the key facts were:

- A hotel operator sold interests in a citrus grove to its guests and claimed it was selling real estate, not securities.
- While the transaction was recorded as a real estate sale, it also included a service contract to cultivate and harvest the oranges.
- The purchasers could have arranged to service the grove themselves but, in fact, most were passive, relying on the efforts of Howey-in-the-Hills Service, Inc. for a return.

Overturning the decisions of the two lower courts to the contrary, the Supreme Court held that the transactions clearly involved investment contracts. In articulating the now famous three-part test, the Supreme Court stressed that “[f]orm [is] disregarded for substance and the emphasis [is] placed upon economic reality.”

As Mr. Hinman explained: “So the purported real estate purchase was found to be an investment contract – an investment in orange groves was in these circumstances an investment in a security.”

#### 4. Application of the *Howey* Test to ICOs – It’s Easy

##### a. The “Typical” ICO Scenario

Mr. Hinman described what he often sees in ICOs.

- In order to raise money to develop networks on which digital assets will operate, promoters often sell the tokens or coins rather than sell shares, issue notes or obtain bank financing.
- In many cases, the economic substance is the same as a conventional securities offering.
- Funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument – usually by selling their tokens in the secondary market once the promoters create something of value with the proceeds and the value of the digital enterprise increases.

##### b. Tokens v. Orange Groves – Similarities

“When we see that kind of economic transaction, it is easy to apply the Supreme Court’s ‘investment contract’ test first announced in *SEC v. Howey*.” As Mr. Hinman explained:

- Just as in the *Howey* case, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit.
- As in *Howey* – where interests in the groves were sold to hotel guests, not farmers – tokens and coins typically are sold to a wide audience rather than to persons who are likely to use them on the network.
- Promoters tout their ability to create an innovative application of blockchain technology.
- At that stage, the purchase of a token looks a lot like a bet on the success of the enterprise and not the purchase of something used to exchange for goods or services on the network.
  - Like in *Howey*, the investors are passive.
  - Marketing efforts are rarely narrowly targeted to token users.
  - Typically at the outset, the business model and very viability of the application is still uncertain.

- The purchaser usually has no choice but to rely on the efforts of the promoter to build the network and make the enterprise a success.

**c. Need for Securities Regulation of ICOs – Correcting Information Asymmetry Between the Investor and Promoter**

“The impetus of the Securities Act is to remove the information asymmetry between promoters and investors. In a public distribution, the Securities Act prescribes the information investors need to make an informed investment decision, and the promoter is liable for material misstatements in the offering materials.”

As explained by Mr. Hinman, providing these important safeguards for investors in ICOs – where digital code is sold to nonusers as part of an investment by promoters to develop the enterprise – by regulating them as securities offerings makes sense under this rationale. Where success of the enterprise and the investor’s ability to make a profit turn on the efforts of the third party (the promoter), learning material information about the third party – its background, financing, plans, financial stake and so forth – is a prerequisite to making an informed investment decision.

“Without a regulatory framework that promotes disclosure of what the third party alone knows of these topics and the risks associated with the venture, investors will be uninformed and are at risk.”

**d. What Else Is “In” or “Out” – Principles and Examples**

Tokens, like orange groves, are not securities all by themselves. The central question in determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers.

“[U]nder certain circumstances, the same asset can be offered and sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others.”

The speech provides examples of assets and transactions that are in (subject to securities regulation) vs. related transactions that are out (not subject to securities regulation). In the “out” category are a house purchased to live in, individual certificates of deposit (CDs) and Scotch whisky. In the “in” category are housing units offered with a management contract or certain other services, CDs offered as part of a program organized by a broker who offers retail investors promises of liquidity and the potential to profit from changes in interest rates, and whisky warehouse receipts sold by promoters to finance the aging and blending processes of Scotch whisky.<sup>3</sup>

**5. Application of *Howey* to Secondary Transactions – Not as Easy**

While concluding that ICOs generally involve the offering of securities may be easy, whether a transaction in a coin or token on the secondary market amounts to an offer or sale of a security requires a careful and fact-sensitive legal analysis.

**a. Principle – Presence of a Decentralized Network**

By the same reasoning applied to ICOs, which focuses on the importance of the promoter, when the “efforts of others” are no longer a key factor for determining the success of the enterprise, a digital asset transaction may no longer represent a security offering.

“If 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.”

At the same time, with the advent of decentralization, material information asymmetries recede.

“As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.”

---

<sup>3</sup> In additional remarks made on the “Closing Bell” program on CNBC, Mr. Hinman also **expressed the view**, to the **apparent** relief of the interlocutors, that their memberships in a book club or a functioning golf club (with a real golf course) would **likely** not be securities.

## b. Bitcoin – Not a Security

Based on this logic, Bitcoin is not a security.<sup>4</sup> The key facts and circumstances are:

- There is no central third party whose efforts are a key determining factor in the enterprise.
- The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception.
- Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value.

## c. Ether – Currently Not a Security

Some two thirds of the way through his speech, Mr. Hinman turned to the question that was probably uppermost on his audience's mind – the securities law status of Ether.<sup>5</sup> His answer – current offers and sales of Ether are not securities transactions – was viewed by many as well worth waiting for. Nonetheless, it was more guarded and complex than the analysis for Bitcoin.

First, Mr. Hinman put to the side “any question of the fundraising that accompanied the creation of Ether.” This leaves open the possibility that, unlike the origins of Bitcoin, the initial offering of Ether may have involved a securities offering.

Second, the current “not an offering of securities” conclusion for Ether is based on Mr. Hinman's “understanding of the present state of Ether, the Ethereum network and its decentralized structure.” This hedging language, which did not appear in the Bitcoin analysis, may be intended to reserve some right for further analysis if new facts come to light (or sales are made in ways that are different from Mr. Hinman's understanding). The current conclusion was based on the view that “as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.” Different facts could change that conclusion.

## d. Other Cryptocurrencies and Related Products

The speech did not address any other specific tokens, but stated that “[o]ver time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required.” The lead in phrase “over time” is ambiguous; one possible inference is that, at present, only sales of Bitcoin and Ether are outside the scope of the federal securities laws by virtue of their decentralized networks. By contrast, the existence of other tokens that remain securities is a certainty: “[O]f course there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise,” in which cases “application of the securities laws protects the investors who purchase the tokens for coins.”

## 6. Words to the Wise

### a. Consider Conventional Funding as Alternative to ICOs

Mr. Hinman suggested that the nonsecurity status of tokens could be clarified by the use of conventional securities fundraising for initial capital. Then, once the network is up and running, tokens or coins could be distributed to participants who need the functionality the network and the digital assets offer.

“This allows the tokens or coins to be structured and offered in a way where it is evident that purchasers are not making an investment in the development of the enterprise.”

---

<sup>4</sup> This was not news. *See, e.g.*, SEC Chairman Jay Clayton speaking on April 26th in a hearing before a House Appropriations subcommittee, informing lawmakers that cryptocurrencies that function exclusively as mediums of exchange are not securities, unlike ICOs, which are. He added that “[a] pure medium of exchange, the one that's most often cited, is Bitcoin.” David Murray, “*Bitcoin Is Not a Security: SEC Chairman*,” BlockExplorer News (April 27, 2018), <https://blockexplorer.com/news/bitcoin-is-not-a-security-sec-chairman>.”

<sup>5</sup> Concern about the status of Ether, the most popular cryptocurrency other than Bitcoin, was heightened after Gary Gensler, the former chairman of the Commodity Futures Trading Commission, said in April that Ether is probably a security. *See* Camila Russo, “Former CFTC Head Says Big Cryptocurrencies Could Be Classified as Securities,” Bloomberg (April 23, 2018), <https://www.bloomberg.com/news/articles/2018-04-23/ether-ripple-may-be-securities-former-cftc-head-gensler-says>.

**b. Even “Nonsecurity” Tokens can be Packaged to Create New Securities**

Mr. Hinman emphasized that “the analysis of whether something is a security is not static and does not strictly inhere to the instrument.” Even Bitcoin (or other digital assets with utility that function solely as a means of exchange in a decentralized network) could be packaged and sold as an investment strategy that can be a security (e.g., by placing Bitcoin in a fund or trust and selling interests). “[I]nvestment contracts can be made out of virtually any asset (including virtual assets), provided the investor is reasonably expecting profits from the promoter’s efforts.”

**c. Seek SEC Guidance to Avoid Fallout Consequences**

In closing, Mr. Hinman emphasized the importance for promoters and other market participants of understanding whether transactions in a particular digital asset involve the sale of a security, and the numerous implications that follow where that is the case. In order to help market participants make their services compliant within the existing framework, he offered the SEC staff’s assistance in working through these issues, as well as a nonexclusive list of illustrative factors that the staff would look at to determine the economic reality of the transaction in question.

This invitation is worth serious consideration. As Mr. Hinman notes, the consequences of getting the status question wrong are serious indeed. Whether this is a realistic suggestion for the industry as a whole is not clear – there are over 1,600 cryptocurrencies in circulation already, and as happy as the staff is to engage, they may experience constraints on time and resources if RSVPs to the invitation are voluminous.<sup>6</sup> Still, those who do engage can play a role in shaping the guidance that the rest of the industry will ultimately have to live with.

**7. Conclusion – What’s New?**

Much of the speech was a recap, especially to securities lawyers, who knew that the SEC would use the *Howey* test to analyze the securities status of digital assets, that Bitcoin was not a security under the test, and that the SEC believes that most, if not all, ICOs are securities offerings.

But some things are, if not entirely new, at least clearer now. Certainly the pronouncement of the status of Ether in its present form as not a security was taken as something of a revelation. In addition, the translation of the *Howey* test to meet the unique circumstances of digital asset transactions is an advance, in particular the focus on decentralization as a move away from the “efforts of others.” The specific questions Mr. Hinman poses (which can be found at <https://www.sec.gov/news/speech/speech-hinman-061418>) provide further detail on how the old bottles can be used for this new wine.

Mr. Hinman’s formal but warmly expressed invitation for market participants to engage is also a step forward, and the ground rules he laid out, including the detailed questions, show possible takers what they can expect and how they should prepare. This bodes well for the possibility of more regulatory certainty emerging through reasoned discourse and advance notice, rather than through regulation by enforcement.

**If you would like more information, contact:**



**John M. Baker**  
jbaker@stradley.com  
202.419.8413



**Sara P. Crovitz**  
scrovitz@stradley.com  
202.507.6414



**Ruth S. Epstein**  
repstein@stradley.com  
202.292.4522



**Nicole M. Kalajian**  
nkalajian@stradley.com  
312.964.3507

<sup>6</sup> All Cryptocurrencies, <https://coinmarketcap.com/all/views/all/> (1,604 cryptocurrencies as of June 21, 2018).