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**BLOG**

# When It Comes to Analyzing Utility Tokens, the SEC Staff's "Framework for 'Investment Contract' Analysis of Digital Assets" May Be the Emperor Without Clothes (Or, Sometimes an Orange Is Just an Orange) (Part II)

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*This is the second in a series of posts critical of the SEC's approach to analyzing so-called "utility tokens" under the federal securities laws. The first post can be found here.*

**Part II: Utility Tokens Are Not Transformed Into "Investment Contracts" Simply Because They Are Sold Pursuant to Them**

In my first post in this series, I concluded that it is untenable to argue that a utility token can be an "investment contract" in its own right. In this post, I will dispose of the corollary notion that the nature of the *contract, transaction* or *scheme* pursuant to which utility tokens are offered and sold determines the nature of the tokens received by the token purchaser. In my next post, I will suggest—based on the conclusions reached in my first post and in this post—some hypothetical scenarios in which issuers of utility tokens should be free to offer and sell tokens without regard to the application of the federal securities laws.

Just as it cannot credibly be argued that a utility token is an "investment contract" in its own right, it cannot credibly be argued that, if a utility token is offered and sold pursuant to an "investment contract," the utility token is somehow transformed into an "investment contract."

I am not the first to observe that, had the promoter and the investors in *Howey*[i] agreed that participants in the "investment contracts" in question would receive their profits in the form of bushels of oranges instead of cash, no one could credibly argue that the oranges were themselves "investment contracts" (or any other form of a "security," for that matter) simply because investors received them as a result of their participation in such "investment contracts."

Or consider the case of so-called "whisky warehouse receipts." At issue in *SEC v. Glen-Arden Commodities, Inc.*[ii] was whether the offer and sale of receipts evidencing ownership of whisky stored in bonded warehouses in Scotland constituted "investment contracts," and thus securities. While, as we shall see, the court concluded that, under the facts and circumstances of that case, the "whisky warehouse receipts" in question constituted "investment contracts," there is not even the slightest suggestion that the casks of whisky represented by such receipts constituted "investment contracts."

Before launching into a recitation of the facts of the case, the court, after citing *Howey*, noted that "[i]t is clear then that the manner in which the Scotch whisky warehouse receipts were sold, the information given, profits predicted, services promised and the obligations to be assumed by the purchasers were at all times relevant to the proceedings before the court."[iii] The recitation of facts would demonstrate that there was a lot more to the offer and sale of the receipts in question than a simple offer and sale of evidences of ownership of casks of whisky.

The evidence established that the defendants' mode of operation was to recruit salesmen familiar with neither the Scotch whisky business nor investment practices, provide these salesmen with a "canned" sales pitch along with sales literature and direct them to potential customers solicited through mass merchandising techniques such as newspaper advertisements and the indiscriminate use of mailing lists. The training of the salesmen consisted of meetings at which defendants or their employees provided data on the price of Scotch whisky, the cost of insurance and cooperage and the profits which could be anticipated from an investment in Scotch whisky warehouse receipts.[iv]

The evidence also established that representatives of the issuer of the receipts ("WWR Issuer") informed prospective purchasers at promotional meetings that: (i) the WWR Issuer would utilize its expertise in selecting the type and quality of Scotch whisky and casks to be purchased; (ii) receipt-holders could call the WWR Issuer to obtain current information about the Scotch whisky market; (iii) the WWR Issuer would provide the cooperage of the whisky; (iv) the WWR Issuer would provide two insurance policies to protect the investments; (v) when the receipt-holders wished to sell their whisky, the WWR Issuer would assist them in making a sale at the current pricing schedule, charging no fee or commission; (vi) the WWR Issuer would handle all administrative details relating to the program; and (vii) customers could expect a doubling of the value of their investment within three to four years and further increments after that.[v]

The prices provided to the salesmen and then quoted to potential customers were inflated and well in excess of the average market prices for Scotch whisky. In addition, salesmen were encouraged to make "quick" presentations using the "support" data supplied by the defendants. Salesmen were specifically instructed not to leave this data with the customers, and customers testified that no data was left with them after sales presentations. The customers were given sales literature and the documents of title only. Each investor was furnished with an original sales order that set out the quantity of whisky and its price, a confirmation of the sales order that included the registration numbers for each barrel, a copy of a warehouse keeper's record reflecting transfer of title to the customer, a transfer warrant issued by the distillery confirming transfer and registration of ownership to the purchasing investor, two insurance policies issued by Lloyds of London, and a form ordering the warehouse keeper to transfer ownership, which included a warranty of the new owner's signature. The sales literature extolled the virtues of an "investment" in Scotch whisky in bond and promised exceptional capital growth because of the unique quality of Scotch whisky in that its value enhances merely with age.[vi]

According to the testimony of the customers, they were not knowledgeable about the Scotch whisky market and relied solely on the expertise of the WWR Issuer to manage their investments. In addition, of critical importance was the testimony of all the investors that, if they had not been furnished cooperage and insurance and had not been promised assistance in the liquidation of their investments, they would not have purchased the warehouse receipts.[vii]

Based on these facts, the court found that there was no merit in the WWR Issuer's contention that it was merely selling gallons of raw unblended whisky that could be consumed, sold or dealt with as a purchaser saw fit. According to the court:

> "The sale of the warehouse receipts must be viewed in their totality; substance and not form is controlling. Unquestionably, the warehouse receipts were merely a means by which the defendants transacted their business. Their true product was an investment package. Ownership, right of possession or the right to consume were in reality of little import to the purchasers of the receipts. Defendants' solicitation, its [sic] advertisements, its [sic] sales literature and, most importantly, the statements of its [sic] salesmen, emphasized that the purchasers were making an investment. Prior to the consummation of a sale, no attempt was made to apprise an investor of the risks and obligations he was assuming. It was only when an investor attempted to liquidate his investment that he was advised of the true significance of his holdings. The court finds that the

> 'investment package' offered and sold by defendants is a security within the ambit of section 2(1) of the Securities Act of 1933." [citations omitted][viii]

The conclusion of the court is not at all surprising. But let's assume that some of the customers had decided to take possession of their casks and sell them on the open market in order to realize profits on their original investments. Would those casks be considered securities, simply because the contracts pursuant to which those customers purchased the casks were "investment contracts?" To ask the question is to answer it.

Finally, leave it to the beavers to make my point. At issue in *Continental Marketing Corporation v. SEC[ix]* was whether an "investment contract" was offered and sold under the following facts and circumstances:

> "Appellant was organized in 1965 as a Colorado corporation and thereafter represented itself as an integral part of the organized domestic beaver industry. Its sales literature, couched in such glowing terms as 'fabulous possibilities' and the 'road to riches,' presented to the prospective purchaser a history of the development of the beaver industry with specific reference to the activities, both past and present, of co-defendants and illustrated for the benefit of the purchaser a charted explanation of what was available in service after purchase of the beaver from appellant. The chart lines a sale of beaver from appellant (or either of two other defendant sales companies) to the owner purchaser. Thereafter the owner may care for his own animals with each pair of beaver requiring a private swimming pool, patio, den and nesting box together with the services of a veterinarian, dental technician, breeding specialist, etc. or the owner may choose to place his animals (at a cost of $6 per month per animal) with a professional rancher who is a member of the defendant North American Beaver Association which in turn has available the technical assistance of two ranchers' service companies… All purchasers of beaver were encouraged not to take possession of the animals and although Continental made over two hundred sales in sixteen states, grossing over a million dollars, all who purchased from appellant elected not to take possession of their beavers and each contracted with one of the ranchers as suggested by appellant.
>
> The history of the domestic beaver industry as represented to prospects by Continental and as revealed by the evidence taken at trial need only be briefly summarized. Prior to 1950, Mark Weaver, one of the defendants… had successfully developed a small herd of domestic beavers and purportedly was 'the first in the world to learn the secrets of the beaver' by discovering 'the feed formula, the mating process, the pen design, [and] the other factors necessary to induce the beaver to reproduce in captivity.' In an attempt to broaden the industry sufficient to establish a market for domestic beaver fur, a program was developed whereby members of the public were invited to invest in beavers. The investor could take up beaver ranching or ranch his beavers with Weaver or someone whom Weaver had induced to take up ranching. In any event, the ranching was done under Weaver's expert supervision and Weaver provided many services incident to the domestic raising of beavers."[x]

The court held that "in this setting" the transactions in question involved the sale of "investment contracts:"

> "Continental's appearance to the public, by design, was that of a representative of the domestic beaver industry, the growth and development of which was necessary to and would bring profit to investors. Purchasers were encouraged to leave their beavers at the ranches where they were located at the time of sale and where they would be 'expertly housed, fed and otherwise cared for.' They were advised that all they needed to do was buy the beavers, pay ranching fees and reap 'geometric profits' as the beavers reproduced and the offspring sold. It was to be a 'once in a lifetime opportunity' and 'an opportunity to share in the profits of the breeding stock stage * * * the most lucrative stage in the development of the beaver industry…
>
> Investment by members of the public was a profit-making venture in a common enterprise, the success of which was inescapably tied to the efforts of the ranchers and the other defendants and not to the efforts of the investors…[xi]

Again, this is hardly a surprising result. But if the investors had decided to break free of their investment contracts by taking possession of the beavers (which they were entitled to do) and selling them on their own in the open market, would anyone seriously contend that the beavers were securities, subject to restrictions on resale under the securities laws?

The conclusion is clear: a distinction must be made between an "investment contract," on the one hand, and a consumptive item that is sold pursuant to an investment contract, on the other hand. The fact that an "investment contract" leads an investor to believe that he or she will receive a return of capital plus profits in connection with the purchase of a consumptive item does not result in the conclusion that the consumptive item sold pursuant to such "investment contract" is transformed into an "investment contract" by virtue of being sold pursuant to one. If the issuer of utility tokens and an investor enter into a contract in which the issuer says: you invest your money with me, and I will use that money to develop a platform that will be of great value to its users, who can be expected to buy the tokens from you at a premium over the prices you paid me for them – that may well be an "investment contract." But the utility tokens issued pursuant to that contract are not, by reason of that fact, "investment contracts" (or any other form of "security").

At first blush, the receipt of utility tokens sold pursuant to an "investment contract" may be thought to be different from receipt of consumptive items such as casks of whisky or bushels of oranges. This is because after a utility token is issued, and even after it is fully functional, the issuer of the token may continue to develop the platform on which the token may be used to purchase goods and services, with the result that the token may increase in value over time based on the managerial or entrepreneurial efforts of the issuer. But, upon close analysis, the same may be said of consumptive items like oranges. Suppose, for example, that a promoter who has agreed to pay investors in the form of bushels of oranges has also promised to engage, around harvest time, in a nation-wide advertising campaign aimed at increasing the demand for, and thus potentially the price of oranges. In other words, suppose the oranges stand to continue to increase in value as the result of the managerial or entrepreneurial efforts of others. [xii] Can it seriously be argued that the ***oranges*** have now been transformed into securities? Must resales of the oranges be stamped with a "restricted securities" legend, right beneath the Sunkist trademark? To be sure, if a participant in the "investment contract" who receives oranges as a result of his participation in such contract were to seek to resell those oranges by employing promotional and marketing efforts that emphasize the potential for continuing appreciation in the value of the oranges resulting from the managerial or entrepreneurial efforts of others, such efforts may involve such reseller in the offer and sale of an "investment contract." But that does not alter the fact that the oranges that are being offered and sold pursuant to such "investment contract" remain consumptive items that are not securities of any type, even though they stand to increase in value over time as a result of the managerial or entrepreneurial efforts of others. Sometimes, an orange is just an orange.

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[i] *SEC v. W. J. Howey Co.,* 328 U.S. 293 (1946).

[ii]368 F. Supp. 1386 (E.D.N.Y 1974), *aff'd sub nom. Glen-Arden Commodities, Inc. v. Costantino*, 493 F. 2d 1027 (2d Cir. 1974).

[iii]*Id.* at 1388.

[iv]*Id.* at 1389.

[v]*Id.*

[vi]*Id.* at 1389-90.

[vii]*Id.* at 1390.

[viii]*Id. See also, SEC v. Haffenden-Rimar Int'l, Inc.*, 362 F. Supp. 323 (E.D. Vir. 1973), *aff'd*, 496 F. 2d 1192 (4th Cir. 1974); *SEC v. Bourbon Sales Corp.*, 47 F. Supp. 70 (W.D Kentucky 1942).

[ix]387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968).

[x]*Id.* at 468-9.

[xi]*Id.* at 470; *see also*, *Waterman v. Alta Verde Indus., Inc.*, 643 F. Supp. 797 (E.D.N.C. 1986) (cattle feeding program); *SEC v. M.A. Lundy Associates*, 362 F. Supp. 226 (D. R.I. 1973) (whisky warehouse receipts).

[xii]Admittedly, oranges do not have a very long shelf life, so they are not susceptible to secondary market trading for an extended period. But, at the risk of comparing apples with oranges, let's assume for purposes of our example that oranges have a shelf life similar to that of apples, which can be stored in refrigerated, climate-controlled warehouses for up to a year before they find their way to your local grocery store, thereby leaving plenty of time for secondary market trading. *See* Kristen Michaelis, "Your Apples Are a Year Old" (*Food Renegade*, April 8, 2018).
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