NISHIMURA & ASAHI

西村あさひ法律事務所

Virtual-Currency Newsletter (2)
Applicability of Securities Laws to Crypto-Currency

North America / Web3/Metaverse Newsletter

June 20, 2023

Author:
E-mail Shinnosuke Fukuoka
E-mail Scott Alper

Contents

Ⅰ Introduction

Although crypto-currency was originally intended as a form of decentralized, peer-to-peer electronic-cash system detached from financial institutions acting as third-party intermediaries, crypto-currency's most popular use is in the form of trading on various platforms.[1] As such, someone may think that crypto-currency[2] can be analogized to stocks and bonds that are traded on public exchanges, such as the New-York Stock Exchange. Indeed, Chairman of the Securities and Exchange Commission (hereinafter, the "S.E.C.") Gary Gensler commented in April 2022 that "many of the tokens trading on these platforms may well meet the definition of 'securities.'"[3]

Some commentators[4] have characterized tokens as falling into three basic categories, although these categories are not legal categories: currency tokens, utility tokens, and investment tokens.[5] Of course, a token could be a combination of any number of those categories.[6] A currency token is a token that functions akin to money and can be used in any transaction in which its value is recognized by both parties.[7] Unlike an investment and a utility token, a currency token has no connection with its creator, or "issuer."[8] As a token that gives its owner a right to participate in the issuer's returns, an investment token is inherently

1 https://crsreports.congress.gov/product/pdf/R/R47425

2 "Crypto-currency" can be considered a type of "token," but some scholars prefer to distinguish the two terms. *E.g.*, Philipp Maume & Mathia Fromberger, *Regulation of Initial Coin Offerings: Reconciling U.S. and E.U. Securities Law*, 19 Chi. J. Int'l L., 548, 558 (2019) (Stating that whereas crypto-currency represents value despite not having any "inherent value" in itself, tokens "give their owner particular rights or entitlements against another person (typically the issuer) or record ownership of assets"). As such, for purposes of this Newsletter, "token" will be the preferred term used.

3 https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422

4 *See, e.g.*, Philipp Maume & Mathias Fromberger, *supra* Note 2, at 558

5 *Ibid.*

6 *See infra* Part III (Discussing MUN tokens, which were a combination of a currency, investment, and utility token).

7 Philipp Maume & Mathias Fromberger, *supra* Note 2, at 559.

8 *Ibid.*

connected with the issuer.[9] It also functions akin to a share of stock since it can sometimes give its owner voting rights in the issuing company.[10] Finally, a utility token offers certain benefits to its owner[11] and can be thought of as akin to a membership or rewards card that gives members benefits, such as discounts on select products, or rewards, such as units of redeemable value given in exchange for certain actions.[12]
If a token is a "security," then there are certain legal obligations, such as registration with the S.E.C., that must be followed under American securities laws, primarily the Securities Act of 1933 (hereinafter, the "Securities Act") and the Securities Exchange Act of 1934 (hereinafter, the "Exchange Act"). Failure to register with the S.E.C., and to follow other legal obligations, can subject a company to legal action from the S.E.C.[13] Therefore, it is important to know whether a token is considered a security. This Newsletter seeks to summarize the applicability of securities laws in America to tokens.

II Overview of Securities Laws

The main statutory authority for security regulations, overseen by the S.E.C., stems from the Securities Act and the Exchange Act.[14] The Securities Act requires that investors receive certain amounts of detailed information, in the form of a "prospectus," that enables prospective investors to "make informed investment decision[s]."[15] The Securities Act also contains anti-fraud provisions prohibiting "deceit, misrepresentations, and other fraud in the sale of securities."[16] On the other hand, the Exchange Act created the S.E.C. and empowers the S.E.C. to regulate various aspects of the securities industry and to bring civil actions in a United States District Court against violators of securities laws.[17] In general, unless there is an applicable exception, securities laws require all offers or sales of securities to be registered with the S.E.C.[18]

"Securities" generally refer to "certificate[s] of interest of participation in any profit-sharing agreement," such as stocks and bonds.[19] "Securities" also includes "investment contracts," which term the S.E.C. and federal courts frequently use in evaluating new types of instruments or deals,[20] such as the use of "shares" to

---

9 *Ibid.*

10 *Ibid.*

11 *Id.*, at 560.

12 *Ibid.*; *see, e.g.*, *In re Munchee Inc.*, SEC Admin. Proc. File No. 3-18304, 1–4 (Dec. 11, 2017) (Involving a token that would be given in exchange for users of the service giving restaurant reviews and which tokens would be exchangeable for food).

13 *See, e.g.*, *Sec. & Exch. Comm'n v. Binance Holdings Ltd.*, https://www.sec.gov/news/press-release/2023-101 (Involving a complaint by the S.E.C. against Binance, which operated a large token-trading platform, on the basis that Binance operated as an unregistered security exchange).

14 https://www.sec.gov/about/about-securities-laws

15 Sec. & Exch. Comm'n, No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (2017) [hereinafter DAO Report]; https://www.sec.gov/about/about-securities-laws.

16 *Id.*

17 *Id.*

18 https://www.sec.gov/files/dlt-framework.pdf

19 *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293, 297 (1946)

20 https://www.sec.gov/files/dlt-framework.pdf

purchase ownership in low-income housing units and the ability to live in them.[21] In order to determine whether an investment contract is a security, courts employ the *Howey* Test, developed by the Supreme Court in the seminal case, *S.E.C. v. W.J. Howey Co.*[22] In *Howey*, the Howey Company offered units of a citrus grove development along with a service contract for the cultivation, development, harvesting, and marketing of the crops provided by Howey-in-the-Hills Service, Inc.[23] The Supreme Court considered whether this arrangement constituted the offering of a "security" in the form of an investment contract.[24] According to the Supreme Court, 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, 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."[25] In other words, a transaction qualifies as a security if it involves four elements: (1) investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) to be derived from the efforts of others. Profit is expected to be derived from the efforts of others if the "efforts made by those other than the investor are the undeniably significant ones" that affect the "failure or success of the enterprise."[26] The Supreme Court found that the respondent companies were offering "an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by" the respondents.[27] In other words, the respondents were not offering ownership of a plot of land along with management services.[28] Because the purchasers lived in "distant localities" and lacked the desire to occupy and develop the land, the purchasers were more akin to investors who only wanted to a return on their investment based upon the efforts of others.[29] As such, the transactions constituted investment contracts under the *Howey* Test and were subject to securities laws.

The Supreme Court has emphasized that weight is placed not upon the name given to a type of transaction but, rather, the "economic reality" of it.[30] As such, merely calling an asset a "token"[31] or a "security" does not have weight in an analysis under *Howey*. One example is *United Housing Foundation, Inc. v. Forman*.[32] In that case, the Supreme Court considered whether shares of stock that entitled an eligible purchaser to lease an apartment for low-income housing in New York were securities under the Securities Act and the Exchange Act.[33] Despite being labelled as "shares," the assets purchased merely enabled the purchaser to occupy an apartment.[34] Although residents did have voting rights in the operation of the apartment complex,

---

21 *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

22 *W.J. Howey Co.*, 328 U.S. 293.

23 *Id.*, at 294–95.

24 *Id.*, at 297

25 *Id.*, at 298–99.

26 *Sec. & Exch. Comm'n v. Glenn W. Turner Enters., Inc.* 484 F.2d 476, 482 (9th Cir. 1973).

27 *Howey* 328 U.S. at 299.

28 *Ibid.*

29 *Id.* at 299–300

30 *Id.*, at 298.

31 *See infra* Part III (discussing DAO Tokens, which, despite being labelled as "tokens," were found to be securities).

32 421 U.S. 837 (1975).

33 *Id.*, at 840.

34 *Id.*, at 842.

those rights were connected with residing in an apartment, irrespective of the number of shares owned.[35] As such, there was no reasonable expectation of profits to be derived from the efforts of others; the purchasers simply were purchasing the right to live in their respective apartments. The Supreme Court, therefore, held that the "shares" were not, in fact, securities despite their name.[36]

III When Do Securities Laws Apply to Tokens?

Generally, securities laws, and the corresponding statutory and regulatory requirements, apply to tokens when they meet the *Howey* Test. Two of the most common situations in which a token has been deemed to be a security are (1) when a company engages in an "initial coin offering," in which a company raises money by creating, advertising, and selling tokens that can be exchanged on on-line platforms and can be traded for other tokens or fiat currency, and (2) when a company issues tokens that are both expected to increase in value and that can have some utilitarian function, to wit a utility token.[37] Each of these instances is discussed as follows.

1. Initial Coin Offering (ICO)

In 2017, the S.E.C. brought an enforcement action against The DAO[38] and its creators.[39] The DAO had been operating a for-profit entity that would use money, which was received in the form of the crypto-currency Ethereum in exchange for issuing purchasers "DAO Tokens," to invest in and to fund projects.[40] Although holders of those tokens had voting rights, weighted by the number of tokens that each respective holder held, such rights were only nominal in approving the funding of the projects.[41] The "Curators," who were employed by The DAO and issued DAO Tokens, would, prior to a vote, review which projects should be funded.[42] However, as token holders were strongly encouraged to vote affirmatively, or abstain, in favor of a project receiving the Curators' positive review, it was essentially the Curators who decided which projects would receive funding.[43] Nevertheless, token holders would still receive any earnings, in proportion to the number of DAO Tokens owned, that were generated from these projects.[44] In addition, token holders could earn money by re-selling those tokens on various Web-based platforms.[45]

---

35 *Ibid.*

36 *Id.*, at 847.

37 Philipp Maume & Mathias Fromberger, *supra* Note 2, at 560–61; *In re Munchee Inc*, SEC Admin. Proc. File No. 3-13304, 3 (Dec. 11, 2017).

38 The DAO, or "Decentralized Autonomous Organization," is a type of "'virtual' organization embodied in computer code" where transactions are recorded on a virtual ledger, or "blockchain." The DAO, *supra Note* 15. See generally V. Gerard Comizio, Virtual Currency Law: The Emerging Legal and Regulatory Framework, 3–7 (2022) (Discussing blockchains as a type of digital ledger of transactions and excerpting relevant portions of Satoshi Nakamoto's "Whitepaper" on Bitcoin).

39 DAO Report, *supra* Note 15, at 1.

40 *Id.*, at 5–6.

41 *Id.*, at 7–8.

42 *Ibid*.

43 *Ibid.*

44 *Id.*, at 5–6.

45 *Ibid*.

Reviewing each element of the *Howey* Test, the S.E.C. determined that the DAO Token was a security and that, accordingly, The DAO was subject to securities laws.[46] Regarding the first prong, the investment of money, the S.E.C. stated that money was involved in the form of Ethereum.[47] The S.E.C. explained that the use of a crypto-currency, Ethereum, instead of fiat currency, was immaterial.[48] With respect to the second prong, a common enterprise, the S.E.C. found that The DAO was a common enterprise because purchasers of the token pooled their money together in order to fund a project in exchange for a return on investment.[49] The third prong, a reasonable expectation of profits, was met because the token holders' original purchase of the token was informed by The DAO's promotional materials, which stated that "The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment."[50] The S.E.C. thought that The DAO's promotional materials were a good indicator of the purchasers' expectation of profits.[51] Finally, the fourth prong of *Howey*, profit based solely on the efforts of others, was met, given the Curators' overriding role in selecting projects.[52] Although the holders of the DAO Tokens did have voting rights on the approval of projects to receive funding, the holders were encouraged to vote affirmatively, or else abstain, from any project receiving the Curators' positive review.[53] As such, the ability of the holders of the DAO Tokens to exercise "meaningful control over the enterprise" was greatly diminished.[54] Therefore, the fourth prong of *Howey* was met, for the efforts made by the Curators were "undeniably [the] significant ones [that] affect[ed] the failure or success of the enterprise."[55] Because the DAO Tokens, despite not being explicitly labelled as "shares" or "securities," met all of the elements of the *Howey* Test, the S.E.C. found that the tokens were securities and were in reality subject to securities laws.

2. Combination Utility-Investment Token

Several months after the S.E.C. brought the enforcement action against The DAO, it brought a separate enforcement action against Munchee Inc.[56] Munchee Inc. was a California-based company that developed a mobile application designed to facilitate restaurant reviews and recommendations by rewarding customers with tokens, called "MUN."[57] Holders of the tokens would be able to use the tokens to purchase goods or services after the application was further developed; however, they were not usable as currency during the period when the S.E.C. was analyzing the token.[58] So as to raise funds for the improvement of the

46 *Id.*, at 11.

47 *Ibid.*

48 *Ibid.* (Citing to *Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564–574 (10th Cir. 1991), which stated that "Howey's reference to an 'investment of money,' [need not be] cash [as] the only form of contribution or investment that will create an investment contract.").

49 *Id.*, at 11–12.

50 *Ibid.*

51 *Ibid.*

52 *Id.*, at 12–13

53 *Id.*, at 12–15.

54 *Id.*, at 15.

55 *Id.*, at 12.

56 *In re Munchee Inc.*, SEC Admin. Proc. File No. 3-18304, 1 (Dec. 11, 2017).

57 *Id.*, at 1–2.

58 *Id.*, 3–4.

application, Munchee Inc. sought to sell MUN to investors.[59] In order to encourage potential investors to purchase the token, Munchee Inc. engaged in advertising campaigns, stating that Munchee Inc. would run its business in such a way, such as by working with restaurant owners to enable MUN to be used in food purchases, that would cause the value of the MUN tokens to increase over time.[60] The advertisements also emphasized the credentials and management capabilities of Munchee Inc.'s staff.[61] In a "white paper"[62] published on its Web site, Munchee Inc. stated that it had con ducted an analysis under *Howey* and concluded that the MUN were a type of utility tokens and their sale was unlikely to be governed by federal securities laws.[63]

Reviewing each element of the *Howey* Test, the S.E.C. determined that the MUN tokens constituted a security and that their sale constituted an unregistered offering of securities under federal law.[64] With respect to the first prong of the *Howey* Test, the S.E.C. stated that there was an investment of money because investors purchased MUN with either Ethereum or Bitcoin.[65] Such a purchase constituted the type of contribution of value that is sufficient under *Howey* to create an investment contract.[66] Regarding the second prong, the S.E.C. found that there was an investment in a common enterprise because investors' money was being placed with Munchee Inc. and would be used to develop Munchee Inc.'s application and business model.[67] With respect to the third prong, the S.E.C. found that promotional materials used to lure purchasers created a significant expectation of profits.[68] Because the promotional materials emphasized that Munchee Inc. would strive to develop an application system in which the value of the MUN tokens would increase over time, the S.E.C. found that a reasonable investor would expect that purchasing MUN tokens would produce profits.[69] Moreover, by explaining that this increase in value would be obtained through the work of Munchee Inc.'s skilled staff, Munchee Inc. was creating an enterprise in which investors' profits would be derived from the "significant entrepreneurial and managerial efforts of others."[70] As such, the S.E.C. found that the fourth prong of the *Howey* Test had been met.[71] Therefore, Munchee Inc.'s actions were subject to federal securities laws.

Despite the fact that when the S.E.C. undertook its analysis the MUN tokens were not providing the types of benefits that a utility token typically would offer, the S.E.C. warned that even if the MUN token had a utilitarian

---

59 *Id.*, at 2–3.

60 *Id.*, at 3–5.

61 *Id.*, at 6.

62 A "white paper" is a document that an issuer of a token will put in its Web site and that contains certain information about the issuer, the issuer's business, the number of tokens available, and the types of investments being planned. Philipp Maume & Mathias Fromberger, *supra* Note 2, at 560.

63 *In re Munchee Inc.*, SEC Admin. Proc. File No. 3-18304, 3–4 (Dec. 11, 2017).

64 *Id.*, at 2.

65 *Id.*, at 8.

66 *Ibid.*

67 *Ibid.*

68 *Ibid.*

69 *Ibid.*

70 *Id.*, at 9.

71 *Ibid.*

quality that it would still be considered a security.[72] The S.E.C. explained that, based upon the Supreme Court's holding in *United Foundation, Inc. v. Forman*, whether a transaction involves a security does not depend upon the name given to the type of transaction.[73] Rather, it depends upon the "economic realities underlying [the] transaction."[74] Therefore, merely characterizing an initial coin offering as being the sale of a "utility token" does not change whether a transaction involves a security.[75]

IV Conclusion

Although crypto-currency was originally envisioned as a type of electronic-cash system, the innovative use of crypto-currency, in the form of tokens, has resulted in it being used to raise money. This innovative use, however, has implications for securities laws. Indeed, a company would be remiss if it did not conduct certain due diligence in order to ascertain whether its selling of tokens constitutes an unregistered offering of a security, lest that company be subject to prosecution by the S.E.C.

Public Relations Section, Nishimura & Asahi E-mail

72 *Id.*, at 4,9.

73 *Id.*, at 9.

74 *Ibid.* (quoting *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975)).

75 *Ibid.*