

Cabinet Commentary

The Securities Law Treatment of Utility Tokens (Or Why It Is Past Time for the SEC to Engage with the Hard Questions)¹

January 11, 2022

This commentary represents the views of the authors only.

I. Introduction

A. *The Hard Questions*

Two hard questions have arisen with respect to the treatment of “utility tokens”² for purposes of the securities laws:

1. Is there a way for the creators of a blockchain network to fund the development of that network through the sale of utility tokens that can be either (i) used to obtain a service on the network or (ii) resold at a profit by the initial purchasers?
2. At what point is a blockchain network sufficiently developed such that it is reasonable to believe that utility tokens for the network are being sold for their use value and not for their speculative or investment value, and thus such tokens are clearly not “securities” for the purposes of the U.S. securities laws?

These questions raise important issues, from both legal and economic standpoints. They also raise challenging public policy issues—there are benefits to be gained and losses to be suffered however

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² New offerings of digital assets to a broad audience typically provide one of two potential uses: (i) either as a payment mechanism (cryptocurrency) with the hope that it will be eventually the subject of broad acceptance, or (ii) that the token will be usable on a closed network. Tokens focused on a specific use or functionality are called “utility tokens.” See Brian Nibley, [What is a Utility Token?](#), SOFI: SOFI LEARN (Dec. 22, 2021) (“A utility token is a crypto token that serves some use case within a specific ecosystem. These tokens allow users to perform some action on a certain network.”).

the Securities and Exchange Commission (“SEC”) (and perhaps ultimately the federal courts) answers the questions.

Currently, under SEC interpretations and in light of the SEC’s litigation against Ripple,³ it appears that the SEC’s answer to the first above question is pretty much a flat “no.” utility tokens can’t be sold for funding purposes. As to the second question, the SEC is apparently of the view that a blockchain network must be financed to completion (an impossible concept for a real-world product) through the sale of debt and equity securities before utility tokens may be sold to the network users. Even if the SEC’s position is legally justified (which is uncertain as to the first question and is not as to the second), and even if the SEC’s position is supported by public policy concerns (which it is), we think that the SEC’s current positions are unfortunate as a policy matter. The SEC leadership should engage more comprehensively with the policy issues raised by the sale of utility tokens usable on blockchain networks.⁴

Before diving into more substantive legal discussion, this commentary addresses three preliminary issues:

1. Which blockchains and digital assets are relevant for purposes of the U.S. securities laws—i.e., it’s not about Bitcoin.⁵ Rather, it is blockchains such as Ethereum and Ripple that are significant.

³ See Press Release, Securities & Exchange Commission, [SEC Charges Ripple and Two Executives with Conducting \\$1.3 Billion Unregistered Securities Offering](#) (Dec. 22, 2020); see also Ryan Browne, [Ripple Seeing ‘Good Progress’ in SEC Case Over XRP, Outcome Expected Next Year](#), CNBC (Nov. 23, 2021).

⁴ In referring to the “SEC leadership,” we mean to carve out SEC Commissioner Hester Peirce, who has published a thoughtful proposal for a token safe harbor, and who, notwithstanding her title, is currently very much a minority view at the SEC. As described in Section III of this commentary, Commissioner Peirce’s effort to define an acceptable way for developers of blockchain networks to use the sale of utility tokens to finance network development is a regulatory proposal that deserves more consideration from the SEC, and if SEC attention is not forthcoming, then from Congress.

It should also be understood that regulation of the sale of utility tokens is not a partisan political issue. During his term as chair of the SEC, Jay Clayton, a political independent appointed by a Republican president, appeared to have the same general level of skepticism of digital assets as current SEC Chair Gary Gensler. Indeed, there appears to be no meaningful gap between the statements of the two Chairs. Compare, e.g., SEC Chairman Jay Clayton, Testimony, [Testimony on ‘Oversight of the U.S. Securities and Exchange Commission’](#) (June 21, 2018), and SEC Chairman Jay Clayton, Public Statement, [Statement on Cryptocurrencies and Initial Coin Offerings](#) (Dec. 11, 2017), with SEC Chair Gary Gensler, Public Statement, [Remarks Before the Aspen Security Forum](#) (Aug. 3, 2021), and SEC Chair Gary Gensler, Public Statement, [Remarks before the Investor Advisory Committee](#) (Dec. 2, 2021). See also Nikhilesh De, [SEC Chairman Gensler Agrees with Predecessor: ‘Every ICO Is a Security’](#) (Aug. 3, 2021).

⁵ It appears now universally acknowledged that Bitcoin is not a “security” under the U.S. securities laws. More than half a decade ago, the Commodity Futures Trading Commission (“CFTC”) categorized Bitcoin and certain other virtual currencies as “commodities” under the Commodity Exchange Act. See [In re Coinflip, Inc. d/b/a Derivabit, and Francisco Riordan](#), CFTC Docket No. 15-29 (Sept. 17, 2015); see also [Bitcoin Basics](#), CFTC (last accessed Jan. 10, 2022); [Digital Assets Primer](#), CFTC, at 24 (Dec. 2020); [SEC Chairman: Cryptocurrencies Like Bitcoin Are Not Securities](#), CNBC (June 6, 2018).

2. Why the sale of utility tokens is a peculiarly useful way to finance networks built on the blockchain.
3. Why the policy issues raised by the sale of utility tokens to provide blockchain network financing are both important and difficult.

B. *The Utility Tokens That Are the Subject of This Commentary*

There are numerous different uses for blockchain technology and likewise different types of digital assets. This memorandum is not concerned with (i) Bitcoin, (ii) stablecoins backed by fiat currency that are used to transfer, for example, dollars held at a bank, (iii) stablecoins backed by a basket of network-approved cryptocurrencies, or (iv) non-fungible tokens (“**NFTs**”) that represent an ownership interest in a unique asset and that are not fungible with other tokens.

Rather, this memorandum is concerned with those tokens:

- a. that can be “spent” on a blockchain network to make use of services that are available through that network;
- b. that can be readily sold (ideally at a profit) by an owner to another person, who may in turn use the token on the network or may resell it (ideally at a profit);
- c. usable on a network that is under the control of a reasonably defined group of individuals upon whose efforts the ultimate success of the network as a commercial venture is dependent;⁶
- d. where a portion of the revenues generated by the individuals who control the network may be used to improve the network because that is what successful developers do—they aim to improve their products constantly;⁷ and

⁶ The U.S. securities laws may provide exemptions for so-called “digital autonomous organizations” (“DAOs”) in which control over a blockchain network is highly dispersed and potentially anonymous. As a general matter, any newly created blockchain network is likely to be controlled by and dependent on the efforts of a limited number of individuals. In any case, discussion of the legal and policy issues surrounding DAOs is outside the scope of this commentary.

⁷ If the relevant network is fully functional, or at least functional to the extent that purchasers of the tokens are happy to buy them without any expectation that the tokens will increase in value with the improvement of the network, the token clearly ought not to be a security.

- e. where a significant part of the value of the network will depend on its ability or eventual ability to attract a large number of users who may use the network to communicate or to transfer information or value between them.

Two of the most significant examples of tokens that either now or at one time fit the description above are Ether, which can be used on the Ethereum blockchain, and XRP, which is used on the Ripple blockchain.

C. *Why Blockchain Networks Are Financed through the Sale of Utility Tokens*

There is something peculiar about the financing of blockchain-based networks through the broad-based sale of utility tokens. By “peculiar,” we mean that there is a reason that blockchain-based networks have been financed in this manner, while, for example, Elon Musk does not finance the building of Teslas through the sale of utility tokens. This peculiarity is very important because if there were no reason that blockchain products might be financed in a different manner than Teslas, there would be no reason to consider whether the U.S. securities laws should be applied differently.

As a starting matter, because utility tokens are intended to be used on a blockchain network, and because the value of the blockchain network increases as more people use it, the purchasers of utility tokens are in fact adding to the value of the network.⁸ Thus, from the perspective of the network developers, it is essential that they obtain wide distribution of the utility tokens. One way to do this is to sell the early purchasers of the tokens an asset that has real potential to appreciate in value, *i.e.*, to sell the early purchasers tokens at a price below the hoped-for ultimate use value of the token. From the perspective of the network builders, this makes sense because their cost of manufacture of an additional token is effectively zero, so selling utility tokens cheap in the early stages of the network to obtain both distribution and financing makes perfect sense. (Obviously, this would not make sense as a way to finance Teslas because the cost to manufacture a Tesla is relatively high. Further, while there are economies of scale in almost any manufacturing process, those economies are not as significant as the benefits of scale in the development of a network, where scale is the be-all.)

It is inherently easy and cheap to transfer utility tokens on the blockchain—easier than going down to the corner grocery store. An unregulated “DeFi” exchange can provide near instantaneous and, in many instances, near costless transfer using peer-to-peer settlement with no intermediary standing between the buyer and the seller. From the standpoint of the network developer, this ease of

⁸ See SEC Commissioner Caroline A. Crenshaw, Speech, [Digital Asset Securities – Common Goals and a Bridge to Better Outcomes](#) (Oct. 12, 2021) (“The network effects aspects of digital assets is a fancy way of saying that for some projects, developers need to widely distribute their tokens, generate sufficient interest in their use and exchange, and align incentives of various cohorts to establish a functional network of motivated participants. Essentially, the economic principle of network effects posits that the more individuals you have actively participating in a network, the more valuable the network is.”) [hereinafter referred to as the “**Crenshaw Speech**”].

acquisition and transfer has both disadvantages and advantages. The disadvantage is that there is no inherent reason for a user of a utility token to buy the token until just-in-time of use, since it is so easy to purchase online. This raises particular difficulties for a network that is constantly improving, as many networks strive to do. Why should purchasers buy utility tokens now if they can easily buy them later? Moreover, perhaps the network will be better later anyways. From the standpoint of the network creator, this disincentive to purchase has to be overcome, and the way to overcome it is to sell utility tokens at a material discount to what the creator expects to be their ultimate use-value or market value, and to allow for the easy resale of the tokens by a purchaser, potentially at a profit.

From the standpoint of the network creator, there is also a great benefit in the fact that there are numerous exchanges for the sale of tokens, and the price of trading is driven down by this competition between exchanges. In contrast to used Teslas (and used cars generally), previously owned utility tokens are absolutely fungible, and do not lose their value by having been driven many miles or been in an accident. Furthermore, unlike Teslas, utility tokens can be sold in very small amounts and at a low dollar price. This is clearly significant for purposes of sales to retail purchasers and where the goal of a network is to obtain widespread consumer usage.

In short, there are reasons specific to blockchain networks for why the sale of utility tokens that may be used either on the network, or transferred to others at a profit, is a good way to finance the development of a network but would not work for the financing of Teslas.

D. Why the Regulation of the Sale of Utility Tokens Is an Important Issue, but Challenging

1. Why It Is Important?

If blockchain networks were just like pet rocks, it would not matter much how the sales of utility tokens were regulated. Perhaps over-regulation of the sale of the pet rocks would cause the United States to lose its advantage in such sales to Iceland, but there would be no material long-term harm done to the U.S. economy.

So the question is, are blockchain networks just like pet rocks? Blockchain technology is almost universally agreed to have immense potential value. For example, the U.S. securities markets may be required to move to T+1 settlement, and such a move appears very likely to be facilitated by the use of blockchain technology.⁹ China is developing its own central bank digital currency that it likely hopes will one day surpass the U.S. dollar as the world's currency of choice.¹⁰ Stablecoins represented by

⁹ See David Chaplin, [Settle Down: DTCC Clears Blockchain for T+0 Take-Off](#), INVESTOR STRATEGY: NEWS (Sept. 17, 2021).

¹⁰ See James T. Areddy, [China Creates Its Own Digital Currency, A First for Major Economy](#), WALL STREET JOURNAL (April 5, 2021).

dollars held at banks are already beginning to pose a very significant challenge to ordinary credit cards as a way to make routine payments without carrying physical currency, but at a lower cost than credit card charges.¹¹ Blockchain networks such as OpenSea that facilitate the transfer of NFTs (and likely at some point real estate ownership and other properties) do billions of dollars of business.¹² Facebook changed its name to Meta for a reason.¹³ There is of course much more. In short, blockchain networks are not pet rocks.¹⁴

2. *Why Is the SEC Intent on Regulating the Sale of Utility Tokens as Securities?*

Blockchain networks are largely startup businesses and often startup businesses fail and lose their investors' money. Furthermore, as with any "exciting" technology that gets widely hyped and is difficult for ordinary consumers to understand or evaluate, there has been very significant outright fraud in the sale of utility tokens by promoters.¹⁵ Given that it is one of the primary tasks of the SEC to protect investors, particularly retail investors, it would be a dereliction of duty by the agency to simply declare that it is hands-off as to digital assets. In fact, the SEC has rightfully brought enforcement actions against purported developers of blockchain networks that were simply fraudsters.¹⁶ (However, we do not accept the conclusion that the existence of fraud is a reason to walk away from the challenge of an important technology.)

II. Securities Laws

A. *The Current State of the Law as to Utility Tokens: Howey and Forman*

There are two major Supreme Court cases that generally inform the SEC's characterization of utility tokens as securities: *Howey*¹⁷ and *Forman*.¹⁸ Both of these cases are discussed in good detail

¹¹ See Avivah Litan, [Credit Card Brands Should Move beyond Bitcoin Trading to Stablecoin Payments](#), GARTNER: BLOG (Feb. 4, 2021); see also Amit Rajpal and Paul Marshall, [Op-Ed: Stablecoin is the Future of Virtual Payments. How Wise Regulation Can Foster its Growth](#), CNBC (July 13, 2021).

¹² See Natasha Dailey, [NFTs Ballooned to a \\$41 Billion Market in 2021 and are Catching Up to the Total Size of the Global Fine Art Market](#), MARKETS INSIDER (Jan. 6, 2022).

¹³ See Salvador Rodriguez, [Facebook Changes Company Name to Meta](#), CNBC (Oct. 28, 2021); see also Ryan Mac, [Meta Aims for 'Deep Compatibility' With Blockchain, According to an Internal Post](#), N.Y. TIMES (Dec. 22, 2021); [Facebook's Parent Meta Promises to Make Friends With Blockchain](#), PYMNTS (Dec. 26, 2021).

¹⁴ For a much fuller discussion of the potential of blockchain, albeit one that is largely focused on cryptocurrency, see former CFTC Chair J. Christopher Giancarlo's recent book *CryptoDad: The Fight for the Future of Money*.

¹⁵ See Securities & Exchange Commission, Investor Alert and Bulletin, [Digital Asset and "Crypto" Investment Scams](#) (Sept. 1, 2021).

¹⁶ See Securities & Exchange Commission, [Cyber Enforcement Actions](#) (last accessed Jan. 11, 2022).

¹⁷ [SEC v. W. J. Howey Co.](#), 328 U.S. 293 (1946).

¹⁸ [United Housing Foundation, Inc. v. Forman](#), 421 U.S. 837 (1975). Given that *Forman* is not so well known as *Howey*, we provide a brief overview: In *Forman*, the Supreme Court found that an asset that was called "stock"—specifically, an ownership

elsewhere (particularly *Howey*¹⁹) so we are not going to retread overly familiar ground in detail. Rather, we are going to state the crux of each of the two cases in (very) oversimplified terms:

1. *Howey* holds that if the *purchase* of an asset is made not to use the asset but to resell the asset at a profit, then the asset is very likely to be a security.
2. *Forman* holds that if the purchaser of the asset cannot resell the asset at a profit, then the asset is not a security.

For the developers of blockchain networks that want to encourage potential purchasers of the utility tokens to buy on the hope that the tokens will not only have a use, but may also increase in value for resale, the simplistic application of *Howey* and *Forman* to utility tokens is a bad result. It means that to avoid *any* risk of the application of the U.S. securities laws, the sellers of the utility tokens must make it essentially impossible for either purchasers to transfer the tokens to other purchasers, or for the tokens to rise in value.

B. The Problem with Applying the Securities Laws to the Sale of Utility Tokens

Speaking generally, newly issued securities can be sold in three ways: (i) in a private placement; (ii) outside the United States; or (iii) in publicly offered sales that are registered with the SEC.

None of these three methods of sale works for the sale of utility tokens in the United States.

If the utility tokens are sold outside the United States, or to private “accredited investors” in the United States, the restrictions on the tokens’ resale in the United States would materially impede and substantially delay the possibility of creating a broad network. Once the tokens (if they are securities) are owned by a reasonably wide network, the tokens would be subject to registration and regulatory requirements under the Securities Exchange Act of 1934 (the “**Securities Exchange Act**”), thus

interest in a co-operative apartment building where the owners of the “stock” would live—was not, in fact, a security, even though the securities laws expressly define “security” as including “stock.” Under the regulations that applied to transfers of the ownership interests, the owners could not sell the interests at a profit. Given these facts, the Supreme Court explained that the investors’ “inducement to purchase [the stock] was solely to acquire low-cost living space; it was not to invest for profit.” *Forman* at 851. In addition to the fact that the investors received a substantial use value from the ownership interests, it is also notable that the construction of the apartment buildings did not depend upon the money raised from the sale of the stock.

¹⁹ Numerous federal court cases have interpreted the Supreme Court’s ruling in *Howey*, which is more commonly known as the “*Howey* Test.” See, e.g., *Eberhardt v. Waters*, 901 F. 2d 1578 (11th Cir. 1990); *Goldberg v. 401 North Wabash Venture LLC*, 904 F. Supp. 2d 820 (N.D. Ill. 2012); *Baroi v. Platinum Condominium Development, LCC*, 914 F. Supp. 2d 1179 (D. Nev. 2012); *De Wit v. Firstar Corp.*, 879 F. Supp. 947 (N.D. Iowa 1995). See also Nathan Reiff, [Howey Test](#), INVESTOPEDIA (July 5, 2021) (providing an overview of the Supreme Court’s *Howey* Test).

largely obviating the benefit of avoiding registering the securities under the Securities Act of 1933 (the “**Securities Act**”).

Conversely, if the utility tokens were to be registered under the Securities Act, the expense of registration would be likely impossible for a startup to bear (pure startups don’t register under the Securities Act). The network would also be immediately subject to the regulatory requirements of the Securities Exchange Act. These are just not manageable expenses for a new blockchain network.

The bottom line of this is that, as a practical matter, it is completely economically impossible to treat the sale of utility tokens on a blockchain network that is intended to have broad participation as distributions of securities. If the expenses of Securities Act registration don’t kill the firm, then the expenses of Securities Exchange Act regulation and the related regulatory burdens will. Indeed, the proof of this statement is in the pudding: no one has attempted this path to “compliance” and we do not believe anyone will.

III. SEC Commissioner Peirce’s Token Safe Harbor Proposal

A. *Summing Up Parts I and II of this Memorandum*

In the above sections of this memorandum, we have tried to establish the following points:

1. Blockchain technology is potentially very significant and the United States should have a strong interest in encouraging the development of the technology—*i.e.*, blockchain networks are not pet rocks.
2. The nature of blockchain technology as a digital network means that there seems to be a logical reason why blockchain networks are commonly financed through the sale of utility tokens—*i.e.*, blockchain networks are not Teslas.
3. As with any new business, there will be many failures. As with any novel financial idea that generates excitement, there will be fraud—*i.e.*, investor protections should not be disregarded.
4. The regulation of the sale of utility tokens as securities just does not work for purposes of sales of utility tokens in the United States. If the SEC is asserting that a utility token must be regulated as if it is an ordinary security, then as a practical matter the token cannot be sold to a broad group of retail investors—*i.e.*, applying securities law registration requirements to the sale of utility tokens is an economic nonstarter.

B. SEC Commissioner Peirce Takes On the Conundrum

Essentially, the question that the above four points raises is as follows: can a reasonable measure of protection be provided to retail investors without regulating utility tokens that are used to raise money to develop the network as securities? (Notice that we do say “reasonable measure” and not “exactly the same measure as in the sale of equity securities.”)

SEC Commissioner Hester Peirce has tried to tackle that problem. In April 2021, SEC Commissioner Peirce outlined an updated proposal that would establish, for a newly issued token, a three-year safe harbor from the registration requirements of the Securities Act of 1933, although the antifraud provisions of the securities laws would continue to apply.²⁰ Commissioner Peirce explained that the purpose of the three-year period is to provide a token’s “Initial Development Team”²¹ the opportunity to develop a network such that the tokens “are actually in use to purchase and sell the services for which they were intended.” In effect, the three years would allow the tokens to transition from the realm of *Howey* (where purchasers of tokens may hope to make a profit on the resale of the tokens) to the realm of *Forman* (where purchasers of the tokens buy them to use on the network without an expectation of profit on a resale).

As proposed by Commissioner Peirce, in order to qualify for the token safe harbor, the developers of a utility token would (i) be required to make a filing with the SEC, (ii) make various initial and ongoing disclosures as to the Initial Development Team and as to progress on the product, (iii) would be subject to the application of the civil liability and antifraud provisions of the Securities Act, and (iv) would be given a limited amount of time to develop a functional product and if the product did not become functional in that time, further sales of the token would become fully subject to the U.S. securities laws.

Commissioner Peirce has twice asked for public comment and suggestions as to her proposal. Additional requirements and conditions could be added. It is not the purpose of this commentary to critique, or to attempt to improve or modify, Commissioner Peirce’s proposal. Rather, we simply want to call renewed attention to its existence, and to point out that it is possible to propose modifications to the application of the securities laws that both provide (i) a reasonable measure of protection to retail investors, and (ii) a way for developers of a blockchain network to raise money in the United States through the distribution of utility tokens.

²⁰ SEC Commissioner Hester Peirce, Public Statement, [Token Safe Harbor Proposal 2.0](#) (April 13, 2021). Commissioner Peirce initially proposed the token safe harbor in February 2020 and revised it after receiving feedback from the cryptocurrency community, securities lawyers and the public. See SEC Commissioner Hester Peirce, Speech, [Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization](#) (Feb. 6, 2020).

²¹ Which includes any individual or entity that “provides essential managerial efforts” towards the development of a decentralized or functional token network.

In reaction to Commissioner Peirce's proposal, Commissioner Caroline A. Crenshaw, who likely represents the majority view at the SEC, appeared to be very skeptical of the value of a utility token safe harbor.²² She describes the proposal as one that puts utility tokens "outside [SEC] jurisdiction," a description of the proposal that appears unfair given that Commissioner Peirce's proposal (i) outlines several disclosure requirements, (ii) requires filing with the SEC, and (iii) provides for the application of the SEC's antifraud authority under the Securities Act. Further, there is no reason to think that Commissioner Peirce's proposal could not be made subject to further reasonable conditions.

IV. The SEC's Failure to Engage

While the SEC has asserted that it has issued numerous investor education pieces (which are just cautions against the risk of investment in digital assets) and other materials in regard to digital assets, there is actually very little that reflects genuine policy engagement with the hard questions surrounding the sale of utility tokens.

A. *Three Uneventful No-Action Letters*

The SEC has issued three no-action letters in regard to SEC registration of utility tokens as securities.²³ No-action letters are generally intended to provide some guidance as to either an area where the law is unclear, and perhaps some limited relief from what might otherwise be considered a securities law violation. None of these letters appears to serve that purpose. It is a requirement of each of the letters that the utility tokens be structured in such a way that it is impossible for the purchasers of the tokens to make a profit on their resale. The letters accomplish this in various ways including by imposing limits on resale, or by the issuer promising to make an infinite quantity of the utility tokens available at the same price so that it would be impossible for a shortage of the tokens to create demands to raise the price.

It would be bad enough if these letters simply tracked *Forman* by preventing resale of the tokens at a profit. In fact, they are more disadvantageous to blockchain network operators. All of the letters require that the network operators not use the revenue from the sales of the tokens to improve their

²² See [Crenshaw Speech](#) ("There have been many suggested paths forward. For example, several proposals would provide certain digital assets exemptions or safe harbors from registration obligations and other regulatory oversight. Rather than solving for how to make the use of these digital asset securities compliant from the moment investors put their capital at risk, these proposals would define the tokens as outside our jurisdiction, at least for several years. One aspect of these proposals makes a lot of sense to me...Requiring honest disclosures of the development team on whom investors are relying is a necessary step. However, it is not sufficient by itself."). In the view of one of the authors of this commentary, Commissioner Crenshaw's remarks on Commissioner Peirce's token safe harbor proposal were negative to the point of being dismissive.

²³ See Securities & Exchange Commission, No-Action Letter, [Turnkey Jet, Inc.](#) (April 3, 2019); Securities & Exchange Commission, No-Action Letter, [Pocketful of Quarters, Inc.](#) (July 25, 2019); Securities & Exchange Commission, No-Action Letter, [IMVU, Inc.](#) (November 17, 2020).

product.²⁴ How can any business survive if it does not use the revenue from the sale of its products to improve such products? This is not a reasonable requirement, nor is it in any way ordinary or realistic. Rather it is one that can be reasonably interpreted as demonstrating the SEC's refusal to engage with the question of how to properly regulate the sale of utility tokens. The letters also impose other conditions that go beyond the limits of *Forman*. For example, as a condition of its no-action relief, the SEC obligated IMVU, Inc. to require purchasers of the utility tokens to "affirm that, among other things, they are acquiring VCOIN [the IMVU utility token] for consumptive use and not for speculative purposes." That is simply not a normal requirement for a purchaser of a product that has zero potential speculative benefit.

B. *Failure to Clarify*

In what may be the friendliest statement made by an SEC official outside of Commissioner Peirce (and it wasn't all that friendly), William Hinman, the former Director of the SEC Division of Corporate Finance, described several factors that may enter into the SEC's consideration of whether a digital asset may be considered a security. In a June 2018 speech, he raised thirteen "facts and circumstances" questions that he believed the SEC should consider in making a determination as to whether a utility token is a security.²⁵ As a practical matter, if there are thirteen facts and circumstances questions that must be answered to make that determination, then, if the determination is important, the burden should be on the SEC at least to suggest how to weigh the various facts and circumstances. But, unfortunately, the SEC has not provided such specific guidance.²⁶

²⁴ See [TurnKey Jet, Inc.](#) ("[Turnkey Jet, Inc.] will not use any funds from Token sales to develop the TKJ Platform, Network, or App, and each of these will be fully developed and operational at the time any Tokens are sold"); see also [Pocketful of Quarters, Inc.](#) ("[Pocketful of Quarters, Inc.] will not use any funds from Quarters sales to build the Quarters Platform, which has been fully developed and will be fully functional and operational immediately upon its launch and before any of the Quarters are sold; see also [IMVU, Inc.](#) ("IMVU will not use proceeds from the sale of VCOIN to finance its Upgrade, which has been fully developed and will be fully functional and operational immediately upon its launch and before any VCOIN is sold.").

²⁵ See William Hinman, Director of the Division of Corporation Finance, Securities & Exchange Commission, Speech, [Digital Asset Transactions: When Howey Met Gary \(Plastic\)](#) (June 14, 2018). Among the factors that former Director Hinman thought needed to be considered in assessing whether a digital asset is offered as a security were the following: (i) whether there is a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value; (ii) whether application of the Securities Act protections make sense (e.g., whether informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset); (iii) whether token creation is commensurate with meeting the needs of users, in contrast to feeding speculation; (iv) whether the primary motivation for purchasing the digital asset is for personal consumption or speculative investment; and (v) whether the assets are marketed across a diverse user base or concentrated in the hands of a few investors that have disproportionate influence over the application.

²⁶ We note that with the exception of the SEC no-action letters discussed in this commentary, it appears that the only guidance that the SEC has published with respect to how to determine whether a digital asset is a security is the SEC's Framework for Investment Contract Analysis of Digital Assets. See Strategic Hub for Innovation and Financial Technology, Securities and Exchange Commission, [Framework for "Investment Contract" Analysis of Digital Assets](#) (last modified April 3, 2019) [hereinafter the "**Digital Asset Framework**"]. The Digital Asset Framework primarily focuses on how promoters, sponsors and third parties providing essential managerial efforts impact the success of the digital asset and the degree to which

What is worse, many of the questions seem ill-considered or irrelevant to the issue. For example, Mr. Hinman asks: Does the developer of the system continue to expend funds to improve the system? Are independent actors seeking to influence trading? As to the first question, the answer is obviously “yes.” What business does not spend some of its revenue trying to improve its product? As to the second question, the answer is, why does it matter what persons who are independent of the developers of the network do? A network developer should not be deemed to create a security because of something an independent person does. But if the SEC really wants to make the law clear, it could at least start with former Director Hinman’s questions and give some guidance as to how they apply to real world situations.

The same issue of a failure to clarify has arisen in the SEC’s enforcement action against Ripple, in which the SEC has asserted that the Ripple utility tokens are securities.²⁷ The lawyers for the Ripple defendants have asked the SEC to provide its internal documents supporting the decision-making process by which the SEC determines which utility tokens are securities. Thus far, the SEC has declined, asserting that its files are privileged. While we understand that the SEC wants to win the case, and turning over the documents may weaken its position, we also believe that the burden of explaining its interpretation of the law to market participants is rightfully on the government, even in the context of litigation.

investors reasonably expect to derive profit from such efforts. As a practical matter, the Digital Asset Framework follows the *Howey* and *Forman* analyses: (i) if digital assets are purchased for profit, such assets are very likely securities; (ii) if digital assets are purchased entirely for use, without regard to the potential for profit, such digital assets are not securities. However, in analyzing the Digital Asset Framework it does not appear that the framework purports to allow for the possibility that a digital asset that was originally a “security” may, through widespread development and usage, lose its character as a security and become a utility token. While the purpose of the Digital Asset Framework was essentially to provide guidance to developers as to the limits imposed on the digital assets that would not be deemed securities, as a practical matter such limits detailed in the Digital Asset Framework are quite severe and effectively would serve to discourage any new digital product where the purchaser of the asset is buying the asset for speculative investment purposes.

²⁷ See Press Release, Securities & Exchange Commission, [SEC Charges Ripple and Two Executives with Conducting \\$1.3 Billion Unregistered Securities Offering](#) (Dec. 22, 2020). A fulsome discussion of the facts of the Ripple litigation are outside the scope. Indeed, the Ripple litigation deserves its own lengthy piece of commentary. However, it should be noted that there is one aspect of the SEC’s lawsuit against Ripple that is particularly distressing. According to Item 3 in the SEC’s complaint, “Ripple engaged in [the] illegal securities offering from 2013 to the present, even though Ripple received legal advice as early as 2012 that under certain circumstances XRP could be considered an ‘investment contract’ and therefore a security under the federal securities laws.” SEC Complaint, [Securities & Exchange Commission v. Ripple Labs, Inc. et al.](#), at 2 (Dec. 22, 2020). In other words, the SEC makes the argument that because approximately ten years ago, a lawyer told Ripple that the law was unclear and that “under certain circumstances,” the relevant token could be a security, then it follows that the token is a security. It is not just that this is bad argumentation. It is a troubling argument even to advance. There are numerous situations in which the law is unclear and market participants must make judgments. Asserting that the fact that a market participant will act in the face of uncertainty means that the market participant has likely violated the law is not a good way to regulate. The burden is on the regulator to define the law.

C. *Like Should Be Treated Alike*

In the interim between Mr. Gensler's service as Chair of the CFTC and his current role as SEC Chair, he gave a series of well-regarded lectures at MIT in regard to the blockchain.²⁸ Briefly discussing the regulation of blockchain products, then-Professor Gensler laid out what he called "The Duck Test"—in effect, that an asset that looks like a duck, and quacks like a duck, should be treated like a duck.²⁹ While he has not been explicit as to this, it appears fairly obvious that what he intends to say is that digital assets, including utility tokens, that have some element of being a "security" inherent in them, should be fully regulated as securities.³⁰

More recently, albeit not in relation to digital assets, Chair Gensler stated that it is the responsibility of the U.S. financial regulators to "[t]reat like cases alike," citing Aristotle to that effect.³¹ While the statement that "like should be treated alike" seems a syllogism, its "truth" is not as obvious as it might appear.³² In practice, the U.S. regulatory system does not treat all similar financial assets similarly, even those assets that are securities. We have different regulations for securities that are equities vs. debt, for U.S. securities vs. foreign, for corporate securities vs. asset-backed, for private securities vs. municipal securities. We have different regulations for open-end funds, closed-end funds, unit investment trusts, ETFs, Section 3(c)(1) private funds and Section 3(c)(7) funds, money market funds, and at least a dozen more. The proper response to "like should be treated alike" is "one size does not fit all."

To repeat what we said earlier, the financing of a blockchain network is not necessarily the same as the financing of Tesla. If those two activities are substantively different, for whatever reason and in whatever way, and if the activities are of importance to the U.S. economy, then it is incumbent upon

²⁸ See Gary Gensler, MIT Lecture Series, [Blockchain and Money](#), MIT OPENCOURSEWARE (Fall 2018).

²⁹ *Id.* at Lecture 1, at approximately [36:46](#) of the lecture.

³⁰ SEC Commissioner Crenshaw makes an analogous statement in the [Crenshaw Speech](#). Specifically, she states: "[G]ranting a special exemption to these projects [for the development of blockchain networks] would provide unfair advantages to blockchain related businesses and disadvantage everyone else: participants who raise capital in compliant ways that support healthy markets and informed investors."

³¹ See SEC Chair Gary Gensler, Speech, [Remarks Before the Healthy Markets Association Conference](#) (Dec. 9, 2021). SEC Chair Gensler made the "like should be treated alike" statement in regard to the treatment of a SPAC as any other initial public offerings.

³² Oddly enough, in his speech supporting that proposition that "like should be treated alike", SEC Chair Gensler refers for support to an article published by political science professors at Princeton and Baylor. While the article does indeed agree that Aristotle was of this view, the authors of the article said "the maxim is either unhelpful or pernicious," because it implicitly does not acknowledge that matters may be like in some respects and wholly different in others. See Benjamin Johnson and Richard Jordan, [Why Should Like Cases Be Decided Alike? A Formal Model of Aristotelian Justice](#), (March 1, 2017) ("[I]nvoking the like-cases maxim is not just a waste of paper; it may also be deeply insidious.").

the SEC to consider those differences and to adjust their regulations accordingly, or at least to consider doing so.

D. *Come In and Work With Us (or Not)*

In light of the uncertainty as to the legal treatment of digital assets and utility tokens, SEC Commissioner Crenshaw has invited market participants to come in and talk to the regulators.³³ However, she has warned those who do come in, that they must “come to us with detailed plans for how you will offer a comparable level of disclosure, investor protection, market access, and other important protections guaranteed by the securities laws.”³⁴ Even with all that, SEC Commissioner Crenshaw warns, “I do not pretend this path is easy, costless, or fast. . . [a] fact that, I know, has deterred many market participants.”³⁵ As to whether the SEC might proactively engage in an analysis of utility tokens without being prompted by market participants, Commissioner Crenshaw said: “We also do not have the resources to do that. And most importantly, analyzing regulatory compliance has always been, first and foremost, the responsibility of the enterprise and their counsel.”³⁶

There are two questions raised by the Crenshaw Speech:

1. Is the invitation to meet with the SEC attractive?; and
2. Should the SEC in fact devote resources to the issue of utility tokens, even in the absence of market participants directly approaching the regulator?

As to the first question, the answer is likely “no.” In fact, even Commissioner Crenshaw recognizes that the terms of the SEC’s invitation “[have] deterred many market participants.” Certainly, there is nothing in the no-action letters referenced above that suggests it would be worthwhile for developers to request a meeting with the SEC.

³³ See [Crenshaw Speech](#) (“But I believe that if market participants accept proactive responsibility for compliance, we can build a bridge that promotes innovation while preserving market integrity and providing the investor protections needed for these new markets to grow. To me, this requires interested parties – including token issuers, exchanges, and others – to conduct their own analysis of their regulatory compliance, and be ready to share that with us. If you likely fall within our jurisdiction, work with us to describe your plan to comply or explain why some exemption is appropriate. If you have concerns that you can only comply with certain requirements because the nature of your project doesn’t completely fit within our existing framework, come to us with detailed plans for how you will offer a comparable level of disclosure, investor protection, market access, and other important protections guaranteed by the securities laws. Do that before moving forward.”).

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

As to the second question, it appears from Commissioner Crenshaw's October 2021 speech that the SEC is not keen on devoting resources in the absence of market participants reaching out to the SEC. That is of course a policy decision. Yet, the decision not to allocate resources to the issue, however strapped the SEC may be, seems imprudent.

E. *Just How Do You Get from Here to There?*

In his June 2018 speech referenced above, former Director of Corporate Finance Hinman says:

*"And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions."*³⁷

In other words, it is possible for a utility token (Ether) to metamorphose from caterpillar (security) to butterfly (utility token). Now, the SEC should tell market participants how it can be done. Presumably, in the case of Ether, the SEC would say it was done by flying under the radar, so that the initial fundraising was done without attracting regulatory notice—*i.e.*, by the time that Ether was within regulatory notice, Ether was no longer a security.

Put bluntly, the remarks of former Director Hinman and the SEC's activity with respect to digital assets collectively appear to indicate to the developers of blockchain networks that "if you can get away with the sale of utility tokens for long enough, you might be ok if you get to be as big as Ethereum, but if you are unlucky, and a little smaller, we might take you to court like Ripple." This message is just not helpful, and it illustrates the failure of the SEC to engage with the regulatory conundrum posed by utility tokens.

V. Conclusion

Ethereum and Ripple are very significant blockchain networks, based on market value and trading liquidity of the tokens, and, in our view, likely more important than Bitcoin in view of the development of the underlying technology. One of these networks (Ethereum) is generally understood to have "escaped" the application of the securities laws (though that remains to be seen with the development of Ethereum 2.0³⁸); the other is now in court.

³⁷ See Hinman, *supra* note 25 (emphasis added).

³⁸ We note that former Director Hinman's June 2018 comments were in regard to Ethereum 1.0. More recently, Ethereum has started development on a set of upgrades collectively entitled "Ethereum 2.0" which are supposed to make the Ethereum blockchain "more scalable, more secure, and more sustainable." See Ethereum, [Upgrading Ethereum to Radical New Heights](#)

Both of these products were developed through the sale of utility tokens, not by the SEC's preferred method of sales of equities or debt leading to the development of a fully usable network before any utility tokens were sold. It is possible that the financing of the leading blockchain networks in this manner is purely coincidental, but it is also possible that there is something inherent in the nature of the networks that makes their financing through the sale of utility tokens a logical way to go.

If the financing of blockchain networks through the sale of utility tokens is effectively prohibited by the SEC, that seems a material impediment to the development of such networks in the United States. That, in turn, is very likely a material loss to the U.S. economy and certainly a loss of financial innovation in the U.S.

Even worse, the SEC's no-action letters and statements on utility tokens imply that a blockchain network would be prohibited from selling utility tokens without SEC registration if the revenue from the sale can be used to improve such network (a requirement of all of the SEC's no-action letters on the subject). That implication is wholly impractical and does not follow from the statement "like should be treated alike," nor from the *Forman* case.

We do not suggest that the necessary alternative to comprehensive securities regulation of utility tokens used to finance a blockchain network is to ignore them entirely and hope that investors are not too badly damaged. Clearly, there is too much fraud, and too many unsophisticated investors for that to be a responsible path, or a politically feasible one, for the SEC to take.³⁹

However, a middle ground seems possible, as illustrated by SEC Commissioner Peirce's proposal. That middle ground may provide somewhat less investor protection than the full application of the U.S. securities laws (which, as demonstrated above, effectively prohibit the sale of utility tokens used for financing), but may be one that provides sufficient investor protection as well as benefits to the U.S. economy by facilitating financial innovation.

Given the significance of blockchain networks and utility tokens in absolute size, and their potential significance to the 21st century global economy, we think it is time for the SEC to move past "like should be treated alike" and on to "one size does not fit all." If the SEC is not willing to engage as to

(last accessed Jan. 10, 2022). The specifics of Ethereum 2.0's development are beyond the scope of this commentary, and the SEC has not made any comment as to the project's status under the Securities Act.

³⁹ Likewise, the suggestion by some market participants and policy makers that digital assets require their own regulator is a nonstarter, both as a political matter and as a matter of governmental efficiency. See Coinbase, [Digital Asset Policy Proposal: Safeguarding America's Financial](#) (Oct. 14, 2021). Any new regulator would simply have to deal with the same questions that the SEC should confront. The regulatory problem is not how to create a new regulator; the regulatory problem is how to deal with the policy challenges created by utility tokens. See also Steven Lofchie and Sebastian Souchet, Comment, [Coinbase Proposes Regulatory Framework for Digital Assets](#), CADWALADER CABINET (Oct. 15, 2021).

the problem of utility tokens, then Congress should consider providing the necessary direction. Such legislation might be very simple; something along the lines of the following:

Study – The SEC shall conduct a study to evaluate:

- (1) the potential for modifying the application of the existing system of securities regulation in order to permit, subject to the imposition of such conditions as the SEC finds in the public interest, the sale by blockchain developers of utility tokens that may be either used on a blockchain network or resold for a profit, where the blockchain may use a portion of the sale price from the tokens to improve the functionality or adoption of the network;
- (2) whether any such modification should impose limits on the persons that would be permitted purchasers of such tokens or, where such limits might be inappropriate (as in the case of blockchain networks intended to be used by retail consumers), limits on the amount that could be purchased;
- (3) initial and periodic disclosures that would be required to be made by the blockchain network developers, including disclosures as to the network development and as to their qualifications and financial interests;
- (4) limitations on the individuals who may be employed by a blockchain network developer for the purpose of excluding those who have a disciplinary history; and
- (5) financial controls that could be imposed on the expenditures made by the blockchain network developers or reporting requirements with respect to such expenditures.

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