Client Update
Bright Lines Don't Work for Blockchain Tokens

The blockchain industry has seen two legal theories emerge for determining when an agreement to buy blockchain tokens should be deemed an "investment contract" under the test set forth in *SEC v. W.J. Howey Co.*,[1] and, therefore, subject to the panoply of federal securities laws.[2] The first relies on the facts and circumstances analysis set forth in *Howey* and its progeny. The second argues for a bright-line test that would distinguish between "functional" and "pre-functional" tokens, such that all agreements to purchase pre-functional tokens would constitute investment contracts. While we understand the attractiveness of this bright-line distinction, we find it unpersuasive for the reasons outlined below.

GOVERNING LAW REQUIRES A FACTS AND CIRCUMSTANCES ANALYSIS

Drawing a bright line between functional and pre-functional tokens substantially oversimplifies the complexities of tokens and their development processes, risking unwarranted and improper application of the federal securities laws to non-securities. We reiterate our long-held view that an analysis of the facts and circumstances is the correct analytical method, from both a legal and practical perspective, for determining whether an agreement or token sale constitutes an investment contract.

It is well-settled law that the determination of whether an investment contract exists is based on an analysis of the facts and circumstances.[3] There is no obvious reason to change the existing standard and there has been no indication from the SEC that a change is appropriate or desirable. In fact, the SEC DAO Tokens report reaffirms that an analysis of the facts and circumstances is

[1] 328 U.S. 293 (1946).

[2] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207 (July 25, 2017), *available* at http://www.sec.gov/litigation/investreport/34-81207.pdf. *See also* SEC Enforcement Provides Clarity on When a Blockchain Token Is a Security, *available at* https://www.debevoise.com/insights/publications/2017/07/sec-enforcement-provides-clarity.

[3] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *Landreth Timber co. v. Landreth*, 471 U.S. 681(1985).

the applicable test for evaluating token sales.[4] Coinbase's "A Securities Law Framework for Blockchain Tokens," with which we assisted, also outlines the applicable framework and provides helpful guidance.[5]

SHORTCOMINGS OF THE BRIGHT-LINE TEST

Apart from being a misapplication and oversimplification of existing law, the bright-line test has five other shortcomings.

First, blockchain tokens are not a homogeneous asset class. As a digital representation on a blockchain of an asset, datapoint, currency unit, license, record or other item or matter, blockchain tokens are not susceptible to easy, uniform categorization. For this reason, an analysis of the functions and features of the token and the platform is needed before classification is possible. For example, a token might be the digital representation of a debt or equity security, an ounce of gold, a person's identity or reputation, or the hospital records of a patient. The character of any of these tokens does not change merely because the token has not yet been created, mined or assembled. While some sales of pre-functional token sales will be sales of securities, others will not.

Second, treating all pre-functional blockchain token sales as sales of securities is inconsistent with the treatment Congress seems to have intended for sales of other pre-functional goods and services under the Title III of the JOBS Act. When Congress passed the JOBS Act and created the framework underlying Regulation Crowdfunding, it sought to distinguish crowdfunding platforms like Kickstarter and IndieGoGo from sellers of securities, and participants in those platforms, who sell items such as software, films and music, from issuers of securities.[6] This differentiation indicates that Congress understands that sales of pre-functional goods (whether tangible or intangible) do not constitute sales of securities.

Third, we wonder how these bright-line advocates would treat sales of pre-functional tokens by an existing business. A company that already has customers seems substantively different from someone with just a dream and a white paper. If, for example, a computer gaming company entered into agreements to sell its new game before development started, or during the development phase, would those constitute investment contracts? If the buyer looks to profit by reselling the right to buy the game, the buyer's agreement with the gaming company might

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[4] SEC Investigative Report, supra note 2.

[5] Coinbase, *A Securities Law Framework for Blockchain Tokens*, 8-22 (Dec. 5, 2016), https://www.coinbase.com/legal/securities-law-framework.pdf.

[6] Regulation Crowdfunding codified as amended at 17 C.F.R § 200, 227, 232, 240 and 249 (2015) available at http://www.sec.gov/rules/final/2015/33-9974.pdf.

well appear to satisfy the *Howey* factors. But the same could be said about any pre-production agreement to buy a scarce and popular item, including those with distributors.

Fourth, the federal securities laws cannot be invoked on an "opt-in" basis. One cannot create a security simply by labeling an agreement "security." Implying that a transaction is subject to the protection of the U.S. securities laws when it is not may be viewed as misleading purchasers.

Fifth, creating a bright-line distinction between functional and pre-functional tokens risks oversimplifying the complexity and variability inherent in software and platform development. Functionality, from a developer's perspective, is often viewed as an evolving standard, subject to changes as the technology develops. Correspondingly, the capabilities of the associated tokens may evolve over time, rendering the pre-functional/functional distinction less concrete than it might initially appear.

CONCLUSION

We recognize the appeal of using a simple bright line to distinguish situations for purposes of securities law compliance; however, we caution against pursuing simplicity at the expense of accuracy. As the SEC nicely put it: "whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction."[7] In the complex and individualized process of bringing blockchain platforms and tokens to market, we believe that more comprehensive thought and analysis is both legally prescribed and practically desirable.

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[7] *See,* SEC Investigative Report, supra note 2.

Please do not hesitate to contact us with any questions.

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