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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 III)

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This is the third in a series of posts critical of the SEC's approach to analyzing so-called "utility tokens" under the federal securities laws. The first and second posts can be found here and here. This post, like the previous two, is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts. Further, the legal treatment of utility tokens is uncertain and continues to develop, and there can be no assurance that any court or regulator would agree with any of the conclusions set forth below.

Part III: What Token Issuers (and Token Resellers) Should Be Free To Do, and When

I wrote in my previous two posts that:

- An "investment contract" is a *contract, transaction* or *scheme* whereby:

  (1) a person invests money

  (2) in a common enterprise and

  (3) is led to expect profits solely from the efforts of the promoter or a third party.

- An item, such as a utility token, that is inherently consumptive in nature cannot be an "investment contract" (or any other form of "security") in its own right.
- Utility tokens are not transformed into "investment contracts" simply because they are sold pursuant to them.

Where does this leave us?

Based on these three conclusions, I sketch out below certain conclusions that I believe follow from them (as supplemented by additional federal securities law considerations). I will provide additional support, grounded in case law, for the conclusions set forth below in subsequent posts.

1. Subject to the considerations set forth in conclusion 3 below, when an issuer of utility tokens and persons acting on its behalf[i] offer and sell such tokens as consumptive items, and, in connection with promoting such tokens, do not make promises or representations that, analyzed ***objectively***, would ***lead potential investors to expect***

profits attributable to the managerial or entrepreneurial efforts of others as a result of their purchase of the tokens ("Investment Contract Marketing Efforts"), the offer and sale of such tokens should not be subject to the federal securities laws.

This conclusion should hold true regardless of whether the utility tokens, at the time of their offer and sale, are Non-Functional Tokens or Functional Tokens.[ii] Admittedly, it may not be possible for an issuer of Non-Functional Tokens to garner sufficient interest in such tokens without employing Investment Contract Marketing Efforts in connection with the offer and sale of such tokens (and, if an issuer wishes to employ Investment Contract Marketing Efforts, the resulting "investment contracts" pursuant to which the issuer sells such tokens must be registered under the Securities Act or exempt from registration under that Act). If, however, the issuer could successfully market Non-Functional Tokens without employing Investment Contract Marketing Efforts, the federal securities laws should not apply to offers and sales of such tokens.

This conclusion should also hold true even if the purchaser of the tokens purchases more tokens than he or she can possibly consume. That is, if the issuer of the tokens has not engaged in Investment Contract Marketing Efforts with respect to such tokens, the subjective belief of a purchaser that the tokens are a "good investment" (prompting him or her to buy more than he or she could possibly use) should not turn the *contract, transaction* or *scheme* pursuant to which he or she purchased them into an "investment contract."

Finally, this conclusion should hold true even if the issuer, in connection with the offer and sale of such tokens, promises to make future improvements to the platform on which such tokens may be used to purchase goods or services—even though such improvements could result in an increase in the value of the tokens—as long as the promise is couched not in terms of potential profits token holders might realize as a result of an increase in value of the tokens, but in terms of the potential for increased use and enjoyment of the tokens on the platform ("Platform Improvement Promises").

2. If a person purchases utility tokens in a scenario in which: (i) the issuer of such tokens offered and sold them as consumptive items and (ii) the issuer did not employ Investment Contract Marketing Efforts in connection with such offers and sales, the federal securities laws should not apply to such purchaser's resale of such tokens (or to any subsequent resale of such tokens), provided the reseller does not employ Investment Contract Marketing Efforts in connection with a resale.[iii]

3. If an issuer of tokens offers and sells such tokens by employing Investment Contract Marketing Efforts, the issuer must, as noted above, register the resulting "investment contracts" under the Securities Act, unless the issuer is entitled to rely on an exemption from the registration requirements of that Act. Once an issuer has employed Investment Contract Marketing Efforts in connection with the offer and sale of its utility tokens, it should not be free to claim that it may immediately begin to offer and sell additional tokens without application of the federal securities laws as long as it refrains from employing Investment Contract Marketing Efforts in connection with the offer and sale of such additional tokens. Such a claim ignores the plausible argument that the issuer's previous Investment Contract Marketing Efforts have "conditioned the market" to treat its tokens as an investment, as opposed to a consumptive, opportunity. Put somewhat differently, until a sufficient period has elapsed between the time a token issuer ceases to engage in Investment Contract Marketing Efforts and the time the issuer commences the offer and sale of additional tokens without employing Investment Contract Marketing Efforts (such period, a "Cooling-Off Period"), the issuer's previous use of Investment Contract Marketing Efforts means that the issuer's "promise of profits" lingers on, with the result that such additional sales must also be considered to be made by way of "investment contracts."[iv]

   How long will an issuer's "promise of profits" linger after the issuer ceases to make it, until such time as it can be said that such promise has fully dissipated? In other words, what is the appropriate length of a Cooling-Off Period? Analogous law (or, more precisely, "lore") suggests that the issuer's prior promises should cease to linger once a six-month period has elapsed since the issuer last made them.[v]

   Accordingly, even if an issuer ceases engaging in Investment Contract Marketing Efforts, it is arguable that it cannot, immediately after ceasing such efforts, claim that it is thereupon free to commence offers and sales of the same tokens, without application of the federal securities laws to such offers and sales, as long as it continues to refrain from engaging in such efforts. Such market conditioning, however, should be deemed to cease once a six-month period has passed since the issuer last engaged in such efforts. At that point, the issuer should be free to offer and sell the same tokens, without application of the federal securities laws to such offers and sales, even if the issuer makes Platform Improvement Promises in connection with such offers and sales (as long, of course, as the issuer does not employ Investment Contract Marketing Efforts in connection with such offers and sales).

4. It is arguable that a person who purchases tokens pursuant to an “investment contract” should be free to resell such tokens immediately without regard to the federal securities laws, at least as long as such person: (i) is not affiliated with and is not acting in concert with the token issuer and (ii) does not engage in Investment Contract Marketing Efforts in connection with such resales. However, it is also arguable that the same considerations as are set forth in conclusion 3 above apply to such resales, i.e., because of the issuer’s lingering “promise of profits,” any resales of such tokens prior to the expiration of the six-month Cooling-Off Period should be considered to be made by way of “investment contracts,” even if the reseller itself does not engage in Investment Contract Marketing Efforts. Accordingly, the prudent approach would to be to assume that resales made during the Cooling-Off Period must either be registered under the Securities Act, or exempt from registration.

5. During the period in which a token issuer engages in Investment Contract Marketing Efforts with respect to its utility tokens, and during the subsequent Cooling-Off Period:

- Holders of such tokens must recognize that their resales of such tokens will be considered to be made pursuant to “investment contracts,” and, accordingly, that resales of such “investment contracts” must be registered under the Securities Act unless an exemption from registration is available.
- Brokers or other persons who assist holders of “investment contracts” involving such tokens in selling such contracts, and/or who assist prospective investors in such “investment contracts” in buying them, must recognize that such activities involve the sale or purchase of “investment contracts,” and thus securities, for purposes of determining whether such persons need to be registered as broker-dealers under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) in order to lawfully engage in such activities.
- Any person or entity that performs the functions of an “exchange as defined in Section 3(a)(1) of the Exchange Act[vi] and that permits “investment contracts” involving such tokens to trade on such exchange must recognize such trading involves the trading of securities for purposes of determining whether such exchange must either register as a “national securities exchange” under the Exchange Act or be eligible to rely on an exemption from such registration, such as that made available to so-called “alternative trading systems” or “ATSs.”[vii]
- Any person or entity that provides investment advice with respect to the purchase or sale of “investment contracts” involving the purchase or sale of such tokens must recognize that it is providing advice with respect to securities for purposes of determining such person’s status as an “investment adviser” under the Investment Advisers Act of 1940, as amended.[viii]
- Any investment fund or other entity that holds “investment contracts” involving such tokens must view such contracts as “investment securities” for purposes of determining its status as an “investment company” under the Investment Company Act of 1940, as amended (the “Investment Company Act”).[ix]

6. Once the Cooling-Off Period has elapsed:

- Holders of such tokens should be free to resell them without regard to the federal securities laws, provided they do not engage in Investment Contract Marketing Efforts in connection with resales.
- Brokers or other persons who assist token holders in selling them, and/or who assist prospective token buyers in buying them, should not be considered broker-dealers for purposes of the federal securities laws solely by virtue of engaging in such activities.
- No exchange on which such tokens are traded should fall within the definition of “exchange” under the Exchange Act solely by virtue of listing such tokens on such exchange or otherwise facilitating the trading of

such tokens on such exchange.

- No person or entity that provides investment advice with respect to the purchase or sale of such tokens should be considered to be an "investment adviser" within the meaning of the Investment Advisers Act solely by virtue of providing such advice.
- Because of the somewhat broader definition of the term "security" used for purposes for determining whether the holder of an "investment security" is an investment company within the meaning of the Investment Company Act, any investment fund or other entity that holds utility tokens should view such tokens as "investment securities" for purposes of determining its status as an "investment company" under the Investment Company Act.[x]

I don't believe that it is sufficient to counter these arguments by invoking the *Howey*-induced mantras of "substance over form" and "economic reality." As we shall see, the central thrust of the case law surrounding the offer and sale of *contracts, arrangements or schemes* involving the sale of consumptive items (which I will discuss in subsequent posts) is that the substance and economic reality of such contracts, arrangements or schemes ***are determined by the nature of the marketing efforts employed by the issuer***. In this connection, perception is reality—not the subjective perception of the persons purchasing such items, but the objective perception that the issuer attempts to induce. If the issuer employs marketing methods that, analyzed objectively, would induce a person to view the purchase of the consumptive item as part of an investment package, then the substance and economic reality is that the issuer has engaged in the offer and sale of an "investment contract." If, however, the issuer employs marketing methods that, analyzed objectively, would induce a person to view the purchase of the consumptive item as just that, then the substance and economic reality is that the issuer has engaged in the offer and sale of a consumptive item, not an "investment contract."

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[i]For purposes of convenience, subsequent references in this post to a token issuer should be read to include persons acting on behalf of the issuer, as well as the issuer itself.

[ii] As explained in my first post, a "Non-Functional Token" is a token that is not fully functional at the time of issuance, whereas a Fully Functional Token is a token that is fully functional at the time of issuance.

[iii]The issue of whether an issuer can play any role in the creation of a secondary market for such tokens, such as by "listing" such tokens on a token exchange or providing information to such an exchange that wishes to list such tokens, will be addressed in a subsequent post.

[iv]This is not to say that the additional tokens offered and sold prior to the lapse of such period are "investment contracts" in their own right; rather, it is to say that such additional tokens are deemed to be sold pursuant to "investment contracts" because an issuer cannot effectively erase the Investment Contract Marketing Efforts it employed in connection with its initial offer and sale of such tokens until a sufficient period has elapsed from the time it last engaged in such efforts.

[v]I will discuss this analogous law in a subsequent post.

[vi]Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or "exchange," directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the "exchange" is registered as a "national securities exchange" under Section 6 of the Exchange Act, or is exempted from such registration. Section 3(a)(1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange." In addition, Rule 3b-16(a) under the Exchange Act provides a functional test to assess whether a trading system meets the definition of "exchange" under Section 3(a)(1) of the Exchange Act. Rule 3b-16(a) provides that an organization, association, or group of persons shall be considered to constitute, maintain, or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by an exchange," as those terms are used in Section 3(a)(1) of the Exchange Act, if such an organization,

association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers, and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

A system that meets the criteria of Exchange Act Rule 3b-16(a), and is not excluded under Exchange Act Rule 3b-16(b), must register, pursuant to Section 5 of the Exchange Act, as a "national securities exchange" under Section 6 of the Exchange Act or operate pursuant to an appropriate exemption (see note vii).

[vii]One of the available exemptions from registration as a "national securities exchange" is for ATSs. Exchange Act Rule 3a1-1(a)(2) exempts from the definition of "exchange" under Section 3(a)(1) an organization, association, or group of persons that complies with Regulation ATS. Regulation ATS requires an ATS to, among other things, register as a broker-dealer, file a Form ATS with the SEC to provide notice of its operations, and establish written safeguards and procedures to protect subscribers' confidential trading information. An ATS that complies with Regulation ATS and operates pursuant to the Rule 3a1-1(a)(2) exemption is not required by Section 5 of the Exchange Act to register as a national securities exchange.

[viii]If an SEC-registered adviser has "custody" of the assets of a client, it must maintain such assets with a "qualified custodian" only if such assets are "funds or securities." The term "funds or securities" clearly does not cover every client asset. *See, e.g.*, the answer to Question II.3 of the SEC staff's Custody FAQs. Because a utility token should not be considered a security, and because it would be difficult to sustain the position that utility tokens constitute "funds," it is arguable that there is no requirement for an SEC-registered adviser that has custody of them to maintain them with a "qualified custodian." Of course, if a client still holds a contract to acquire utility tokens that have not yet been delivered to the client, and if that contract is an "investment contract," that "investment contract" would be considered a security for purposes of the Custody Rule and, as a result, would need to be maintained with a "qualified custodian" if an SEC-registered adviser has "custody" of such "investment contract."

[x]Section 3(a)(1)(A) of the Investment Company Act defines an "investment company" as any issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. Section 3(a)(1)(C) of the Investment Company Act defines an "investment company" as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in "securities," and owns or proposes to acquire "investment securities" having a value exceeding 40% of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. Under Section 3(a)(2) of the Investment Company Act, the term "investment securities" includes all "securities" as defined in Section 2(a)(36) of the Investment Company Act (including "investment contracts"), with certain limited exceptions.

[x]*See, e.g.*, *Digital and Digitized Assets: Federal and State Jurisdictional Issues*, American Bar Association Derivatives and Futures Law Committee, Innovative Digital Products and Processes Subcommittee Jurisdiction Working Group (March 2019) at pp. 150-1: "The term 'security' under the [Investment Company Act]…serves two distinct purposes. First, the term 'security' is used to determine whether a person is an 'issuer,' and for that purpose would generally follow the Securities Act interpretation…The second use of the term 'security,' which is of broader significance for the investment company status issue, is to identify the types of investments that, when held by the issuer, count as 'securities' under the definition of investment company…For that purpose, the SEC and its staff have long held that there are differences between the Securities Act and the Exchange Act definitions, on the one hand, and the [Investment Company Act] definition, on the other, and that the [Investment Company Act] definition can be broader…Thus, some instruments can be securities for purposes of the [Investment Company Act] even though they are not securities under the Securities Act or Exchange Act…"

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