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A CRITICAL REVIEW OF U.S. SECURITIES LAWS
AND THE STATUS OF INITIAL COIN OFFERINGS:
POTENTIAL SOLUTIONS FOR ISSUERS

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Submitted to the faculty of Indiana University Maurer School of Law
in partial fulfillment of the requirements
for the degree
Master of Laws – Thesis
December 2018
Accepted by the faculty, Indiana University Maurer School of Law, in partial fulfillment of the requirements for the degree of Master of Laws - Thesis.

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ACKNOWLEDGMENTS

I want to express my gratitude to my advisor, Professor Sarah Jane Hughes, who was always there to help me in the preparation of this thesis. I had the opportunity to complete this challenging journey thanks to her support. It was a great honor for me to do this work under her supervision.

I would also like to thank everyone in the Office of Graduate Legal Studies and International Programs with all my sincerity. Each of them helped me in the process of writing this thesis. I am especially grateful to Professor Gabrielle Goodwin, who gave invaluable advice on thesis writing techniques. I would also like to express my appreciation to Ms. Rhea May, who helped me with the English language and citation editing.

I would like to thank the Turkish Ministry of National Education for the language education and my master’s degree in the US. With the scholarship I received from the Ministry, I have had the opportunity to visit other countries, meet new people, and experience different cultures. When the time comes, this network will allow me to build friendly relationships between Turkey and other countries.

Last but not least, I would like to express my heartfelt appreciation to Ms. Qi Wang, who always motivated me to focus on this thesis. Ms. Qi Wang has continuously supported me and appreciated what I have accomplished, which was one of the most significant factors in the completion of this work. I would like to thank my mum, who is on the other side of the world and called me every day to comfort me, and my father, who helped me organize my thoughts and overcome my fears. My brother, my brother-in-law, my sister, my sister-in-law, and my sweet nieces all deserve my appreciation as well. Praise Allah for giving me such a beautiful life that is full of kind people.
ABSTRACT

Securities law in the United States has a unique approach to defining what is a security and what is not a security. It includes broadly defined terminology and describes several investment instruments that may be considered a security. Courts use one of two methods to determine whether an investment contract is a security: the Howey Test and the Risk Capital Test.

Initial Coin Offerings are one of the most recent instruments that courts and other governmental organizations need to examine in order to answer whether they meet the criteria of being a security. Depending on the result, the issuers may need to take certain actions, or they will have to bear the consequences. The Securities and Exchange Commission and the courts have been trying to interpret existing securities law in terms of this new instrument. However, courts, governmental institutions, companies, and individuals do not have specific answers as to whether or not these offerings are securities.

Since many Initial Coin Offerings remain within the area of securities law, there are solutions for issuers who want to avoid severe consequences. First, the Initial Coin Offeror can choose to apply for exemptions from registration. The issuer can also structure the token in such a way that courts and governmental institutions could not consider the token to be a security.
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INTRODUCTION

I began this research because of my interest in crypto-currencies and a specific means by which entrepreneurs have begun to use them to raise funds for crypto-based project development. While I was in the LL.M. program at Indiana University Maurer School of Law, a surge of new offerings in crypto-currencies allowed entrepreneurs to raise significant sums of equity or capital with which to build their businesses. The manner of these offerings became known as “Initial Coin Offerings” (ICOs) because the entrepreneurs offered to sell “tokens” representing one coin to members of the public. Though they were able to find investors willing to buy these tokens, the issuers of these tokens tripped over federal and state securities laws in the United States and attracted the attention of federal and state regulators and law enforcement agencies. In some cases, the issuers were sued by their customers for selling what the customers have argued—and regulators have acknowledged—may be securities under federal or state law definitions of the term “securities,” which violates laws designed to protect the investing public.

Although most of the funds raised by sales under these ICOs were collected from investors in the United States, investors in other nations were also investing in ICOs. This prompted me to want to explore whether, and to what extent, U.S. federal or state securities laws apply to ICOs. This led me to the central questions in this thesis:

1.) Are all ICOs governed by U.S. federal or state securities laws?

2.) If not, then how do crypto-entrepreneurs know when they must comply with federal or state securities laws before they become the subjects of federal or state investigations or defendants in lawsuits brought by their customers?

3.) Do regulations promulgated by the U.S. Securities and Exchange Commission (SEC) help some ICO issuers by exempting them from full “registration” of their offerings
with the SEC and from the obligations on issuers of “securities” to disclose key facts about their businesses when they offer to sell equity to the public?

In addition to these important questions about U.S. laws, my research interests extend to the manner in which ICOs might be viewed by other governments around the world. This thesis, however, focuses on the key aspects of U.S. securities laws and exemptions from their effect that have been developed over more than 75 years, the manner in which courts in the U.S. have viewed the key term “securities” in this regulatory scheme in the past, and how ICOs might benefit or suffer from that regulatory and case law history. This thesis does not discuss non-U.S. securities laws, in part because I hope to make that the subject of future research.

In Chapter 1 of this thesis, I evaluate the longest-standing judicial interpretation of the term “securities” under the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act) announced by the United States Supreme Court in 

**Securities and Exchange Commission v. W. J. Howey Co.** in 1946:

The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The Court – relying on the definition in 15 USCS § 77b – held that

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the term “security” covered any offering to the general public that met the following criteria: an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.\(^3\)

I also examine which courts are interpreting state “blue sky” laws and have held that tokens are “securities” under those laws.

In Chapter 2, I examine the facts in several ICOs since 2016 that have attracted attention either from regulators as law enforcement agencies or from investors. I also explain how, in my opinion, these ICOs do or do not qualify as “securities” under the definitions in the 1933 Act and 1934 Act.

In Chapter 3, I analyze four different tokens in terms of the positions taken by the SEC, state law enforcement agencies, and the courts. I think that these tokens are essential in the formation of token securities law.

In Chapter 4, I set forth the only means for escaping the registration-and-disclosure requirements of the 1933 Act and 1934 Act, which is to offer a token that does not qualify as a “security” under the Acts as interpreted in Howey or to offer tokens in a manner that qualifies for several statutory and regulatory “exemptions” to those Acts.

In the Conclusion, I offer preliminary advice to entrepreneurs who plan to offer their tokens in the United States, but do not want to be subject to the requirements of the 1933 Act, the 1934 Act, or state “blue sky” laws. In this set of conclusions, I urge attention to the exemptions to registration that are available to issuers who offer tokens in the United States.

\(^3\) Howey, 328 U.S. at 298-99.
CHAPTER 1: INVESTMENT CONTRACTS

1.1 Securities Act of 1933 and Securities Exchange Act of 1934

To be covered under the Securities Act of 1933 (the 1933 Act) or the Securities Exchange Act of 1934 (the 1934 Act), the offering and resulting assets must be deemed to be “securities.” The definition of the term “security” is intentionally broad, and courts in the United States have been interpreting the term liberally for more than 80 years.

Does it matter whether an offering qualifies as a “security” or not? The answer is yes. The presence of a security in a transaction leads to some regulatory consequences under the 1934 Act. For this reason, it is essential to look at the factors that the Securities and Exchange Commission (SEC) and U.S. courts use when determining whether the offering falls under the definitions provided in the 1933 and 1934 Acts.

This section will first explain the differences between the definitions of a “security” in the 1933 Act and the 1934 Act. Next, it will focus on the definition of the term “investment contract,” a term used in both Acts, and the manner in which the SEC and U.S. courts have interpreted that term in order to bring offerings that do not otherwise fit within the parameters of other terms under the definitions of “security” in the Acts. The “investment contract” definition and judicial gloss added since the 1930’s are particularly helpful to determine when “initial coin offerings (ICOs)” qualify as “securities” governed by the 1933 and 1934 Acts, which is the core work of this thesis.

1.2 Definition of Security

The Securities Act of 1933 defines the term “security” as follows:
When used in this title, unless the context otherwise requires—The term ‘‘security’’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘‘security’’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.4

The Securities and Exchange Act of 1934 similarly defines the term “security” as:

any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a ‘‘security’’; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.5

The definition of security in the 1933 Act and the 1934 Act is almost the same.6 However, the last part of the definition in the 1934 Act, starting with “but shall not include any note,” is regulated under section 3 in the 1933 Act.7 Therefore, while the 1933 Act exempts the short-term

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notes from being a security, the 1934 Act excludes the short-term notes from the definition. Congress wanted to exclude short-term notes from the securities definition. Otherwise, even a personal loan could qualify as a security and would need an exemption from registration.

There are two types of instruments that are considered a security. Note, stock, and bond, are considered a specific type of security instrument. Then, there is “a laundry list of securities” in the Acts, such as “evidence of indebtedness,” “participation in any profit-sharing agreement,” “investment contract,” and “any instrument commonly known as a security.” However, the phrase “unless the context otherwise requires” can change the scope of these Acts. Therefore, even though the instrument that appears to fall into any of the statutory definitions, the instrument may not be held to be a security if the context otherwise requires.

Due to the broad statutory definition of the term “security,” there is a vast range of uncommon investments that fall to the world of U.S. securities laws. Subsequently, the statutory language is extensive, and courts are struggling to provide predictable guidelines. Congress intended to cover several financial instruments, such as stocks and bonds, as well as other more hidden arrangements. Offerings involving Scotch whiskey, cosmetics, beavers,

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9 Id.
11 Id.
12 Id.
13 THOMAS LEE HAZEN, PRINCIPLES OF SECURITIES REGULATION 30 (2016).
14 Id.
15 SEC v. SG Ltd., 265 F.3d 42, 46 (1st Cir. 2001).
16 SEC v. Glen-Arden Commodities, Inc., 368 F. Supp. 1386, 1389 (E.D.N.Y. 1974). (Scotch whiskey warehouse receipts were considered a security. Customers were promised to get profit from the investment.)
17 SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 477 (5th Cir. 1974). (Pyramid promotion enterprise of cosmetics were considered a security.)
18 Cont'l Mktg. Corp. v. SEC, 387 F.2d 466, 470 (10th Cir. 1967). (Live beaver brokerage business was considered a security. The issuer promised “geometric profits” when the live beaver reproduced.)
Investment contracts are the device that courts use to find out whether the underlying agreement is a security. In order to determine what is and what is not an “investment contract,” courts apply the Howey Test.  

1.3 Judicial Analysis of the Term “Investment Contract” in SEC v. Howey

The legal meaning of security has been established mainly from the statutory term “investment contract.” Courts, which must follow Supreme Court precedent, have attempted to reach a workable definition. Therefore, the courts have formulated various tests and approaches to establish the criteria for an investment contract.

SEC v. C.M. Joiner Leasing Corp was the first case to deal with the investment contract issue. In order to determine whether a security existed, the Court looked to the “terms of the offer,” “the plan of distribution,” and the “economic inducements that were held out to the prospective prospect.”

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19 State v. Robbins, 185 Minn. 202, 205 N.W. 456 (1932). (Defendants sold muskrats under profit-sharing agreement.).
20 United States v. Freiberg, 34 F. App’x 281, 282 (2002). (Ostrich breeding venture was considered as a security.).
21 SEC v. Pyne, 33 F. Supp. 988, 989 (D. Mass. 1940). (Fishing boat shares were considered as a security.).
22 SEC v. Edwards, 540 U.S. 389, 397 (2004). (Buyers received fixed amount of money depending on being member of the program.)
23 SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946). (Buyers received profit from their farmlands where the issuer managed the whole process.).
25 SEC v. SG Ltd., 265 F.3d 42 (1st Cir. 2001).
26 HAZEN, supra note 13.
27 HAZEN, supra note 13.
28 HAZEN, supra note 13.
29 SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 348 (1943). (Defendants were offering exploration as an investment.)
30 Id. at 353; THOMAS LEE HAZEN & DAVID L. RATNER, SECURITIES REGULATION CASES AND MATERIALS 18 (2003); HAZEN, supra note 13, at 30.
However, *SEC v. Howey* (the Howey case) was one of the most important cases for the definition of investment contracts.\(^{31}\) In terms of the 1933 and 1934 Acts, an investment contract is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”\(^{32}\) The investment contract classification expresses a flexible principle instead of a static principle.\(^{33}\)

In the Howey case, the company sold farmlands where the company maintained orange groves.\(^{34}\) However, the company also offered management contracts with the sale of these farmlands.\(^{35}\) In these management contracts, the company promised to raise, harvest, market, and sell the orange groves.\(^{36}\) The Court indicated that offering farmlands with a management contract could be a security.\(^{37}\) The Court did not define the term “security,” and instead looked at the investment package as a whole.\(^{38}\) Even the way these management contracts were marketed was important in the Court’s decision.\(^{39}\) Therefore, how it is being presented is more significant than what is being offered.\(^{40}\)

To understand the Howey Test better, we need to analyze the four prongs of the test that the court used. While analyzing these prongs, decisions from other courts will be analyzed to help us understand how we should interpret the Howey Test. Other courts have further interpreted and improved the Howey decision.

\(^{32}\) Id. at 299. (Interestingly, Canada also adopted a test similar to the Howey Test in their security law. Canadian authorities look at four prongs: an investment of money, in a common enterprise, with the expectation of profit, to come significantly from the efforts of others. Cryptocurrency Offerings, CANADIAN SECURITIES ADMINISTRATORS (CSA Staff Notice 46-307, Aug. 24, 2017), http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170824_cryptocurrency-offerings.htm.)
\(^{33}\) Id. at 299.
\(^{34}\) Id at 295.
\(^{35}\) Id.
\(^{36}\) Id.
\(^{37}\) HAZEN, supra note 13, at 31.
\(^{38}\) HAZEN, supra note 13, at 31.
\(^{39}\) HAZEN, supra note 13, at 31.
\(^{40}\) HAZEN, supra note 13, at 31.
1.3.1 An Investment of Money Requirement

The Supreme Court stated that an investor in securities law is a person who invests his or her money. According to subsequent case law, the investment of services or property instead of money can satisfy this prong.41

In order to understand precisely what the term “investment of money” means, the SEC and the courts ordinarily implement the analysis from Teamsters v. Daniel.42 In this particular case, the problem was whether noncontributory, mandatory pension plans generate an investment contract according to the meaning of the federal securities law. The trial court applied the Howey Test in order to determine whether this pension plan was a security. The trial court found that the retirement plan offered by the employer was a security. However, the Supreme Court reversed the trial court’s decision since there was no investment of money in this case. The Court said that

41 HAZEN, supra note 13, at 31.
the individual who was supposed to be an investor had decided to give up a particular consideration in order to get a separable financial interest.\textsuperscript{43}

In its reasoning, the Court stated that contributions from the employer to these employee pension plans were relatively unimportant for the employee’s total compensation package. The Court also thought that an employee who participated in this program made no payment to the pension fund. The Court further asserted that the worker was not primarily selling labor to make an investment. However, the main purpose of the employee’s labor was to earn a salary.\textsuperscript{44}

There were other reasons why the Court did not recognize these retirement plans as being a security. According to congressional and administrative records, employment pension plans were not securities, and the Employee Retirement Income Security Act of 1974 had provided individuals in these kinds of plans with the right to challenge decisions.\textsuperscript{45} All in all, the mandatory, employer-funded retirement plan did not satisfy the criteria of the Howey Test. Therefore, there were not any investment contracts or securities.\textsuperscript{46}

Investing money in return for profit will satisfy this prong.\textsuperscript{47} Besides that, the investment of service or property can also satisfy the investment of money requirement.\textsuperscript{48} Therefore, while deciding whether there is an investment of money, the courts look for the intention of the investors. If the investors gave up some considerations in order to receive some financial interest, the court may find that there was an investment of money.

\textbf{1.3.2 A Common Enterprise Requirement}

\begin{itemize}
\item \textsuperscript{43} \textit{Id.}
\item \textsuperscript{44} \textit{Id.} at 560.
\item \textsuperscript{45} HAZEN \& RATNER, \textit{supra} note 30, at 32.
\item \textsuperscript{46} HAZEN \& RATNER, \textit{supra} note 30, at 34.
\item \textsuperscript{47} SEC v. SG Ltd., 265 F.3d 42, 49 (1st Cir. 2001).
\item \textsuperscript{48} HAZEN, \textit{supra} note 24, at 41.
\end{itemize}
A common enterprise is another prong for determining the existence of an investment contract according to the Howey Test. The common enterprise requirement concentrates on whether the success of the investor’s interest rises or falls with other individuals who participate in the enterprise. Whether commonality exists is a critical question because the Howey Test will not be satisfied without a finding of a common enterprise.\textsuperscript{49}

According to court decisions, there are two sorts of commonality: horizontal and vertical. Courts have different opinions on whether horizontal commonality or vertical commonality

\begin{quote}
\textsuperscript{49} HAZEN, \textit{supra} note 24, at 41-2.
\end{quote}
satisfies the Howey Test.

Horizontal commonality focuses on the collection of “every individual investor’s fortune to the fortunes of the other investors by the pooling of assets.”\textsuperscript{50} Pooling of interests among at least two investors is the most obvious example of horizontal commonality.\textsuperscript{51}

Vertical commonality focuses on the connection between the issuer and the investors. There are two variances of vertical commonality: broad vertical commonality and strict vertical commonality. For broad vertical commonality, the investor’s fortunes rely upon the promoter’s efforts and expertise.\textsuperscript{52} On the contrary, narrow vertical commonality requires that the investor’s profits be linked to the manager’s earnings.\textsuperscript{53} What this means is that narrow vertical commonality requires investors’ fortunes to be mixed with and reliant upon the success of the promoters.\textsuperscript{54}

Some courts accept horizontal commonality for deciding there is a common enterprise.\textsuperscript{55} Some courts hold that a common enterprise can also exist with vertical commonality.\textsuperscript{56} Some courts have decided that broad vertical commonality is able to satisfy the Howey,\textsuperscript{57} while other courts reject broad vertical commonality.\textsuperscript{58}

1.3.3 An Expectation of Profit Requirement

\textsuperscript{50} HAZEN & RATNER, supra note 30, at 26.
\textsuperscript{51} HAZEN, supra note 24, at 42.
\textsuperscript{53} Id.
\textsuperscript{54} SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir. 1974).
\textsuperscript{55} SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974).
\textsuperscript{56} SEC v. Unique Financial Concepts, 196 F.3d 1195, 1199 (11th Cir. 1999).
\textsuperscript{57} SEC v. SG Ltd., 265 F.3d 42, 49 (1st Cir. 2001).
\textsuperscript{58} Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994).
If the investor does not have an expectation of profit, this will prevent a finding of a security. The profit motive must be at a certain level. If the purchasers’ main purpose is utilizing the product rather than making a profit, there would be no expectation of profit.

The Supreme Court has recognized an expectation of profit in two circumstances: capital gain from the original investment or participation in earnings resulting from the usage of the investor’s money.

If the promoter promised to share a fixed income stream, this could satisfy the expectation of profit requirement. According to the Court, there is no difference between fixed return and variable return. The seller stated that purchasers do not participate in the earnings of the enterprise; however, the buyers received a fixed rate of return. This did not change the overall result.

1.3.4 Efforts of Others Requirement

According to the Howey Test, the investors’ return needs to have been anticipated “solely from the efforts of the promoter or a third party.” However, other courts interpreted this rule differently and concluded that the profits should be expected from “mainly or considerably from the efforts of others.”

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59 HAZEN, supra note 8, at 44.
61 Id. at 857.
62 Forman, 421 U.S. at 852.
63 SEC v. Edwards, 540 U.S. 389 (2004); HAZEN, supra note 13, at 32.
64 Edwards, 540 U.S. at 394.
65 Id. at 389.
If the efforts of the investor were significant to the success of the enterprise, there would be no investment contract.\(^6\) This means that the courts do not strictly follow the Howey Test in terms of being solely from the efforts of others. Courts consider the word “solely” out of the fourth element.\(^6\) Actually, this interpretation of the efforts of others is more accurate than the Howey Test. The reason behind this idea is that we can protect investors from pyramid schemes. In order to avoid the Howey Test, perpetrators make the investor participate in the scheme and, in that way, it is no longer solely the efforts of others.

Though investors needed to put in a little effort to get a return, if the enterprise depends on upper management to be successful, there is still an investment contract.\(^7\) The SEC and the courts try to protect investors through the interpretation of case law.

In contrast, if the investors have significant power over the enterprise, it would be sufficient evidence that there is no managerial effort of others.\(^7\) Therefore, even if the investor needs to participate somewhat in an operation, like in pyramid sales arrangements, if the effort is not crucial for the success of the enterprise, there will be an investment contract.\(^7\)

We cannot assume that every effort of the promoter satisfies the managerial efforts of others prong. For example, post-investment services that are just ministerial cannot be adequate to fulfill this prong.\(^7\)

The Howey Test is not the only test courts apply. The Risk Capital Test is the second the most important test for many state courts.

\(^6\) HAZEN, supra note 13, at 32.
\(^6\) STEPHEN CHOI & ADAM PRITCHARD, SECURITIES REGULATION, CASES AND ANALYSIS 135 (2012).
\(^7\) Turner Enterprises, 474 F.2d at 483.
\(^7\) HAZEN, supra note 13, at 33.
1.4 Blue Sky Law and the Risk Capital Test

Not only federal courts and the SEC but also state courts and organizations are authorized to regulate securities law within their region. In the beginning, securities law arose from state regulations.\(^{74}\) The first state that applied the “blue sky” law was Kansas.\(^{75}\) In 1911, Kansas started to regulate the industrialists to protect the state farmers.\(^{76}\) This is significant because Kansas regulated securities law 22 years before the federal government. Kansas was trying to stop sale of the “blue sky” to its farmers for a simple fee.\(^{77}\) In this context, “blue sky” is a metaphor describing an invaluable investment in exchange for some amount of money.

Today, all states have their own “blue sky” laws.\(^{78}\) However, this blue sky law varies state to state.\(^{79}\) For example, an issuer in New York is not required to register with the New York securities administration department, but the state enforces antifraud provisions against the issuers.\(^{80}\) On the other hand, California requires an issuer to pass the merit test to sell securities in the state.\(^{81}\)

Blue sky law allows states to protect their citizens from securities fraud. For some states, the blue sky law allows investors to obtain material information of relevant facts.\(^{82}\) According to one commentator, research in blue sky law is always difficult.\(^{83}\) Since the law varies state to state, it is highly unlikely that there would be uniformity in its application.

With the 1996 National Securities Markets Improvement Act, the federal government wanted to limit the states’ influence on securities law in terms of state registration.

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\(^{74}\) HAZEN, supra note 8, at 329.
\(^{75}\) CHOI & PRITCHARD, supra note 69, at 575.
\(^{76}\) HAZEN, supra note 8, at 329.
\(^{77}\) LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATIONS, 14 (7th ed. 2018).
\(^{78}\) HAZEN, supra note 13, at 15.
\(^{79}\) CHOI & PRITCHARD, supra note 69, at 575.
\(^{80}\) CHOI & PRITCHARD, supra note 69, at 575.
\(^{81}\) CHOI & PRITCHARD, supra note 69, at 575.
\(^{82}\) HAZEN, supra note 13, at 15.
\(^{83}\) HAZEN, supra note 8, at 330.
requirements. However, state laws did not lose their importance in protecting against fraudulent transactions.

Therefore, we need to look at the other test that states have applied in order to understand which instruments are investment contracts. Apart from the dominance of the Howey Test, the other test implemented by state courts is the Risk Capital Test.

Some state courts have been following Silver Hills Country Club v. Sobieski decided by California Supreme Court, which was the first instance of the so-called Risk Capital Test. The Supreme Court of Hawaii, Arkansas, District Court of Guam, Court of Appeals of Ohio, Supreme Court of Oregon follow this decision. Alaska, North Dakota, Georgia, Michigan, Washington, Oklahoma have also adopted this Risk Capital Test by statute. There are some regulatory rules in New Mexico, Wisconsin, Wyoming, North Carolina, and Illinois that follow the Risk Capital Test.

The critical part of the Risk Capital Test is that the investors should rely upon others for the success of the business and that the promoter uses the activity as an investment tool. It is very similar to the Howey Test; however, the test has some considerable differences. The Risk Capital Test has four key prongs:

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85 HAZEN, supra note 8, at 306.
89 Id.
90 Id. Washington’s statutory defines a security as follows: “investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture.” WASH. REV. CODE § 21.20.005(12).
91 HAZEN, supra note 24, at 45.
92 HAZEN, supra note 24, at 45.
(1) An offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.  

For the Risk Capital Test, it is crucial to see whether funds have been raised to develop an enterprise. Additionally, it is important to see if the promoter presented the transaction to the public as a whole. Aside from that, whether or not the investors are relatively powerless to affect the success of the enterprise is also taken into account. The primary problem is whether the investor’s fund is substantially at risk since it is insufficiently secured.

In *Silver Hills Country Club v. Sobieski*, the court ruled that the petitioners had solicited risk capital to develop a business for profit. Even if investors do not receive any material benefit, the court held that the securities act still protects those investors.

The court in the *Sobieski* case held that the sale of membership to a country club is a security. In this case, the court made an effort to preserve the public from the financial risks

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96 Id.
97 Id.
that the promoters could possibly cause.\textsuperscript{98} The investors risked the capital hoping to receive some benefits from the country club. In this case, the court stated that the securities act applies even if the investor does not expect to have any material benefits.\textsuperscript{99} In the Howey Test, an expectation of profit is substantial in order to determine whether the investment can be considered a security.

For the Risk Capital Test “what investors stand to lose” is more important than “what the investors expect to gain.”\textsuperscript{100} Also, the Court held that the Risk Capital Test has a significant advantage when contrasted with the Howey Test. The definition of a benefit is not as narrow as it is in the Howey Test since a benefit does not have to be material.\textsuperscript{101}

Another court found that the offer to pay interest on an investment would be a security according to Risk Capital Test. However, if the investors’ capital was not at risk because the offeror secured the investment with valuable materials, such as a diamond that was worth at least $500, then there is no risk capital since the customers were properly secured.\textsuperscript{102}

Thus, there are some differences between the Risk Capital Test and the Howey Test. The Risk Capital Test is more flexible compared to the Howey Test. An investor does not have to prove that there is a common enterprise. Also, under the Howey Test, the anticipated return must be substantial. Nevertheless, the Risk Capital Test does not concentrate on substantial benefit. For instance, interest in a golf club satisfied the Risk Capital Test in California. On the other hand, since there was no expectation of profit, it would not be a security according to the Howey Test.\textsuperscript{103}

\textsuperscript{98} \textit{Id.}
\textsuperscript{99} \textit{Id.}
\textsuperscript{100} Wolf v. Banco Nacional De Mexico, 549 F. Supp. 841, 852 (N.D. Cal. 1982).
\textsuperscript{103} HAZEN, \textit{supra} note 24, at 46.
Generally, state courts that follow the Risk Capital Test apply both the Howey Test and the Risk Capital Test. Therefore, if the instrument fulfills the definition of a security under one of the tests, courts hold that an instrument is a security. State courts that do not follow the Risk Capital Test follow the Howey Test in order to decide whether an instrument is a security.\textsuperscript{104}

\textsuperscript{104} The Risk Capital Test - List of States, supra note 88.
CHAPTER 2: ANALYSIS OF ICOS ACCORDING TO U.S. SECURITIES LAW

This chapter will analyze Initial Coin Offerings (ICO) in terms of the Howey and Risk Capital Tests. If the tokens pass these tests, it is likely that they will be considered securities, whether in a federal court or a state court. The issuers should look at these regulations when issuing tokens; if they are likely to pass these tests, the issuers should consider the solutions I discuss in the last section.\textsuperscript{105}

First, I will analyze what an ICO is. While explaining what an ICO is, I will discuss the differences and similarities between ICOs and Initial Public Offerings (IPOs). Then, I will describe the differences between payment, utility, and security tokens. There are no certain borders between these tokens, though. One token can be a utility token in the beginning, and then later become a payment token. Applicable law will be different according to the type of token involved.

Federal courts and many state courts follow the Howey Test to decide whether there is an investment contract and, therefore, a security.\textsuperscript{106} If there is a security, these courts will apply securities law to these transactions. On the other hand, as we mentioned in the first chapter, some state courts apply the Risk Capital Test to determine whether the scheme is a security.\textsuperscript{107} This analysis will review the Howey Test more than the Risk Capital Test since the application of the Risk Capital Test is geographically limited.\textsuperscript{108}

2.1 What is an ICO?

\textsuperscript{105} \textit{Infra} Chapter 4.
\textsuperscript{106} \textit{Supra} 1.3 Judicial Interpretation of the Howey Test.
\textsuperscript{107} \textit{Supra} 1.4 the Risk Capital Test.
\textsuperscript{108} \textit{Supra} 1.4 the Risk Capital Test.
The ICO is a concept that describes a means of a new fundraising event. In the ICO process, companies or individuals sell their tokens to the public. This part of the token sale only focuses on the transaction from the issuer to the first buyer. This means that the ICO does not focus on secondary market activities.

Tokens give some individual rights to their owners in exchange for fiat money like the U.S. dollar, Chinese Yuan, European Euro or payment tokens like Bitcoin or Ethereum. These rights will determine the types of tokens the issuer sells. Typically, companies explain in their white paper how the system works, what kind of rights the buyer will receive, and how purchasers will receive a return from the process.

While reducing transaction cost, ICOs offer unique liquidity and efficiency for companies as well as individuals. Beginning from Mastercoin in 2013, there are many ICOs held by people. Until now, companies were able to raise millions of dollars in a short period of time.

2.2 Similarities and Differences between an ICO and an IPO

The name of the ICO (initial coin offering) is very similar to IPO (initial public offering). Therefore, ICOs are generally compared to IPOs, which is the process that companies use to sell their shares to the public for the first time.

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109 Infra 2.3.1 Payment Tokens.
113 Erin Griffith, Why Startups are Trading IPOs for ICOs, FORTUNE (May 5, 2017), http://fortune.com/2017/05/05/ico-initial-coin-offering/.
The main similarity between an ICO and an IPO is that they are both a fund-raising mechanism for companies. When companies and people are in need of funds, one way to raise money is issuing stocks and selling them to the public. Also, with token sales, the companies receive the capital from the market.

There are many differences between ICOs and IPOs. The first difference is that, while companies in their early stages use ICOs, well-settled companies use IPOs. The other difference between ICOs and IPOs is that, while IPOs are undoubtedly subject to the 1933 Act and the 1934 Act, ICOs may or may not be subject to these Acts. In the U.S., the IPO procedure is such an extended process that it involves hiring investment banking and securities law attorneys. On the other hand, individuals can create tokens through a blockchain system, explain how it works to the public, and start fundraising events without these intermediaries. While the ICO process is shorter and cheaper, the investors are less secure compared to the IPO process.

Furthermore, in an IPO, businesses sell their ownership rights to the public; on the other hand, most ICOs do not give equity or ownership interests to the buyers. While shareholders have rights in a company’s bankruptcy, token holders generally do not have a claim to the company’s assets since there are no ownership rights on the company.

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114 Collomb, De Filippi & Sok, supra note 112, at 5.
116 Id.
117 Id. at 27.
2.3 Categorization of Tokens

This section will examine three different kinds of tokens: payment tokens, security tokens, and utility tokens. The differences among these tokens are significant because, based on the status of token, the applicable law can be changed. As an example, while payment tokens are considered a commodity, security tokens are considered a security. Utility tokens are found somewhere in the middle. The Securities and Exchange Office and Commodity Futures Trading Commission always watch the activities in these markets.

Tokens can be used in a broader range than cryptocurrencies.\(^1\) Cryptocurrencies represent inherent value; however, they do not include legal tender status.\(^2\) This thesis analyzes cryptocurrencies under payment tokens. In contrast to payment tokens, a utility token can give some access rights to its holders.\(^3\) Also, security tokens give their owner some particular ownership rights, such as getting dividends or voting about the company’s decisions.\(^4\)

According to one study, the tokens are used for 44% as a payment token, 35% a utility token, 14% as an investment token.\(^5\) According to another survey that includes all initial coin offerings between 2013 to 2017, approximately 75% of all tokens were used to access to a

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\(^3\) Infra 2.3.2 Utility Tokens.

\(^4\) Infra 2.3.3 Security Tokens.

service, 50% were used as payment, 25% were granted for investment and some other reasons.\textsuperscript{123}

These differences arise most likely from different understandings of categorizations.\textsuperscript{124}

Therefore, this thesis will analyze three types of tokens in terms of securities law. Even if the general category gives some ideas, every individual token should be examined in order to reach a solid conclusion.\textsuperscript{125}

\subsection*{2.3.1 Payment Tokens}

Payment tokens, in other words cryptocurrencies, have inherent value like gold or cash that are designated to enable sales, purchases, and other transactions. Many of the payment tokens are promoted as providing the same functions as the U.S. dollar, Turkish Lira, Chinese Yuan, etc. but without being backed by a government or other financial institution.\textsuperscript{126}

\begin{itemize}
\item Tokens
\item Payment
\item Utility Tokens
\item Security Tokens
\end{itemize}

\begin{flushleft}

\textsuperscript{124} Maume & Fromberger, \textit{supra} note 123.

\textsuperscript{125} \textit{Infra} Chapter 3.

\textsuperscript{126} Clayton, \textit{supra} note 119.
\end{flushleft}
Cryptocurrencies are marketed for different reasons. People generally try to get cryptocurrency to transfer their money without an intermediary, such as a bank. Also, in the cryptocurrency system, there are no geographic limitations, and the cost of transactions is lower than the banking system.

Generally, U.S.-based cryptocurrency trading platforms are regulated as money transmission services. These money transmission systems have not been subject to direct overview by the SEC or the CFTC. The Department of the Treasury, Financial Crimes Enforcement Network (FinCEN) regulates the money transmission systems.

In general, the SEC only regulates securities transactions and the companies who participate in the securities market. The SEC does not have the right to control the transactions in currencies and commodities and money trading platforms.

It is not essential to the SEC if a company chooses to refer to its tokens as a cryptocurrency. The SEC always looks for what the real thing is under that name. Simply calling something a currency or a currency-based product does not mean it is not a security and is not going to be subject to SEC regulations.

Bitcoin is one example of a payment token. According to CFTC, Bitcoin is a commodity. Also, according to Jay Clayton, the president of the SEC, Bitcoin is not a security but a

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127 Clayton, supra note 119.
129 Clayton, supra note 119.
130 Clayton, supra note 119.
medium of exchange. In another case, the Court found that Bitcoin was a medium of exchange, a store of value, and a means of payment. If a token has similar characteristics to Bitcoin, it will most likely be treated as a commodity.

2.3.2 Utility Tokens

Utility tokens, which can be called app coins or app tokens, offer users access to merchandise or services. There are two types of utility tokens issuers sell to the people: pre-functional and fully-functional.

People can find out whether a token is pre-functional or fully-functional from the company’s white papers. If the white paper indicates that the issuer will develop the system after the fund-raising event, then the token is most likely a pre-functional security token. On the other hand, if the issuer has already built the system, then the token is most likely a fully-functional utility token.

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Issuers of tokens sometimes prepare Initial Coin Offerings for utility tokens. For example, Filecoin was a pre-functional utility token. It raised $257 million to provide a decentralized cloud storage service.\textsuperscript{135} ICO funders received tokens that they could use to purchase storage space from Filecoin once the company had launched the service.\textsuperscript{136} Also, the Munchee token can be considered under this section. The Munchee token was used as a form of payment in restaurants to incentivize food reviews. It also allowed its holders to trade in secondary trading.\textsuperscript{137} This means that the Munchee token was not only a payment token but also a utility token and a security token at the same time.\textsuperscript{138}

While pre-functional utility tokens are most likely an investment contract, fully-functional utility tokens are not. For the fully-functional utility tokens, there would be no expectation of profit from the efforts of others.\textsuperscript{139} If the instrument has consumptive value, like fully-functional utility tokens, it would not be a security since there is no expectation of profit.

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{136} Wilmoth, supra note 134.
\item\textsuperscript{137} Infra 3.2 MUN Token.
\item\textsuperscript{138} Maume & Fromberger, supra note 123.
\item\textsuperscript{139} Supra 1.3 Howey Test.
\end{enumerate}
\end{footnotesize}
from the efforts of others. On the other hand, pre-functional utility tokens are most likely an investment contract since the holders do not have the right to consume. They need to wait until the issuer develops the system.

2.3.3 Security Tokens

Security tokens are equivalent to traditional securities; however, issuers created them on decentralized or centralized ledger systems. From time to time, these tokens offer cash flow or voting rights. Sometimes they are just labeled as security tokens.

Issuers of security tokens who hope to raise money to develop a business generally sell tokens rather than sell shares, issue notes, or obtain bank support. Investors invest their money with the expectation of profit supported by the issuer’s effort.

Even if the token itself is not a security, like the citrus groves in the Howey Test, the same asset can be offered in a way that causes investors to have a reasonable expectation of profit based on the efforts of others. For example, Bitcoin itself is not a security according to William Hinman, the Director of Division of Corporation Finance. However, in Shavers, the court concluded that the scheme involving Bitcoin was an investment contract and, therefore, was a security contract. DAO tokens can be considered under these tokens.

2.4 Howey Test for ICOs

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143 Id.
145 See the discussion in DAO.
2.4.1 Whether or Not ICOs Satisfy the Investment of Money Prong?

Issuers sell a number of tokens for cash.\textsuperscript{146} In terms of the Howey Test, these ICOs definitely satisfy the investment of money prong.\textsuperscript{147} The reason is that these ICOs include the same type of investment with the Howey Test.\textsuperscript{148} On the other hand, some ICOs include sales of tokens for other payment tokens.\textsuperscript{149} These token sales also satisfy the investment of money prong since in the \textit{Shavers} case, even though the defendant claimed that Bitcoin cannot represent an investment of money, the court ruled that the investment of money prong can be satisfied even when there is no legal tender status.\textsuperscript{150}

Sale of tokens is not the only way the token holder receives tokens. Issuers can offer tokens for participation in the token ecosystem.\textsuperscript{151} The best example of this would be the Filecoin tokens. Filecoin completed its ICO in 2017; however, the issuer offered tokens to the individuals who provided storage to the Filecoin system.\textsuperscript{152} As I discussed in the first chapter, according to case law, investment of services can also satisfy the investment of money prong.\textsuperscript{153} Since the investors chose to give up usage of their computers as an investment of service in Filecoin, it is highly likely that the court would find that the mining service satisfied the investment of money prong.\textsuperscript{154}

\textsuperscript{147} \textit{SEC v. W. J. Howey Co.}, 328 U.S. 293, 301 (1946).
\textsuperscript{148} \textit{Id.}
\textsuperscript{149} \textit{Infra} 3.4 DAO Tokens were sold for Ether.
\textsuperscript{153} \textit{Supra} 1.3.1 An Investment of Money Requirement.
\textsuperscript{154} \textit{Supra} note 42.
On the other hand, not every investment of service satisfies the investment of money prong. Courts generally look at the whole picture to decide whether the activity fulfills this prong. As we remember from *Teamsters v. Daniel*, the plaintiff’s investment of service was not considered as investment of money.\(^{155}\) However, this case can be easily distinguished from Filecoin since the participants tried to get a reward in exchange for service. In *Teamsters v. Daniel*, the main purpose for the employee was earning a salary rather than interest in the pension plan. Therefore, the pension plan was not considered an investment contract.\(^{156}\) Investment of service in ICOs most likely satisfies the investment of money prong.

### 2.4.2. Whether or not ICOs Satisfy Common Enterprise Prong?

Specific features of ICOs are used to determine whether there is a common enterprise. As I discussed in the first chapter, there are three types of commonality tests that courts use to define a common enterprise in investment contracts:\(^{157}\) horizontal, broad vertical, and strict vertical.\(^{158}\)

When the issuers of tokens pool the money from their investors to develop a network, horizontal commonality can be found easily.\(^{159}\) Utility tokens can be evaluated under horizontal commonality since the issuer pools the investors’ money to develop an application.\(^{160}\)

When the value of tokens issued for the ICOs relies on the expertise of the issuer, such as developing an application, the initial coin offering may involve broad vertical commonality.\(^{161}\) Many tokens satisfy the broad vertical commonality test since the investors generally depend on

\(^{155}\) *Id.*

\(^{156}\) *Id.*

\(^{157}\) *Supra* 1.3.2 A Common Enterprise Requirement.

\(^{158}\) *Id.*

\(^{159}\) *SYKES, supra* note 151, at 13.

\(^{160}\) *Supra* 2.3.2 Utility Tokens.

the expertise of the issuers. For example, the investors of Filecoin depended on the expertise of the Filecoin managers to develop the decentralized data storage system.\textsuperscript{162}

On the other hand, if the value of tokens depends on the issuer’s profits, dividends, or other kinds of returns, there would be a narrow vertical commonality.\textsuperscript{163} In this context, if the promoter is successful, the investor will receive the profits. However, these kinds of tokens are rare.\textsuperscript{164}

\textbf{2.4.3 Whether or Not ICOs Satisfy the Expectation of Profit Prong?}

The specific features of tokens should be evaluated according to the expectation of profit prong. Primary objectives of buyers will determine the results. Of course, when deciding the primary reason for the token holders, we should also look at the whitepaper to see what the issuer promised. Especially in terms of utility tokens, this prong is very important.

It is necessary for us to evaluate whether the buyers get the tokens to use, to consume, or to invest.\textsuperscript{165} If the token holders have an expectation of the increased value of initial investment or participation in the profit sharing, this Howey prong can be satisfied.\textsuperscript{166} For instance, the Munchee company explained in its white paper that the buyers should expect to receive a profit from holding the tokens.\textsuperscript{167}

What kind of benefits the token holders will receive is significant when deciding whether the token holders reasonably expected profits.\textsuperscript{168} If the issuers claim the token will gain value or the holders will receive financial benefits from holding the token, then the token satisfies the

\begin{itemize}
\item\textsuperscript{162} Higgins, \textit{supra} note 135.
\item\textsuperscript{163} \textit{Supra} 1.3.2 A Common Enterprise Requirement.
\item\textsuperscript{164} Batiz-Benet, Clayburgh & Santori, \textit{supra} note 146, at 7.
\item\textsuperscript{165} \textit{Supra} 1.3.3 An Expectation of Profit Requirement.
\item\textsuperscript{166} \textit{Supra} 1.3.3 An Expectation of Profit Requirement.
\item\textsuperscript{167} \textit{Infra} 3.2.
\item\textsuperscript{168} Teague v. Bakker, 35 F.3d 978, 989 (4th Cir. 1994).
\end{itemize}
expectation of profit prong of the Howey Test. On the other hand, if the benefits are based on goods or services to exchange, the token cannot be considered a security since the primary expectation is not gaining a profit.\textsuperscript{169}

Some commentators argue that utility tokens may be produced or bought for two purposes.\textsuperscript{170} First, the token holders can use the token to receive goods or services.\textsuperscript{171} This part is unrelated with the field of the securities law. Second, the holders have an expectation of profit from buying and selling the token.\textsuperscript{172} This expectation can create an investment contract; therefore, there is a security. The main function of the token will determine the result.\textsuperscript{173} If the purchaser’s primary purpose is just using the token for the services the issuer provides, the expectation of profit prong will not be satisfied. On the other hand, if the seller says or implies that the token holder may receive profits from holding the tokens, courts may find that the issuer created an expectation of profit, even if the token could only be used for buying goods or services.\textsuperscript{174}

2.4.4. Whether or Not ICOs Satisfy Managerial Efforts of Others Prong?

Control powers of buyers over the tokens and the token venture is important in the evaluation of ICOs.\textsuperscript{175} The degree of control will determine whether they relied primarily on the managerial controls of others. To figure out what degree of control the buyers have, we need to look the rights, obligations, and powers the token provides.\textsuperscript{176}

\begin{itemize}
\item [\textsuperscript{170}] SYKES, supra note 151, at 18.
\item [\textsuperscript{171}] Id.
\item [\textsuperscript{172}] Id.
\item [\textsuperscript{173}] Rice, 922 F.2d at 790.
\item [\textsuperscript{174}] Teague v. Bakker, 35 F.3d 978, 987 (4th Cir. 1994).
\item [\textsuperscript{175}] Supra 1.3.4 Efforts of Others Requirement.
\item [\textsuperscript{176}] Batiz-Benet, Clayburgh & Santori, supra note 146, at 9.
\end{itemize}
If the token holders have plenty of rights and powers to manage the token venture, an initial coin offering is unlikely to depend on the managerial efforts of others.\textsuperscript{177} On the other hand, if the token holders have restricted rights on the venture, the token holders most likely rely on the managerial efforts of others.\textsuperscript{178} Therefore, it is critical to look at the white paper of the initial coin offerings to see who is going to be responsible for making the profit.

Pre-purchase and post-purchase efforts would be another thing we need to focus on while we are looking at the managerial efforts of others prong.\textsuperscript{179} If the token issuer performed the managerial efforts after the token sale, there would most likely be an investment contract.\textsuperscript{180} However, if the post-purchase efforts were ministerial or clerical rather than managerial, there would not be an investment contract.\textsuperscript{181}

2.5 Risk Capital Test for ICOs

The Risk Capital Test is one of the tests that some states apply to determine whether instruments, schemes, or transactions are securities.\textsuperscript{182} Since the Risk Capital Test application is limited geographically, scholars have analyzed this test less than they have the Howey Test. However, it is essential for the issuer of the tokens to know whether the token is a security or not. According to this result, the issuer may or may not need to register the tokens at the state level as well.

There is a possibility for the issuer that the token is not a security under federal law, but it is a security under state law. As I discussed in the first chapter, while the Howey Test is looking

\textsuperscript{177} Supra 1.3.4 Efforts of Others Requirement. \\
178 \textit{Id}. \\
180 Supra 1.3.4 Efforts of Others Requirement. \\
181 \textit{Life Partners}, 87 F.3d at 545. \\
182 Supra 1.4 Blue Sky Law and the Risk Capital Test.
for commonality and expectation of essential profit, the Risk Capital Test looks for some profit from the instrument and is not interested in the commonality.  

While we are considering whether the token is a security under the Risk Capital Test, we need to focus on four prongs:  

1) whether the token buyers give an initial value to the token issuer,  
2) whether this initial value is subject to the risk of the token venture,  
3) whether the token holder expects some valuable benefits, and  
4) the token holder does not have the right to control the venture.  

If these four prongs are satisfied, then the token should be registered in states that use the Risk Capital Test to determine whether the instrument is a security. 

In terms of payment tokens, there is no difference between fully-functional utility tokens and security tokens under the Howey Test and the Risk Capital Test. Payment tokens and fully-functional utility tokens have consumptive value; therefore, they are not securities under either test. Security tokens satisfy both the Howey and Risk Capital Tests.

However, in terms of pre-functional utility tokens, the Risk Capital Test can provide a more solid solution than the Howey Test can. Generally, for pre-functional utility tokens, issuers raise capital to develop the application. The buyer can then put her money at risk with this investment. Therefore, in terms of the Risk Capital Test, there would be no confusion whether this is an investment contract.

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183 Supra 1.4 Blue Sky Law and the Risk Capital Test.  
184 Id.  
185 Id.  
186 Id.  
The general assumption is that, if the token satisfies the Howey Test, it will most likely fulfill the Risk Capital Test. The Risk Capital Test tries to protect investors more than the Howey Test while reducing the level of expectation of profit and commonality. Therefore, token issuers should exercise caution when offering their tokens in states that apply the Risk Capital Test.

There have been some recent decisions made by the North Dakota securities office regarding ICOs. As Chapter 1 explained, states have the right to protect their citizens from fraudulent schemes. In order to protect North Dakota’s citizens, the securities office created an ICO Task Force department. Since this department protects citizens from securities fraud, it must be analyzed under blue sky laws.

As we know, North Dakota is one of the states that applies the Risk Capital Test to determine whether an instrument is a security. The North Dakota Securities Commission implemented securities law to several ICOs. One example is Magma Coin. The company fraudulently alleged that the coin was backed by Gold and ETFs. The names of the executive team members were also fake. North Dakota’s ICO Task Force explained that whitepapers generally represent the “idea.” As far as we discussed in the Risk Capital Test section, tokens

188 Supra 1.4 Blue Sky Law and the Risk Capital Test.
189 Infra 3.1 Whether XRP Token is a Security under California Law and Federal Law.
191 Supra 1.4 Blue Sky Law and the Risk Capital Test.
193 Supra 1.4 Blue Sky Law and the Risk Capital Test.
195 Id.
196 Id.
that involve only ideas would be considered securities. Therefore, they would need to be registered before they can be sold in North Dakota.
CHAPTER 3: ANALYSIS OF INDIVIDUAL TOKENS: THE GRAY AREA

So far, this thesis has analyzed the Howey Test, the Risk Capital Test, ICOs, and different types of tokens. However, while deciding whether individual tokens are securities, lawyers should look at the token closely. There are small differences that can change the overall result. The SEC and the courts do not focus on every prong from the Howey and the Risk Capital Tests while determining whether a specific token is a security. The SEC and the courts should have made a more detailed decision to clarify whether the old law fits into the new token system.

This part of the thesis will analyze the XRP token, the Munchee Token, the Storj Token, and the DAO token. There are several discussions we can make on these tokens to clarify some parts of the Howey and Risk Capital Tests. The reason I chose these tokens is that they are the leaders of their fields.

3.1 Whether XRP Token Is a Security under California Law and the Federal Law?

Ripple created XRP to solve the problem of Denial of Service Attacks.\textsuperscript{197} Denial of Service Attacks occurs when someone maliciously creates many identities in a distributed ledger system to exercise considerable influence on the ledger system.\textsuperscript{198} If there are enough requests from the attackers, consensus process substantially disrupts the settlement process.\textsuperscript{199} XRP, like Bitcoin, is a math-based cryptocurrency.\textsuperscript{200} The difference between XRP and Bitcoin is that, while the publicly distributed ledger system controls Bitcoin, Ripple ledger system approves transactions for the XRP tokens.\textsuperscript{201}

\begin{footnotesize}
\textsuperscript{198} Pedro Franco, Understanding Bitcoin: Cryptography, Engineering, and Economics 102 (2015).
\textsuperscript{199} Id.
\textsuperscript{200} Rosner & Kang, supra note 197, at 659.
\textsuperscript{201} Id at 660.
\end{footnotesize}
To determine whether XRP is a security or commodity, professionals need to analyze whether there is an investment contract. XRP is a very questionable token that there is a class action lawsuit in California.\textsuperscript{202} California state applies Risk Capital Test; on the other hand, the federal courts apply the Howey Test.\textsuperscript{203}

Buyers of the XRP tokens sued Ripple, XRP II and the CEO of the Company. The plaintiffs alleged that Ripple, XRP II, and the CEO indorsed, sold and solicited the sale of XRP and raised millions of dollars. Plaintiffs are claiming that XRP is unregistered security tokens and there is no valid exemption for not being registered.\textsuperscript{204}

According to SEC, securities cannot be sold without registration if there is no valid exemption from the registration. Also, Jay Clinton Chairman of the SEC stated that changing the traditional corporate interest which is recorded in a central ledger to blockchain entry on distributed ledger may not change the substance.\textsuperscript{205} Therefore, we should apply the Howey Test and Risk Capital Test to these tokens.

Investment of Money: Plaintiffs analyzed the XRP tokens regarding the Howey Test and the Risk Capital Test. People can purchase the XRP tokens with U.S. dollars, Euro or other cryptocurrencies.\textsuperscript{206} As we know from the \textit{Shavers} case, investment of Bitcoin is also considered as an investment of money.\textsuperscript{207} Therefore, we can conclude that the plaintiffs satisfied the first prong of the Howey Test which is an investment of money.

\textsuperscript{203} \textit{Supra} Chapter 1.
\textsuperscript{204} Complain Letter, Case 3:18-cv-06753-WHA at 2, (11/07/18)
\textsuperscript{206} BITSTAMP, https://www.bitstamp.net/ (last visited 12/19/2018). This website is selling XRP for US dollar, Euro, or BTC.
Plaintiffs state that XRP token is not only as a means of exchange but also investment contract. In this respect, plaintiffs claim that XRP token is not only a payment token but also an investment token. If XRP is only payment token, it is a commodity. On the other hand, if it covers investment token, it cannot be considered just as a commodity.

The expectation of profits: according to plaintiffs Ripple does hold not only the tokens but also improves the XRP network. Ripple changed many functions of the XRP token such as decreasing transaction time, improving system security and compatibility. Ripple also released a white paper regarding return on investments. Ripple is making statements about the return of investments about XRP tokens. Therefore, Ripple’s statement creates an expectation of profit for the buyers.

Managerial Efforts of Others: Plaintiffs main argument in their complaint letter that Ripple manages, controls, and improves the XRP token. They distinguished the XRP token from the Bitcoin and Ethereum. They stated that Ripple created the XRP token and gave 20% to the founders of Ripple and 80% held in the company. The Ripple company sells this 80 % in order to raise fund and improve the company operations. In this respect, XRP tokens are centralized if we compare with the Bitcoin and Ethereum.

Plaintiffs provided several statements from the Ripple announcements. These statements indicate that Ripple has authority on the XRP. For example, Ripple announced that Ripple put $55B in an escrow account and the managers of XRP tweeted this as a big success of the XRP.
Plaintiffs also claimed that Ripple markets the XRP token, drive demand and tries to increase the price of XRP. Ripple shows in his website that how people can buy the XRP tokens.\textsuperscript{214} Ripple mentioned in its website that the Ripple company committed to the health and stability for the XRP in the long run.\textsuperscript{215}

According to plaintiffs, the Ripple Company’s primary source of income is coming from the sale of XRP to the investors. Therefore, the price of the XRP token directly tied to the managerial skills and efforts of Ripple.\textsuperscript{216} Also, Ripple stated that Ripple would accelerate the speed of XRP ledger to build on speed, uptime, and scalability.\textsuperscript{217} Ripple announced that the company would ensure XRP is the most trusted digital currency.\textsuperscript{218} All these factors show that Ripple is the only authority in the management of XRP tokens.

In a Common Enterprise: plaintiffs just mentioned the common enterprise prong in their complain letter.\textsuperscript{219} They did not make detailed analysis for this prong. The reason behind this would be that the courts and governmental organizations can easily find out horizontal commonality in ICOs.\textsuperscript{220} Ripple sold the XRP tokens and pooled the money to improve the system; therefore, there is a horizontal commonality.

Risk Capital Test: Plaintiffs sued the Ripple company in California. Therefore, the court will also analyze the Risk Capital Test. Plaintiffs argued that Ripple uses the XRP funds to operate its business, the Ripple Company offers XRP tokens for sale to the public at large,

\begin{flushleft}
\textsuperscript{216} Complain Letter, Case 3:18-cv-06753-WHA at 15, (11/07/18)
\textsuperscript{218} Id.
\textsuperscript{219} Complain Letter, Case 3:18-cv-06753-WHA at 23, (11/07/18)
\textsuperscript{220} Supra DAO.
\end{flushleft}
plaintiffs do not have the power to control the success of Ripple, and plaintiffs’ investment is substantially at risk.\textsuperscript{221}

In this case, plaintiffs made a wise movement that they sue the Ripple Company in California. As we discussed in the second chapter, the Risk Capital Test is more protective than the Howey Test.\textsuperscript{222} Since Risk Capital Test does not focus on common enterprise and expectation of essential profit prongs, the declaration of security token is more straightforward. On the other hand, the defendants are trying to move the case from State Court to the Federal Court.\textsuperscript{223} I think that the main reason behind this request is that the defendants do not want to be subject to Risk Capital Test since it is more protective than the Howey Test.

\textbf{3.2 Whether MUN Token, Which Is Pre-functional Utility Token Promising Profit, Can Be Considered a Security?}

MUN token is very significant since it is one of the representatives of pre-functional utility tokens. For pre-functional utility tokens, issuers generally raise fund in order to develop the application. Even if the token had some functions, the company raised the capital for further developments. Also, the company created faith to make a profit for the people.

Munchee Incorporation (Munchee) created MUN token and sold in October and November 2017.\textsuperscript{224} The SEC commenced an administrative proceeding for Munchee. Munchee submitted an Offer of Settlement to the SEC.\textsuperscript{225} SEC accepted this settlement.\textsuperscript{226}

Munchee is a privately-owned Delaware company based in California created an iPhone app for restaurant reviews. Munchee Inc wanted to recruit users to write evaluations, sell food

\textsuperscript{221} Complain Letter, Case 3:18-cv-06753-WHA at 23, (11/07/18)
\textsuperscript{222} Supra 1.4 Blue Sky Law and the Risk Capital Test.
\textsuperscript{223} De, supra note 202.
\textsuperscript{225} Id.
\textsuperscript{226} Id.
and conduct some other transactions using MUN tokens. 227 Munchee stated in their white paper that MUN tokens would be more valuable because of Munchee’s efforts. 228

Munchee started developing the Munchee Application in late 2015. They launched the application in 2017. In October 2017, Munchee announced Munchee would launch an initial coin offering for the sale of MUN tokens. Munchee in its white paper explained how the company will use the raised funds, how people will get a return from this investment. Munchee created 500 million MUN tokens and planned to sell 225 million in the initial coin offering process. 229 The rest of the MUN tokens held by the company to improve the company’s business, hire new people, pay the employees, and facilitate future advertisement. 230 Munchee offered MUN tokens to build a profitable enterprise for the MUN holders. 231

Even if Munchee told that holders of MUN tokens could buy goods and services through its website, no one could purchase these goods and services in this period. 232 This was because the system was not fully completed.

Munchee explained how MUN tokens gain value with the Munchee ecosystem. After the initial coin offering of MUN token, Munchee may burn some Munchee tokens which are held by the company. Also, the company said the advertisement rate in Munchee’s website would increase since many restaurants will want to be advertised. 233

We need to discuss the prongs from the Howey Test in order to understand whether the Munchee tokens are the securities.

227 Id. at 1-2.
229 Munchee White Paper, at 10.
231 Id at 4.
232 Id.
233 Id. at 5.
Investment of money: Munchee created 500 million MUN tokens in Ethereum blockchain and declared that Munchee would not create an additional token. Munchee sold MUN tokens to raise around $15 million that Munchee Inc could improve its existing app. Investors paid Bitcoin or Ether to buy the MUN tokens. According to the Shavers case, it is enough for the satisfying investment of money.

The Expectation of Profit: in the advertisements of MUN ICO, Munchee made several public statements that if the people are early enough, they will likely get a return on it. Munchee offered to give MUN tokens the people who advertise the tokens in social platforms such as BitcoinTalk.org. Even if Munchee did not offer any dividend or other periodic payment, the company created an expectation for the token will be more valuable. Also, Munchee promised to provide a secondary trading market for the MUN tokens.

Efforts of the Munchee Inc: Buyers of Munchee tokens would have the expectation of profit from the Munchee’s effort. Munchee’s whitepaper indicated that the founders of the company worked at prominent technology companies and they have excellent skills for running a business and creating software. Investors of MUN tokens had little effect on the price of tokens. Therefore, they relied on Munchee’s expertise.

SEC just mentioned in the order that MUN tokens had a practical use at the time of offering. However, it did not stop SEC from concluding that MUN tokens are not securities but

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234 Id. at 2.
235 Id. at 1-2.
236 Id. at 8.
239 United Housing Foundation., Inc. v. Forman, 421 U.S. at 852
241 Id. at 7.
242 Id. at 8.
utility tokens. SEC should have analyzed this prong to make it clear for the other token issuers. If the token had full functions in the beginning, developing the system cannot make the token as a security. If the MUN tokens’ holders purchased a commodity for personal consumption, SEC or the courts could not consider it as a security.

In this matter, after the SEC official contacted with Munchee, the company stopped the sale of the tokens and consented the SEC order. Also, the company returned the money the people who had already bought the MUN tokens. Therefore, the SEC did not impose a civil penalty to the Munchee. This matter shows us that token sales involving potential profits most likely qualify as securities.

3.3. Whether Pre-Functional Non-Profit Promising Storj Token Can Be Considered a Security?

This token is one of the unique tokens since there is no action taken by the SEC and the courts against the Storj token. The Storj Company promises to store files for its token holders in early 2019. The company’s purpose is facilitating and maintaining data storages through the decentralized system. Storj token holders can use the tokens for interaction with Storj network.

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243 Id.
244 United Housing Foundation, Inc. v. Forman, 421 U.S. at 851.
248 Id.
249 Id.
Storj blockchain system motivates the token holders to give an opportunity to participate in the system with these tokens. The Storj ecosystem offers two functions. The token holders buy these decentralized storages or sell their unused storages to the system. If the token holder buys the storage from the Storj, he or she needs to pay with the Storj token.

Now I am going to discuss the important parts of Howey and the Risk Capital Test in order to find the small difference. According to my analysis, Storj is an investment contract under the Risk Capital Test, but not under the Howey Test.

The first prong of the Howey Test and Risk Capital Test can be easily satisfied for the Storj token. People can buy these Storj tokens from Binance which is one to of the token sales platform with Bitcoin, Ether, and other coins. According to Shavers case, Bitcoin investment can be considered as an investment of money.

The second prong of the Howey Test the common enterprise, and the second prong of the Risk Capital Test the business venture, can be easily found as well. The reason is that the Storj company pooled all of the people’s money for developing the application. Therefore; horizontal commonality and the business venture prong are satisfied in this case.

The third prong of the Howey Test is that the investors should depend on the managerial efforts of others. Also, in the Risk Capital Test, if the investor does not have control over the enterprise, the test can be satisfied. In this case, the Storj team is responsible for developing the application. According to the whitepaper, the token holders do not have the right to control the Storj system.

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252 Id.
253 Supra 2.4.1 Whether or not ICOs Satisfy the Investment of Money Prong?
254 Supra 2.4.4 Whether or not ICOs Satisfy Managerial Efforts of Others Prong?
255 Supra note to 1.4 Blue Sky Law and The Risk Capital Test.
The fourth prong for the Howey Test and the Risk Capital Test make a difference for Storj. As we discussed in the first chapter, while the Howey Test focuses on the expectation of essential profit, Risk Capital Test concentrates on some valuable benefits. The Storj whitepaper highlighted that the buyers do not have any intention for investment, speculation and other financial purposes. Therefore, the company clarifies that there is no expectation of profit for the Storj token. So the token fails in this prong of Howey Test. However, for the Risk Capital Test, the result is not the same. The Storj company created these tokens for the purpose of allowing the purchaser to use the decentralized storage system. However, the token holders do not have the right to use these tokens now. They need to wait until early 2019. The company is still improving the system. Therefore, in terms of Risk Capital Test there is still some valuable benefits; therefore it an investment contract.

3.4 Whether Decentralized Autonomous Organization Tokens Can Be Considered a Security?

This thesis will analyze the Decentralized Autonomous Organization (the DAO) tokens under securities tokens. The SEC prepared a report for the DAO tokens after the attackers hacked the DAO’s account on Ethereum Blockchain. People did not have a chance to start using the DAO tokens the way described in DAO’s whitepaper. However, the SEC took action against the DAO since it did not comply with U.S. securities law. The DAO tokens are one of the most

256 Id.
258 Supra Note the Risk Capital Test.
260 Jentzsch, supra note 110.
leading matter regarding security tokens. While analyzing other tokens, the SEC cites from this
decision. \( ^{261} \) Therefore, it is crucial to analyze this token in a detailed manner.

In May 2016, the DAO sold approximately 1.15 billion DAO tokens in exchange for a
total of 12 million Ether which is a virtual currency (payment token) used on the Ethereum
Blockchain. \( ^{262} \) The DAO raised $150 million from this initial coin offering. \( ^{263} \)

The DAO is one example of a Decentralized Autonomous Organization. \( ^{264} \) Slock.it and
co-founders of Slock.it created the DAO tokens. \( ^{265} \) They sold DAO tokens to the public in order
to use the raised money for the projects. The holders of DAO tokens expected earnings from the
projects as a return on their investments on DAO tokens. \( ^{266} \) Also, DAO token holders can resell
their tokens on several web-based platforms that supported secondary trading. \( ^{267} \)

In the report, SEC did not analyze whether DAO was an investment company according
to Investment Company Act of 1940. DAO did not start its business operations for funding
projects. \( ^{268} \) If the business were started, there would be some other questions need to be
answered as well.


\( ^{262} \) DAO Report at 2.


\( ^{264} \) DAO Whitepaper at 1.

\( ^{265} \) DAO Report at 1.

\( ^{266} \) Id.


In DAO matter the organization used smart contracts for specific functions such as how to achieve quorum, how to vote, how to prepare the contracts and so on.\textsuperscript{269} The smart contract means that a computer-based application executes terms of the contract.\textsuperscript{270} The smart contracts satisfy contractual conditions, including but not limited to payment terms, liens, and confidentiality.\textsuperscript{271}

The purchase of DAO tokens gives a right for the participant to receive rewards (this is almost same with dividends).\textsuperscript{272} The DAO token holders have the right to vote on contract proposals, such as proposing the project, funding the accepted project, distributing the anticipated earnings.\textsuperscript{273} The DAO tried to claim that the DAO was autonomous in these project proposals.\textsuperscript{274} The DAO alleged that smart contracts controlled the whole process.\textsuperscript{275}

DAO token holders have certain voting and ownership rights. If the DAO earns money from the projects, DAO token holders will vote whether use distribute the rewards to the token holders or fund new projects.\textsuperscript{276}

In this system, anyone had the right to buy DAO tokens as long as he or she had ETC in exchange. DAO token holders were able to sell their DAO tokens in various ways in the secondary market. After the offering period, the DAO promised that DAO tokens would be freely transferable on the Ethereum Blockchain.\textsuperscript{277}

\textsuperscript{269} DAO Whitepaper at 11-31.
\textsuperscript{271} \textit{Id}.
\textsuperscript{272} DAO Whitepaper at 3.
\textsuperscript{273} DAO Report at 4.
\textsuperscript{274} DAO Report at 4.
\textsuperscript{276} SEC DAO Report, at 5
\textsuperscript{277} SEC DAO Report, at 6.
However, DAO’s code was vulnerable to the attacks. Attackers moved 3.6 million ETH from DAO’s Blockchain address to the attacker’s blockchain address. The DAO wanted to eradicate the consequences of the attack. Therefore, the DAO applied for Hard Fork to the Ethereum Blockchain. Ethereum Blockchain system accepted the Hard Fork, and the DAO received the tokens back.\(^\text{278}\)

In order to determine whether DAO tokens are securities, the SEC applied the Howey Test. However, the SEC did not apply every single prong of the Howey Test. In this case, SEC so much focused on managerial efforts of others. This concentration makes sense since the core of this case depends on this prong. The DAO system wanted to circumvent from SEC regulations by this prong.

The DAO token holders invested their money in DAO system. Courts do not require the cash in order to find there is an investment contract.\(^\text{279}\) Also, in SEC v. Shavers, the court holds that investment of Bitcoin meets the requirement of Howey.\(^\text{280}\) Participants of DAO used ETH to make these contributions.\(^\text{281}\) These contributions can satisfy the prong under investment contracts under Howey.

DAO token holders anticipated getting some profits from their investment. There were several ways the token holders could expect getting profit. First of all, the holders could receive rewards.\(^\text{282}\) Also, through the successful projects, the value of the token would be increased.\(^\text{283}\) Also, the token holders can get profit from the token market speculations.

\(^{278}\) SEC DAO Report 9-10.
\(^{279}\) Uselton v. Comm. Lovelace Motor Freight, Inc 940 F. 2d 574.
\(^{281}\) DAO White paper, 1.
\(^{282}\) DAO White paper at 3.
\(^{283}\) DAO Report 11
The managerial efforts of others prong is the most challenging point in this case since DAO managers tried to give the power to the DAO token holders. In theory, the holders were going to decide what to do.

The Supreme Court looks for whether the efforts made by the managers other than the investor are indisputably essential regarding failure or success of the enterprise. In this case, the SEC finds out that curators had significant rights on the proposals from the DAO token holders.

Also, the DAO system limited the voting rights of DAO token holders through review of the curators. The DAO tokens system some curators regulated which proposal will be voted. According to the white paper, they had considerable power on the proposals. Also, curators had power on the quorum; they had the power to reduce 50% every other week. According to supreme court even if the investors help to make the enterprise profitable, it may not be enough to shift managerial efforts of others prong to the investors. The help from the investors should be significant to shift this prong. The voting rights provided by the DAO did not provide them with meaningful control over the enterprise. The DAO token holders did not have the opportunity to find each other to make a decision as well.

It can be concluded that if the DAO token was decentralized and DAO token holders were given the right of voting without restrictions, it would be possible that DAO token cannot satisfy Howey and therefore it cannot be considered as security. Since the managerial efforts of

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284 SEC v. Glenn W. Turner Enters, Inc 474 F.2d 476,482.
285 DAO Report at 12.
287 Glenn W. Turner, 474 F.2d at 482.
288 Id.
289 SEC DAO Report, at 17.
others prong are crucial, the issuers of tokens can try to use this part to create token without securities law applications.

On the other hand, SEC did not discuss the common enterprise prong. The SEC recognized that common enterprise as part of the investment contract.\textsuperscript{290} Maybe SEC sees horizontal commonality and thinks that there is no need for discussion. It is evident from the incident that the DAO system pooled the investor’s money in a common enterprise. It means that each investor’s fortunes tied to the fortunes of other investors by the pooling assets.\textsuperscript{291} Therefore, in DAO token case there is a horizontal commonality.

Some commentators do not agree with this conclusion.\textsuperscript{292} According to DAO’s whitepaper, the token holders have the right to withhold their contributions if they do not want to invest in the project.\textsuperscript{293} The author argues that if the token holders do not choose to participate, the token holders will not share the profits and losses of the enterprise; therefore, there is not horizontal commonality.\textsuperscript{294} However, if the token holders did not make any movement for accepting or declining, they will participate in the project. Therefore, I think that the DAO system has already pooled the investors’ money in its enterprise.

DAO tokens can also satisfy the broad vertical commonality.\textsuperscript{295} One court found that vertical commonality can be found when the promoters provide advertisement, training, products, and the areas where product are sold.\textsuperscript{296} In the DAO matter, the founders advertised the DAO

\textsuperscript{290} SEC DAO Report, at 11.
\textsuperscript{291} Revak v. SEC Realty Corp., 18 F.3d 88.
\textsuperscript{292} Robinson, \textit{supra} note 115, at 37.
\textsuperscript{293} DAO Whitepaper at 2.
\textsuperscript{294} Robinson, \textit{supra} note 115, at 38.
\textsuperscript{296} Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1124.
tokens, explained how this system works, also the curators of DAO token approved the offers, open the offer to vote. Therefore, the broad vertical commonality can be found in the DAO.\textsuperscript{297}

Since there is no relationship between the investors and the founders after founders provided the code, it is hard to find narrow vertical commonality.\textsuperscript{298} For the most court, a lack of vertical commonality does not defeat common enterprise, since there is still a horizontal commonality.\textsuperscript{299}

\begin{flushright}
\textsuperscript{298} Id.
\textsuperscript{299} Id at 641.
\end{flushright}
CHAPTER 4: SOLUTIONS FOR COMPANIES: HOW CAN COMPANIES ISSUE
TOKENS WITHOUT BREAKING U.S. SECURITIES LAWS?

Previously, we discussed whether tokens are securities. If tokens are securities, then the
issuers should register those tokens as securities with the SEC. Otherwise, the company and the
founders might face several severe consequences, such as debarment (a ban on working in the
securities market), disgorgement, or civil penalties, or a combination of these three. Therefore, if a person wants to raise funds in any offering that is possibly a security, the person needs to register the offering with the SEC unless a statutory exemption applies or the person obtains a “no-action” letter. Otherwise, the person must structure the offering so that it does not fit under the 1933 Act’s definition of the term “security.”

In this chapter, I discuss the statutory exemptions available under the statutes enforced by the SEC, the gloss added by SEC regulations, and judicial interpretations of statutory and regulatory exemptions that might be available to token issuers. Then, after laying out requirements for potential exemptions, I use the requirements and limitations to describe a path

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300 15 U.S.C. § 77t(e) (LEXIS through Pub. L. No. 115-281, approved 12/1/18) states:
In any proceeding under subsection (b), the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated section 77q(a)(1) of this title from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 78 of this title or that is required to file reports pursuant to section 78o(d) of this title if the person’s conduct demonstrates unfitness to serve as an officer or director of any such issuer.

In any cease-and-desist proceeding under subsection (a), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

Whenever it shall appear to the Commission that any person has violated any provision of this subchapter, the rules or regulations thereunder, or a cease-and-desist order entered by the Commission pursuant to section 77h–1 of this title, other than by committing a violation subject to a penalty pursuant to section 78u–1 of this title, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation.

through which a token issuer might be able to avoid SEC registration without violating U.S. securities laws.

**4.1 Exemptions**

There are several exemptions from the 1933 Act. The SEC is authorized to promulgate the regulations to enable the 1933 Act. There are many reasons Congress wanted to give these exemptions. One of the most important reasons is that registration with the SEC is not an easy or fast process. The entrepreneur needs to hire attorneys who specialize in securities law, and it can take months to register tokens. Furthermore, the process is extremely expensive, often costing more than one million dollars. Therefore, Congress passed these exemptions in order to protect capital formation. Exemptions provide lower costs for both the issuers and the buyers.

Four statutory and regulatory exemptions may be available to issuers or tokens: Section 4(a)(2), Regulation D, Regulation A, and Regulation Crowdfunding (CF). There are some differences between these exemptions. Persons planning offerings of tokens need to evaluate them before registering with the SEC. An issuer that seeks to rely on one or more of these exemptions will have the burden of proving that their offering complies with the specific

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309 There are three exemptions under Regulation D: Securities and Exchange Commission, 17 C.F.R. § 230.504 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018); Securities and Exchange Commission, 17 C.F.R. § 230.506(b) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018); and Securities and Exchange Commission, 17 C.F.R. § 230.506(c) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018).
310 Securities and Exchange Commission, 17 C.F.R. § 230.251 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
311 Securities and Exchange Commission, 17 C.F.R. § 227.100 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
requirements or limitations put in place by Congress or the SEC on the exemption from registration.\textsuperscript{312} Since the issuer has the burden of proof for the exemption(s), the issuer should prepare a detailed evidentiary record to support its claim.\textsuperscript{313}

4.1.1 1933 Act Section 4(a)(2)

According to the 1933 Act, Section 4(a)(2), transactions not involving any public offerings are exempt from SEC registration.\textsuperscript{314} The 1933 Act states, “The provisions of section 77e of this title shall not apply to transactions by an issuer not involving any public offering.”\textsuperscript{315} According to this provision, offerings limited to “qualified investors” need not be registered with the SEC. Section 4(a)(2) exemption applies to both U.S. and non-U.S. private or public companies.\textsuperscript{316}

In order to understand what this exemption means, we need to focus on the term “public offerings.” There is no definition of the term “public offering” in the 1933 Act or the 1934 Act. Therefore, this thesis will analyze relevant case law and secondary sources, including SEC rulings.

According to the case law, investors should be qualified for these investments. In \textit{SEC v. Ralston Purina, Co.}, the court held that investors should be able to “fend for themselves”.\textsuperscript{317} This phrase means that investors should be knowledgeable in the transaction, experienced regarding finance, and aware of the risks and merits.\textsuperscript{318} Qualified institutional buyers, such as banks,
savings and loan associations, accredited investors such as registered broker-dealers, and key employees can fend for themselves in terms of this prong.\textsuperscript{319}

An issuer who qualifies for a Section 4(a)(2) exemption will most likely need to register with the state securities office.\textsuperscript{320} Since each state has their own registration requirements, the issuer should seek counsel to see whether the instrument needs to be registered.

If the issuer of the tokens sells the tokens to the public without any limitation, this offering will not fall for an exemption under Section 4(a)(2). For example, if the issuer of DAO tokens sold those tokens under this exemption, the buyers should know what kind of business they are going to engage in and what kind of risks and merits they are going to get from the business.

Generally, in order to avoid selling exempted securities to non-eligible investors, the number of investors is limited.\textsuperscript{321} On the other hand, in token sales, the number of purchasers is generally high.\textsuperscript{322} However, with a computer coding system, the issuer can limit the number of buyers.

General solicitation and advertising of the instrument are prohibited for this exemption.\textsuperscript{323} If the issuer of tokens solicits or advertises the exempted securities on the internet, he or she cannot get benefit from this exemption.

There are sale restrictions on these exempted securities.\textsuperscript{324} Buyers of the restricted securities should hold these securities for at least one year before they attempt to resell them.\textsuperscript{325}

\textsuperscript{319} Id.


\textsuperscript{321} Section 4(a)(2) and Regulation D, supra note 316.


\textsuperscript{323} THOMAS LEE HAZEN, The Law of Securities Regulation 179 (5th ed. 2005).
It is one of the downsides for this exemption in terms of token sales. In general, the circulating supply for the tokens is high. This high circulating supply means that people who bought the tokens want to sell them to other people and that other people desire to buy the tokens.

In conclusion, there are some obligations for getting benefit from the exemption under the 1933 Act, Section 4(a)(2). According to one commentator, it is hard for the token sellers to get benefit from this exemption since it is hard to control the buyers. According to another commentator, token issuers can provide more limited offerings to the smaller number of investors get an exemption from the SEC. This exemption can be achieved by the coding systems. Also, the best thing with this exemption is that there is no dollar limitation like Regulation A, Regulation Crowdfunding, and Regulation D.

**4.1.2 Regulation D**

The token issuers can apply for the Regulation D exemption. Regulation D has three different exemptions in it. These exemptions are set out under Rules 504, 506(b), and 506(c). The SEC promulgates these rules.

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324 Id.
325 Securities and Exchange Commission, 17 C.F.R. § 230.144(1)(ii) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
327 Rohr & Wright, supra note 322.
330 Securities and Exchange Commission, 17 C.F.R. § 230.504 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
331 Securities and Exchange Commission, 17 C.F.R. § 230.506(b) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
332 Securities and Exchange Commission, 17 C.F.R. § 230.506(c) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
For Rule 504, there is a five million dollar limitation for every year.\textsuperscript{334} Offerings should not exceed this amount in order to get benefit from this exemption. There is no limitation for the investor qualifications in this rule.\textsuperscript{335} However, there are resale restrictions on the exemption.\textsuperscript{336} Also, the offering most likely needs to be registered or qualified for the exemption under state law.\textsuperscript{337}

For Rule 506(b), there is no dollar limitation on the size of the offering.\textsuperscript{338} If there are “accredited purchasers,”\textsuperscript{339} there is no limitation on the number of investors.\textsuperscript{340} For the accredited purchasers, the issuer shall reasonably believe that the investors are accredited.\textsuperscript{341} Other than accredited purchasers, only 35 purchasers can buy these exempted securities.\textsuperscript{342} The issuers shall furnish specific information for the non-accredited investors.\textsuperscript{343} There is a resale restriction for this exemption. The offerings exempted under Rule 506(b) are potentially not to be registered to the states.\textsuperscript{344}

\textsuperscript{334} 17 C.F.R. § 230.504 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
\textsuperscript{335} THOMAS LEE HAZEN, The Law of Securities Regulation 179 (5th ed. 2005).
\textsuperscript{336} Id.
\textsuperscript{338} Securities and Exchange Commission, 17 C.F.R. § 230.506(b) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
\textsuperscript{339} Accredited purchasers are defined by the SEC. If the natural person earns $200,000 prior two years before buying the securities, he or she can be qualified as an accredited purchaser. Also, if the person has more than $1,000,000 net worth, he or she can be considered as an accredited investor. Besides the trusts total value higher than $5,000,000 can qualify for this. The companies, banks and other institutional organizations can be accredited purchasers if the all equity owners are accredited investors.
\textsuperscript{341} Section 4(a)(2) and Regulation D, \textit{supra} note 340.
\textsuperscript{342} 17 C.F.R. § 230.506(b) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
\textsuperscript{343} THOMAS LEE HAZEN, The Law of Securities Regulation 180 (5th ed. 2005).
For Rule 506(c), there is no limit to the size of the offering. Only accredited investors can buy these securities. Issuers of the token must reasonably believe that the investor is accredited. Moreover, investors should take reasonable steps to verify all investors are accredited. This exemption also has resale restrictions. Buyers should hold these securities for six months if the issuer is the reporting company or one year if the issuer is a non-reporting company. Since only accredited investors can buy this security, there is no need for furnishing certain information. Also, under Rule 506(c) there is most likely no state registration requirement.

According to rule 504, 506(b), and 506(c) investors have resale restrictions. In the token sales, people generally buy and sell quickly in a short time. Also, restrictions for the investors (being “accredited investors” or a limited number of non-accredited investors) prevent the customers from buying certain utility tokens. With this restriction, the intended buyers cannot achieve certain services that rely on the tokens.

Reselling these exempted utilities could be a problem for the investors. Investors should wait six months or one year. Even if these are the backsides, the SEC can oversee what is going on with the token sales. In this way, the SEC can protect the investors.

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345 Securities and Exchange Commission, 17 C.F.R. § 230.506 (c) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
346 Section 4(a)(2) and Regulation D, supra note 42.
347 Frequently asked questions about exempt offerings, supra note 320.
348 Supra note 339.
350 Holding periods of restricted securities takes place in Securities and Exchange Commission, 17 C.F.R. § 230.144 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018). According to the rule:

(i) If the issuer of the securities is, and has been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, a minimum of six months must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those
Filecoin can be the leading token for this exemption, specifically for Rule 506(c). On August 25, 2017, the company filed form D, which is an exemption application form. In the application, the company chooses to get benefit from Rule 506(c). Therefore, the company promised to sell the tokens to the accredited investors and promised to verify the accredited investors’ information. The company did not have a dollar limitation for this fundraising. Filecoin collected 257 million dollars from the token sale. Regulation 506(c) can be one of the best solutions for companies that want to sell their product to accredited investors without dollar limitation.

4.1.3 Regulation A

Regulation A can be another solution for the ICO issuers. The best part of Regulation A is that there are no resale restrictions, unlike Regulation D and Regulation CF. For Regulation A, issuers can raise up to 20 million dollars for the first tier, and 50 million dollars for the second tier. For the first tier, there is no specific requirement for the investors; however, for the second tier, there are some restrictions for unaccredited investors.
For the first tier, the issuer still most likely needs to register or qualify for the exemption in the state he or she wants to sell the securities.\(^{359}\) On the other hand, there is most likely no state registration requirement for the second tier.\(^{360}\) Even if the issuers do not have to register for the second tier, they need to comply with state filing fees and antifraud provisions.\(^{361}\) The issuer should check whether he or she needs to register with the specific state before selling the securities.

Some commentators consider Regulation A as a mini-IPO.\(^{362}\) Therefore, the amount of money companies spend on getting a Regulation A exemption could be very high. According to one estimate, Regulation A offerings cost around $350,000.\(^{363}\)

On the other hand, some commentators believe that Regulation A is better than Regulation D for token issuers.\(^{364}\) The specific resale restrictions for Regulation D make it harder for the issuers and first-time investors to sell the tokens. Also, Regulation A is better than Regulation D in terms of tokens’ fast trade volume.

The average ICOs’ size is around 25 million dollars in 2017.\(^{365}\) Taking this into consideration, many token issuers can get benefit from the Regulation A exemption. However, if we compare the Regulation A exemption experience with one of the largest token sales, such as

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\(^{360}\) Id.

\(^{361}\) Id.


the DAO which raised $150 million, the maximum amount that can be raised would be not
enough.

4.1.4 Regulation Crowdfunding

Regulation Crowdfunding can be another solution for token issuers.\footnote{Securities and Exchange Commission, 17 C.F.R. § 227.100 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018).} The issuers can only raise up to $1,070,000 with this exemption during each year.\footnote{Id.} There are certain limitations on the amount that the individuals can participate in crowdfunding.\footnote{Securities and Exchange Commission, 17 C.F.R. § 227.100(a)(2) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018).} If the individual investor’s annual income or net worth is under the $100,000, that individual can participate only up to $2,000 or 5% of annual income.\footnote{Securities and Exchange Commission, 17 C.F.R. § 227.100(a)(2)(i) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018).} If the investor’s annual income is higher than $100,000, the investor can contribute 10% of its annual income.\footnote{Securities and Exchange Commission, 17 C.F.R. § 227.100(a)(2)(ii) (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018).}

Issuers shall use the registered funding portal or SEC-registered broker or dealers.\footnote{Regulation Crowdfunding, U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding (last modified Sept. 27, 2018).} Also, there are several resale restrictions for crowdfunding.\footnote{Securities and Exchange Commission, 17 C.F.R. § 227.501(Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018).} There are some exceptions from this restriction in this rule that apply to certain issuers, accredited investors, and family members of the purchasers.\footnote{Securities and Exchange Commission, 17 C.F.R. § 227.501(Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018).} It would lower the cost of the registration process.

Some authors state that the crowdfunding exemption is not a good solution for initial coin offerings.\footnote{5 U.S.C § 77r(b)(4) (LEXIS through Pub. L. No. 115-281, approved 12/1/18).} One million dollars may not be enough for the average initial coin offerings.\footnote{15 U.S.C § 77r(b)(4) (LEXIS through Pub. L. No. 115-281, approved 12/1/18).}
Second, there are resale restrictions for the buyers. Third, there is a specific intermediary requirement for regulation crowdfunding. The author states that blockchain eliminates the need for an intermediary since everything is recorded on the ledger. I do not agree with this opinion because a registered intermediary can also create a blockchain ledger to manage crowdfunding processes.

On the other hand, there are several positive aspects of regulation crowdfunding. There is no restriction in the regulation that states only accredited investors, or a limited number of accredited investors, can participate. Also, these tokens will most likely be exempted from the state registration requirement. Depending on the size of the initial coin offerings, issuers can choose to get this exemption.

4.2 Decentralization of Managerial Efforts of Others

We discussed in the exemption part that if the token is a security what exemptions the issuers could get. In this part, we will focus on how we can create a token without it being a security in light of the SEC and the Courts’ decisions. The companies which issue the tokens can structure their tokens in a little bit different way.

As I discussed in the DAO decision, the SEC mainly focused on whether curators used the managerial efforts in the company. The SEC found out that DAO’s curators used

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375 As we discussed before, the average initial coin offering size is around 25 million dollars. *Supra* note 365.
376 Rohr & Wright, *supra* note 374.
377 Securities and Exchange Commission, 17 C.F.R. § 227.100 (Lexis Advance through the December 19, 2018 issue of the Federal Register. Title 3 is current through December 10, 2018)
379 *Supra* 3.4 Whether Decentralized Autonomous Organization Tokens Can be Considered As a Security?
managerial authority on the business. How can we create tokens without having managerial efforts from the group or individuals? The answer comes with the new technology: decentralization of the decision-making mechanism.

The DAO wanted to shift the managerial authority to the token owners, which almost hit the right point. However, the white paper mentioned that the company wants to protect the investors from the majority attacks and, therefore, they hired curators. The power of curators was very high. They had the power to choose which proposed agreement would be whitelisted and offered to the DAO token holders. Also, they had the right to decide how many proposals would be submitted to the system.

Let’s imagine the DAO fully decentralized the managerial efforts to all token holders. In the first moment, when token holders make decisions, there would be no responsible person or group for these managerial efforts. Therefore, there would be no responsible person to bear the managerial efforts of others prong in the first phase. However, after the project is selected, there will be one person or group who will be responsible for the rest of the managerial efforts. In this scenario, DAO tokens cannot be considered as a security. However, after the people raise funds to individual projects, there would be one person or group who would take responsibility for the project. Then, that project could be an investment contract; therefore, it would be a security.

4.3 Completely Functional Utility Token Solution for the Pre-Functional Utility Tokens

As we discussed in the second chapter, the intended purpose of the utility tokens is that they are designed to provide access for products or services. In short, if the token issuers

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380 Supra 3.4 Whether Decentralized Autonomous Organization Tokens Can be Considered As a Security?
381 Jentzsch, supra note 110.
382 Supra note 259.
383 Supra note 259.
promise to provide this access after a while, the token can be considered as pre-functional. On the other hand, if the issuer gives all the rights and services to the token holders at the time of sale, there is a fully-functional utility token.

Though pre-functional utility token issuers promise that they are going to develop the project, and one day the token holders will get the benefit, this promise cannot stop the SEC and Courts from deciding that pre-functional utility tokens are not securities. As we mentioned in Munchee and Storj tokens, pre-functional utility tokens are likely to be considered a security. The reason is that people have an expectation of profit from the managerial efforts of the token developer. The token holders believe that the company or the group will develop the application. Therefore, his or her investment becomes more valuable. Especially under the Risk Capital Test, the risk is higher for the investor who invests his or her money into the pre-functional utility tokens.

Therefore, companies should not try to launch an initial coin offering until they are confident that the token has real functions in it. This suggestion is for companies that want to launch real utility tokens, but did not make the token ready for use. If the company defrauds investors, blue sky law will stop the issuers at a certain point.

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386 Supra 3.2 Whether MUN Token, Which is Pre-functional Utility Token Promising Profit, Can be Considered as a Security? Supra 3.3 Whether Pre-functional Non-Profit Promising Storj Token Can be Considered as a Security?

387 Supra 3.2 Whether MUN Token, Which is Pre-functional Utility Token Promising Profit, Can be Considered as a Security?

388 Supra 1.4 Blue Sky Law and the Risk Capital Test.

CONCLUSION

Securities law is a legal field that is important for both federal and state governments. In 1911, Kansas started to regulate securities in order to protect its agriculturists from the wealthy industrialists. In 1933, the federal government adopted and expanded the application area of securities law. Although the federal government has made many decisions and continues to have primary control in securities law, states still have the power to enforce states’ securities regulations within their borders.\textsuperscript{390}

Both federal courts and federal administrative institutions, as well as state courts and state administrative bodies, analyze ICOs with different tests. The federal government and the majority of states implement the Howey Test to determine whether ICOs are securities. States that do not use the Howey Test apply the Risk Capital Test to ICOs instead, and they act according to the results. The primary purpose of the states is to record securities that are being sold in their region and to prevent fraud. Recently, North Dakota made many decisions on ICOs after the securities commission found out about illegal activities occurring within the state that had caused significant harm to investors.\textsuperscript{391}

Since this paper found that the majority of ICOs remain in the area of securities law, entrepreneurs must comply with the rules of this field. Until now, crypto entrepreneurs wanted to stay outside of securities law because the registration process is time-consuming and requires them to spend a considerable amount of money. Therefore, I focused on the registration exemptions and structure of the tokens to make the registration process easier and more accessible to entrepreneurs.\textsuperscript{392}

\textsuperscript{390} \textit{Supra} Chapter 1.  
\textsuperscript{391} \textit{Supra} Chapter 2.  
\textsuperscript{392} \textit{Supra} Chapter 4.
After deciding if a token is a security, there are ways for the issuers to comply with securities law. First, the issuer can register these tokens before selling them to the public. I did not discuss this option in this paper since many entrepreneurs do not favor this solution. Second, the issuer can apply for an exemption from registration. All exemptions have their own advantages and disadvantages.

The 1933 Act Section 4(a)2 and Regulation D Rule 506 have no limitation regarding the amount raised for companies. However, Regulation D Rule 504 has an upper limit of 5 million dollars, and Regulation A Tier I, Regulation A Tier II, and Regulation CF have upper limits of 20 million, 50 million, and 1.07 million dollars, respectively. Regulation D Rule 504 and Regulation A are the only exemptions with no resale restrictions. Other exemptions have six month or one-year exemptions, depending on the status of the issuers. If the issuer is the reporting company, then the restrictions are just for six months; otherwise, the resale restrictions are for one year. Regulation CF, Regulation A Tier I, and Regulation D Rule 506 generally do not need to be registered with the state securities office. However, 1933 Act Section 4(a)(2), Regulation D Rule 504, and Regulation A Tier II will most likely need to be registered with the state securities office. Token issuers should assess the benefits of the exemptions and apply for them with the SEC accordingly. In so doing, the obligations of the state for the registration or notification should also be reviewed, and these obligations must be fulfilled.\footnote{Id.}

Although it may be difficult to realize, issuers may be relieved of these obligations by going beyond the application of securities law. One of the solutions for remaining outside of securities law would be the decentralization of the decision-making mechanism to the investors. In this way, the investors will have control over the company. Therefore, the managerial efforts of others prong will shift to the investors. However, it is better for the investors to keep in mind
that, even if the DAO were to try this prong, the company would fail since there were curators who had the power to publish the offers according to their judgment. 394

Issuers may market their fully-functional tokens rather than unfinished projects. Many utility tokens were launched to develop new projects. For example, it is possible for the Storj token to be an investment contract under the Risk Capital Test, even if it does not offer a profit. The reason behind this is that issuers made the investors risk their money on unfinished projects. Therefore, if the issuer produces fully-functional utility tokens, there will be no investment contracts that investors will have to put at risk.395

394 Supra 3.4 Whether Decentralized Autonomous Organization Tokens Can be Considered As a Security?
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