A Proposal to Modernize Securities Laws in the Age of Tokenization: Considering Self-Regulation and Adaptive Reform

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ABSTRACT

Token sales gained mainstream notoriety in 2017 and mass attention from the media, markets, and regulators. This modern form of crowdfunding promises to upend capital markets, allowing for direct ownership without intermediaries. The current landscape, however, is flush with fraud, volatility, and regulatory uncertainty. America's securities watchdog expressed its view that most token sales involve violations of federal securities laws, releasing a series of warnings, bringing several ICO-related enforcement actions, and promising to strictly surveil the developing industry, implying that lawyers will not be immune from prosecution. As more turn to tokenization as a viable funding option, the need for an analysis through the lens of securities laws will be paramount, though lawyers lack sufficient guidance in the face of these complex new technologies. Attorneys contend with growing liability and antiquated legal regimes that displace attempts to reasonably advise clients contemplating innovative fundraising options. This note proposes that regulators should consider endorsing a self-regulatory body that will work with federal agencies to fashion a unified, comprehensive framework focused on clarifying blockchain-based assets, preventing fraud, facilitating responsible innovation, and promoting adaptive reform that considers the nuances of distributed technologies.

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I. INTRODUCTION

Technology modernizes more swiftly than the laws and regulations that apply to it, leaving authorities and professionals to consider how legacy frameworks contemplate unique, modern arrangements.[1] This rings true today as markets contend with the proliferation of virtual currencies powered by distributed ledger and blockchain technologies. In 2017, token sales, or initial coin offerings (ICOs), allowed businesses and start-ups to raise upwards of $5 billion while forgoing the lengthy and expensive process of conducing a registered securities offering.[2]

The mania, volatility, and rampant fraud in the international token market led some regulators and businesses to take a defensive position. In September 2017, China moved to ban all ICOs, calling them "illegal and disruptive to economic and financial stability."[3] In February 2018, major credit card companies banned purchases of virtual currencies.[4] The flood of

[1] *See e.g.,* Chicago Mercantile Exchange v. SEC, 883 F.2d (7th Cir. 1989) (describing how judges are often called upon to "decide whether tetrahedrons belong in square or round holes").
[2] *See* Daniel Diemers, Initial Coin Offerings, A Strategic Perspective: Global and Switzerland, PWC, Crypto Valley (Dec. 21, 2017), available at https://cryptovalley.swiss/wp-content/uploads/20171221_PwC-S-CVA-ICO-Report_December_final.pdf. Filecoin raised over $250 million to fund a "decentralized storage network." Protocol Labs, *Token Sale Completed* (Sept. 13, 2017), available at https://filecoin.io/blog/sale-completed/. The Tezos project raised $232 million, promising to develop the next Ethereum, in its uncapped offering, which is now the subject of several ongoing investors lawsuits. In one of the first ICOs from an established company, the Canadian-based messaging app Kik raised close to $100 million. Howard Marks, *The ICO Is Dead. Long Live the ICO 2.0*, HACKERNOON (Feb. 21, 2018), available at https://hackernoon.com/the-ico-is-dead-long-live-the-ico-2-0-7bb269987513. An ICO for a new web browser raised over $35 million in under 30 seconds. Jonathan Keane, *$35 Million in 30 Seconds: Token Sale for Internet Browser Brave Sells Out*, COINDESK (May 31, 2017).
[3] Wolfie Zhao, *China's ICO Ban: A Full Translation of Regulator Remarks*, COINDESK (Sept. 5, 2017), available at https://www.coindesk.com/chinas-ico-ban-a-full-translation-of-regulator-remarks/ (English translation); http://www.circ.gov.cn/web/site0/tab6554/info4080736.htm (original report).
[4] David Z. Morris, *Major Banks Ban Buying Bitcoin With Your Credit Card*, FORBES (Feb. 4, 2018), available at http://fortune.com/2018/02/04/banks-ban-buying-bitcoin-credit-card/. Banks also began listing virtual currencies as a material risk to business in their annual reports. *See e.g.,* J.P. Morgan Chase, Annual Report (Form 10-K) (Feb. 27, 2018); Goldman Sachs, Annual Report (Form 10-K) (Feb. 26, 2018); Bank of America, Annual Report (Form 10-K) (Feb. 22, 2018).

advertisements for token sales on social media prompted Facebook to ban all ads promoting ICOs, reasoning that many of their sponsors "are not currently operating in good faith."[5]

While the technology propelling ICOs promises to revolutionize the future of financing, these sales implicate distinct legal and regulatory issues. The Securities and Exchange Commission (SEC) stated that it has yet to see a token that did not possess all the hallmarks of a "security."[6] Other regulators have called them "commodities,"[7] "property,"[8] "alternative currency,"[9] and "money."[10] More troublingly, they may be securities that quickly "transform"

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[5] Megan Rose Dickey, *Facebook is Banning Cryptocurrency and ICOs Ads*, TECHCRUNCH (Jan. 30, 2018), available at https://techcrunch.com/2018/01/30/facebook-is-banning-cryptocurrency-and-ico-ads/. The CFTC advised customers to not purchase virtual currencies based on social media tips, warning of "pump-and-dump" schemes, whereby fraudsters initiate sudden price spikes by disseminating false information about a coin or token. CFTC, Customer Advisory: Beware Virtual Currency Pump-and-Dump Schemes (Feb. 15, 2018).

[6] Dave Michaels, Paul Vigna, *SEC Chief Fires Warning Shot Against Initial Coin Offerings,* THE WALL STREET JOURNAL (Nov. 9, 2017), available at https://www.wsj.com/articles/sec-chief-fires-warning-shot-against-coin-offerings-1510247148.

[7] The Commodity Futures Trading Commission (CFTC) asserted that bitcoin and other virtual currencies are "commodities" under the Commodity Exchange Act (CEA). *See* In the Matter of Coinflip Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29 (Sept. 17, 2015); In re TeraExchange LLC, CFTC Docket No. 15-33, 2015 WL (CFTC Sept. 24, 2015); CFTC, *A CFTC Primer on Virtual Currencies*, Lab CFTC, 14 (Oct. 17, 2017). The CFTC's jurisdiction is invoked where a virtual currencies are used "in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce." *Id.* "Beyond instances of fraud or manipulation, the CFTC generally does not oversee 'spot' or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing." *Id.*

[8] The Internal Revenue Service (IRS) stated that virtual currencies are properly classified as "property." IRS Virtual Currency Guidance: Virtual Currency Is Treated As Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply, IR-2014-36 (March 25, 2014).

[9] Cal. AB-129 (the "Alternative Currencies Act") (amending Cal. Corp. Code § 107 which previously stated that "[n]o corporation, social purpose corporation, association, or individual shall issue or put in circulation, as money, anything but the lawful money of the United States").

[10] The SEC found virtual currencies investments to constitute investments of "money" and stated that virtual currencies themselves may be securities. *See* SEC v. Shavers, 2013 WL 4028182 (E.D. Texas Aug. 6, 2013). Many states consider virtual currency transactions to be "money transmissions" such that licensure is required. *See* 23 NYCRR § 200 (New York's "BitLicense"); H.B. 215, 2017 Leg., Reg. Sess. (Ala. 2017) § 8-7A-2(10) (Alabama's Monetary Transmission Act); H.B. 7141, 2017 Leg., 2017 Jan. Reg. Sess. Gen. Assemb. (Conn. 2017); Ga. Code Ann. § 7-1-690(b)(1); 2017 North Carolina Laws S.L. 2017-102 (H.B. 229); H.B. 182, 2017 Gen. Assemb., Reg. Sess. (Vt. 2017); VA Code Ann. § 6.2-1900; Uniform Money Services Act. H.B. 1327, 63rd Leg., Reg. Sess. (Wash. 2013). *But see* H.B. 436, 2017 Leg.,165th Sess. (N.H. 2017) (exempting "persons who engage in the business of selling or issuing payment instruments or stored value solely in the form of convertible virtual currency or receive convertible virtual currency for transactions to another location" from the state's money transmission laws). Some states, like Illinois, Kansas, and Texas, have explicitly excluded virtual currencies from the definition of "money." *See* llinois Department of Financial and Professional Regulation, Digital Currency Regulatory Guidance, (July 13, 2017) (stating digital currencies are not "money" under the Transmitters of Money Act and therefore "[a] person or entity engaged in the transmission of solely digital currencies" would not be required to obtain license); Kansas Office of the State Bank Commissioner, Guidance Document MT 2014-01, Regulatory Treatment of Virtual Currencies Under the Kansas Money Transmitter Act, (June 6, 2014) (advising that cryptocurrency is not considered 'money' for the purposes of the Kansas Act); Jennifer Jensen, et al, Sales and Use Taxes in a Digital Economy, The Tax Adviser, (Jun. 1, 2015) (stating that the Nebraska Department of Revenue doesn't consider the term "currency" to include bitcoin or other virtual currencies); Memo, Tx. Dep't of Banking, Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act (April 3, 2014) (stating that virtual currencies will not be treated as legal money in Texas); *see also* Florida v. Espinoza, F14-2023 (dismissing the charge of money laundering because virtual currencies are not "money" as defined by the state's Money Laundering Act).

into commodities.[11] Until Congress signifies otherwise, states, federal agencies, and courts operate with concurrent authority over the new asset class, presenting the potential for conflicting legal treatment and extensive liability among market participants.[12]

This note describes a response to the regulatory uncertainty surrounding token sales. Part II begins with an overview of American securities regulation. Part III provides a background into blockchain technologies and tokenized assets. Part IV describes the increased scrutiny facing ICOs. Part V articulates the distinct problems in current approaches to regulating tokens. In conclusion, Part VI advocates for a future regulatory environment that offers clarity, removes inefficiencies in existing regulation, and contemplates the technological nuances of tokenization.

II. BRIEF HISTORY OF AMERICAN SECURITIES REGULATION

a. Establishing the SEC

The Stock Market Crash of 1929 prompted radical legislative action to address the abuses found in America's largely unregulated securities markets.[13] Congress passed the Securities Act of 1933 (1933 Act), also known as the "truth in securities" law, to govern the primary market for securities.[14] Legislators enacted the Securities Exchange Act of 1934 (1934 Act), which established the SEC and authorized it to regulate the sale of "securities" in order "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[15]

b. What is a Security?

No single bright-line test provides solace in determining whether a product qualifies as a "security" under federal securities laws.[16] The Acts contain nearly the same broad, expansive definition that includes both specific and general terms.[17] It includes a specific list of commonly

[11] Brian Quintenz, Comm'r, CFTC, Address to Georgetown University Law Center (Oct. 19, 2017) (stating that "[t]hey may start their life as a security from a capital-raising perspective but then at some point—maybe possibly quickly or even immediately—turn into a commodity").
[12] *See* CFTC v. Patrick K. McDonnell, 2018 U.S. Dist. LEXIS 36854 * 2 (E.D.N.Y. Mar. 8, 2018). Commissioners from both the SEC and CFTC met with Congress to discuss a coordinated plan of regulation and whether additional congressional authority is needed. *See* Ted Knutson, *U.S., Foreign Regulators Working Well Together To Combat Cryptocurrency Fraud, Says CFTC Chair*, FORBES (Mar. 7, 2018), available at https://www.forbes.com/sites/tedknutson/2018/03/07/u-s-foreign-regulators-working-well-together-to-combat-cryptocurrency-fraud-says-cftc-chair/#2bec17ed424e.
[13] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975).
[14] Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2012).
[15] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-nn (2012). 15 U.S.C. § 78d. The 1934 Act concerns the secondary market for securities, which includes brokerage firms, clearing agencies, and exchanges, which are known as self-regulatory organizations (SROs). Gathering, Analysis, and Retrieval (EDGAR) system. SEC, The Laws That Govern the Securities Industry, available at https://www.sec.gov/answers/about-lawsshtml.html. *See* 15 U.S.C. § 78b (2012) (recognizing that securities laws aim "to insure the maintenance of fair and honest markets").
[16] *See e.g.,* SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) ("Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a 'security.'").
[17] Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1). Securities Exchange Act of 1934 § 3(a)(1), 15 U.S.C. § 78c(a)(10). The definition applies "unless the context appears otherwise." *Id.*

traded speculative instruments, like "notes," "stocks," and "bonds," as well as securities of a more variable nature, such as "investment contracts," "certificate of interest or participation in any profit sharing agreement," and "any interest or instrument commonly known as a security."[18]

In the landmark *Howey* case, the Court characterized an "investment contract" in flexible terms to mean "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."[19] The court emphasized substance of the transaction over the form.[20] It looked at the "economic reality" of the transaction to find that the sales of the orange grove units were securities that should have been registered with the SEC or sold pursuant to an exemption.[21]

The Ninth Circuit defined a "common enterprise" as "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[22] Courts read "solely" to mean "predominately," contemplating whether "the efforts made by those other than the investor are the undeniably significant ones."[23] The treatment of business partnerships illustrates the concept: general partnerships (GPs) are

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[18] Securities Act of 1933 § 2(1), 15 U.S.C.S. § 77b(1). *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985) (stating that when an instrument bears the name "stock"–the "specific instrument" test– and possesses the typical indicia of stock, investors may justifiable assume that securities laws apply). The Court described the features of "stock:" (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value. *Id.* If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining: (1) motivation or desire to profit; (2) plan of distribution; (3) reasonable expectations of the parties; and (4) other risk-mitigating regulatory schemes. Reves v. Ernst & Young, 494 U.S. 56, 60-61 (1990) (finding that the notes issued by the farmers were securities under the "family resemblance" test).

[19] SEC v. Howey, 328 U.S. 293, 298–299 (1946) (stating that the definition of a "security" under the Act should be a flexible one rather than a static principle).

[20] *Id.* at 299 (stating that it was "immaterial whether the shares in the enterprise [were] evidenced by formal certificates or by nominal interests in the physical assets of the enterprise").

[21] *Id.* at 300–301 (finding that all the elements of a profit-seeking business venture were present regardless of the legal terminology in which the contracts were clothed: "The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise.").

[22] SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973). That court described what is known as "vertical commonality," which focuses on the connection between the promoters and the investors, whereas other circuits adhere to "horizontal commonality," which focuses on the pooling of investor funds. *See* SEC v. Edwards, 540 U.S. 389, 397 (2004) (utilizing the principles of strict vertical commonality to find that an investment scheme offering a fixed rate of return was an investment contract); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974) (finding that a "common enterprise" existed, even though investors expended efforts in soliciting recruits, because the promoters retained immediate control over the essential managerial conduct of the enterprise and investor's realization of profits were inextricably tied to the fortune of the promoter).

[23] SEC v. Glenn W. Turner Ent., Inc., 474 F.2d 476, 482 (9th Cir. 1987). The Eighth Circuit elaborated that in determining whether investors' contributions were nominal or significant, the emphasis is not on what efforts were actually required of them, but rather those that they "were reasonably led to believe were required of them at the time they entered into the contracts. Miller v. Central Chinchilla Group, Inc., 494 F.2d 414, 417 (8th Cir. 1974). Similarly, when contemplating whether investors held "a reasonable expectation of profits," courts consider the motivation and intent of investors at the time of the transaction. *See* United Housing Found., Inc. v. Forman, 421 U.S. 837, 852–854 (1975) (rejecting the argument that the apartment sales were investment contracts because the investors purchased with the intent of obtaining housing and not for profit or return). "What distinguishes a security transaction—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use." *Id.* at 858.

presumptively not securities because there is no expectation of profits solely from the efforts of a third party, whereas limited partnerships (LPs) are presumptively securities because of the significant reliance on the efforts of another.[24] Limited liability companies (LLCs), on the other hand, must be analyzed on a case-by-case basis to determine if they align more with the qualities of GPs or LPs pursuant to the *Howey* test.[25]

c. Registration Statements and Prospectuses

One of the primary goals of securities legislation was to protect ordinary investors from misinformation by increasing the amount and quality of data made available to them regarding their investments.[26] The 1933 Act effectuated this objective by requiring substantial disclosures in the form of a registration statement from issuers offering securities to the public for the first time, principled on the notion that investors have insufficient information concerning such issuers.[27] Registration entails filing a prescribed registration statement with the SEC, which includes information about: the issuer's business, operations, finances, board of directors, control persons, certain legal proceedings, the proposed offering, use of the fund, and any counsel who prepared any opinion with respect to the legality of the transaction.[28]

Section 5 specifically forbids the delivery or sale of a security through use of a "prospectus" without an effective registration statement.[29] Prospectus means any "notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."[30] After a registration statement is filed,

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[24] *See* Great Lakes Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376, 391–92 (D. Del. 2000) (holding that the sale of the LLC was not governed by securities law where there was no transfer of stock, no common enterprise, and the plaintiff's authority to remove a member of the LLC without cause indicated that the plaintiff was not a passive investor).

[25] *Id.* Pursuant to this reasoning, manager-managed LLCs align more with LPs such that their members are passive, whereas member-managed LLCs look comparable to GPs in that members are not passive and thus their interests look like securities. *Id.* at 392.

[26] *See* Randallv. Loftsgaarden, 478 U.S. 647,648-49 (1986); Doran v. Petroleum Management Corp., 545 F.2d 893, 904 (5th Cir. 1977); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

[27] H.R. Rep. No. 73-85, at 3 (describing the Act's goal in promoting "full disclosure of every essentially important element attending the issue of a new security").

[28] Securities Act of 1933 § 7, 15 U.S.C. § 77g. Securities Act of 1933 Schedule A, 15 U.S.C. § 77aa. Section 11 prohibits false or misleading statements or material omissions in an effective registration statement. Securities Act § 11(a), 15 U.S.C. § 77k. It provides a cause of action for "any person acquiring such security," explicitly listing persons that can be held liable: any person who signed the registration statement, directors or partners of the issuer, underwriters, and market professionals who prepared or supported part of the statement or "any report or valuation which is used in connection with the registration statement. If successful in their suit, investors can get the difference between the price paid for the security and the current value under Section 11(e). *Id.* A defendant may assert the "due diligence" defense in response to a Section 11 claim, alleging that he did not know of the violation and even with his "due diligence" he would not have known. *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 687 (S.D.N.Y. 1968) (finding that the "due diligence" defense was ineffective were a defendant made no effort to verify the information relayed to it by the corporation).

[29] Securities Act of 1933 § 5(a)(1)–(2), 15 U.S.C. § 77b(a)(1)–(2).

[30] Securities Act of 1933 § 2(a)(10), 15 U.S.C. § 77b(a)(10). Securities Act of 1933 § 2(a)(3), 15 U.S.C. § 77b(a)(3). The 1933 Act defines "offer to sell" expansively to mean "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The court held that a press release constituted an "offer to sell" where it contained a "statement of value." Chris-Craft Industries, Inc. V. Piper Aircraft Corporation, 480 F.2d 341 (1973).

the statute permits the use of a prospectus only if it meets the requirements of Section 10.[31] The 1933 Act imposes strict liability for violations of Section 5, including the sale of unregistered securities, and permits investors to sue anyone from whom they purchased the security and get their money back.[32] Section 12(a)(2) establishes liability for improper prospectuses.[33]

d. Safe Harbors and Exemptions

The protections afforded by securities laws are not equal, but rather two-tiered, conditioned on the idea that some investors and investments warrant less protection than others.[34] The 1933 Act provides for certain exempted securities, including those issued by local, state, or federal municipalities, and exempted transactions, such as offerings conducted entirely intrastate.[35] Section 4 states that Section 5 shall not apply to transactions "not involving any public offering."[36]

Regulatory "safe harbors" permit offerings to be conducted without registration, or with modified registration, if they strictly comply with the statutory guidelines—for example, Regulation D offerings limit participation to only "accredited investors," i.e. wealthy individuals and institutional investors.[37] In 2012, Congress passed the Jumpstart Our Business Startups Act (JOBS Act), aiming to make it easier for companies to raise capital.[38] It added Section 4(a)(6), called Regulation Crowdfunding, to the 1933 Act, allowing businesses to raise small amounts of capital from unaccredited investors through online "funding portals."[39] The JOBS Act also increased the amount an issuer can raise in a Regulation A+ offering to $50 million and disposed of the prohibition against public advertising for Regulation D offerings.[40]

e. Combating Fraud in Securities Transactions

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[31] Securities Act of 1933 § 10, 15 U.S.C. § 77j. Securities Act of 1933 § 5(b)(1), 15 U.S.C. § 77b(b)(1). The statute provides for limited instances where a document will not be deemed a prospectus such the requirements of Section 10 need not be met. Securities Act of 1933 § 10, 15 U.S.C. § 77j. When the document merely identifies the security, its price, by whom the orders will be executed, and from whom a prospectus meeting the requirements of Section 10 can be obtained, it shall not be deemed to be a prospectus within the meaning of Section 2(a)(10). *Id.*

[32] Securities Act § 12(a)(1), 15 U.S.C. § 77l(a)(1). SEC v. Softpoint, Inc., 958 F. Supp 846, 859-60 (S.D.N.Y. 1997) ("The prohibitions of Section 5 ... sweep[] broadly to encompass 'any person' who participates in the offer or sale of an unregistered, non-exempt security.").

[33] Securities Act § 12(a)(2), 15 U.S.C. § 77l(a)(2). The provision applies only to public sales because there must be an obligation to distribute a Section 10 prospectus in the first place. *See* Gustafson v. Alloyd Co., 513 U.S. 561, 571 (1995) (determining that the term "prospectus" relates only to documents of a public securities offering). In response to a Section 12 claim, a defendant may assert the "reasonable care" defense, asserting that "if he had exercised reasonable care, he would not have known" of the violation. Securities Act § 12, 15 U.S.C. § 77l.

[34] SEC, The Laws That Govern the Securities Industry, available at https://www.sec.gov/answers/about-lawsshtml.html.

[35] 15 U.S. Code § 77c(a)(11) (intrastate exception); 15 U.S. Code § 77d(a)(2).

[36] Securities Act § 4(a)(2).

[37] *See* 17 CFR 230.500 (Regulation D); 15 U.S. Code § 77d(a)(6) (Regulation Crowdfunding); and 17 CFR Part 230 §§ 230.251–230.300-230.346 (Regulation A).

[38] 112 P.L. 106.

[39] 17 CFR 227.100 et seq. (Regulation Crowdfunding). Offerings are limited to $1,070,000 and investors are constrained in the amount that they can contribute according to their net worth. *Id.*

[40] 17 C.F.R. §230.251 et seq. (Regulation A).

The SEC possesses broad antifraud authority under securities laws.[41] Section 10(b) prohibits the use of interstate commerce to employ "any manipulative or deceptive device" in connection with the purchase or sale of securities, registered or unregistered.[42] Rule 10b-5 forbids "any device, scheme, or artifice to defraud" in connection with the sale of any security.[43]

While Rule 10b-5 does not include an express private cause of action, courts have found an implied cause of action for private parties aggrieved by fraud in securities transactions.[44] Section 17 of the 1933 Act affords no private right of action, but remains as an attractive tool for the SEC because courts have determined that two of the three provisions of the Section to not require proof of scienter—"a mental state embracing intent to deceive, manipulate, or defraud."[45]

f. Lawyer Liability in Focus

Where were the lawyers when these transactions were effectuated?[46]

Lawyers face the threat of liability in connection with their clients' violations of securities laws.[47] The SEC has pursued lawyers for their conduct in connection with their clients' violations of securities laws, including the preparation of legal opinions, registration documents, investor communications, and private placement materials.[48] While commonly resulting in

[41] Securities Exchange Act § 10(b), 15 U.S.C. § 78j. Securities Exchange Act Rule 10b-5, 17 CFR 240.10b-5.
[42] Securities Exchange Act § 10(b), 15 U.S.C. § 78j.
Drafters originally phrased the language more broadly as simply "thou shall not devise any other cunning devices." Stock Exchange Regulation, Hearing before House Comm. on Interstate & Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) (testimony of Thomas Corcoran) (describing an earlier drafted version of Section 10(b) that was initially denominated as Section 9(c) that followed the more specific prohibitions against market manipulation in Sections 9 and 10 of the 1934 Act). *See also* JOHN C. COFFEE, JR., HILLARY A. SALE, M. TODD HENDERSON, SECURITIES REGULATION CASES AND MATERIALS, 13th ed., Foundation Press, 1040 (2015).
[43] *See* JOHN C. COFFEE, JR., HILLARY A. SALE, M. TODD HENDERSON, SECURITIES REGULATION CASES AND MATERIALS, 13th ed., Foundation Press, 1039 (2015).
[44] Securities Exchange Act § 10(b), 15 U.S.C. § 78j. Securities Exchange Act Rule 10b-5, 17 CFR 240.10b-5. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-32 (1975) (describing how a private right of action exists under Rule 10b-5). Courts have held that a 10b-5 suit can run concurrent with a claim under Sections 11 and 12(a)(2). *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 380–81 (1983) (discussing how the 1933 Act and the 1934 Act "constitute interrelated components of the federal regulatory scheme governing transactions in securities"); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Berger v. Bishop Inv. Corp., 695 F.2d 302, 308 (8th Cir. 1982).
[45] Securities Act § 17(a), 15 U.S.C. § 77q(a). *See* Aaron v. SEC, 446 U.S. 680, 695–96 (1980) (finding that the SEC did not have to pled scienter under two of the three clauses of Section 17(a) of the 1933 Act, whereas the SEC and private plaintiffs must pled scienter for claims of violations of Rule 10b-5). "[S]center is an element of a violation of Section 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of relief sought." *Id*. at 691. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (describing it an independent element of a Rule 10b-5 violation). Section 8A of the Act exists as another tool for the SEC, allowing it to issue an injunction against violators or impose civil penalties if doing so would serve the public interest. *See* Securities Act § 8A, 15 U.S.C. § 77h-1.
[46] Lincoln Say. & Loan Ass'n v. Wall, 743 F. Supp. 901,920 (D.D.C. 1990) (Sporkin, J.) (inquiring into the role of attorneys in the stock market scandal of the 1990s).
[47] *See e.g.,* Matter of Carl N. Duncan, Securities Exchange Act Release No. 34-68501 (Dec. 20, 2012); Complaint, SEC v. Treaty Energy et al., No. 4:14-cv-812 (E.D. Tex. filed Dec. 15, 2014).
[48] *Id.*

monetary penalties, attorney misconduct could result in prohibitions from practicing before the SEC, disbarment, or criminal liability.[49]

The courts remain more skeptical in prosecuting attorneys for the misconduct of their clients due to the potentially chilling effect on legal practice.[50] Several decisions have limited attorneys' exposure to secondary liability for aiding and abetting violations of federal securities laws, though lawyers still contend with exposure to primary liability under Section 10(b) and Rule 10b-5.[51]

III. PRIMER ON VIRTUAL CURRENCIES, INITIAL COIN OFFERINGS, AND TOKENS

> *Systems are organic, living creatures: if people stop working on them and improving them, they die*.[52]

a. Blockchain Technology

From the ruins of the Financial Crisis emerged a paper introducing the concept of a "peer-to-peer" payment system that bypasses intermediaries and prevents the double-spending issue.[53] The author described how a type of blockchain or distributed ledger technology based on mathematical code could reduce the need for trust in financial dealings.[54]

Blockchains use cryptography and consensus mechanism to operate,[55] permitting them to record and preserve transaction data while also setting the rules that govern the transactions themselves.[56] A network of computers, known as miners, work on a reward-based system to confirm additions to the chain.[57] "Blocks" correspond to transactions and are connected in a

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[49] *See e.g.,* SEC Rule of Practice 102(e); SEC Rule of Practice 205.3(b)(3); SEC Rule 205.3(d).
[50] *See* Barbara Black, *Tattlers and Trailblazers: Attorneys' Liability for Clients' Fraud*, 91 WASHBURN L.J. 92 (Jan. 1, 2006).
[51] *See, e.g.,* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) (limiting attorney liability under Section 10(b) for aiding and abetting violations); Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (finding that a "prospectus" pertains only to public offerings); Pinter v. Dahl, 486 U.S. 622 (1988) (limiting the definition of a "seller" so that it does not expose "securities professionals" to liability pursuant to their performance of professional services); Cent. Bank of Denver, 511 U.S. at 191 (describing how lawyers can still be liable under 10b-5 as a primary actor in the absence of 10(b) aiding and abetting liability).
[52] STEVE LEVY, HACKERS: HEROES OF THE COMPUTER REVOLUTION 101 (O'Reilly 2010).
[53] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* 1 (2008).
[54] *Id.*
[55] *See* CHRIS BURNISKE & JACK TATAR, CRYPTOASSETS: THE INNOVATIVE INVESTOR'S GUIDE TO BITCOIN AND BEYOND 18 (Oct. 19, 2017) (describing consensus mechanisms as the process through which code establishes a means to agreeing to the validity of transactions).
[56] *See* Finextra, *Banking on the Blockchain* 14 (Jan. 2016) (stating that the "transformational opportunity" created by blockchains is the fact that "we can now attach behavior to money—which opens the gate for new capital market instruments"). *See* European Securities and Markets Authority, *The Distributed Ledger Technology Applied to Securities Markets* 8 (Feb. 6, 2016), https://www.esma.europa.eu/sites/default/files/library/2016-773_dp_dlt_0.pdf.
[57] *Id.* at 15. The confirmation efforts of miners prevent double spending, an issue that persists in our financial world where funds are recorded on the ledgers of multiple entities—this is known as proof-of-work. Other blockchain systems include proof-of-stake, proof-of-service, proof-of-existence, proof-of-burn, proof-of-elapsed-time and proof-of-capacity. *Id.* at 19. *See also* Peter Van Valkenburg, *Framework for Securities Regulation of Cryptocurrencies*, COIN CENTER, 13–16 (Jan. 2016) (examining the different consensus methods and discussing how

chronological manner using a cryptographic hash to form a perpetual ledger of transparency.[58] The hash function translates data into code that specifically references the preceding block, making it difficult for hackers to modify blocks as the chain gets longer, given the computing power needed to do so.[59]

Blockchains can be public, where anyone with the right hardware and software can access the network, or private, where permission is required for access.[60] Another distinguishing feature of blockchains is the ability to "fork" a chain and separate it from the original protocol to operate under an altered set of rules.[61]

b. Cryptography and Public/Private Keys

Some affix the term "crypto" with a negative connotation, as it seems to connote a tone of dark secrecy—the kind that the industry has been trying to shed since the highly-publicized take down of Silk Road, the online marketplace that offered drugs and other illicit services in exchange for bitcoin.[62] The term "cryptocurrency" simply reflects the asset's ability to be transferred and verified through cryptography, the use of secret codes and ciphers to transmit data in a form that is only usable by the intended party.[63]

Using cryptographic code to communicate has been a prevalent practice for centuries, used in wars and by governments, but the emergence of the internet brought cryptography to the public realm in a new way.[64] The expanded access to information left many concerned about its effects on privacy, leading cryptographers, like Whit Diffie, to create a type of code to protect information, namely "public key" cryptography.[65] In public-key cryptography, there are two sets of keys that encrypt and decrypt:[66] "public" keys can be shared and authenticate the sender;

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they can impact interpretation under securities laws). "Well functioning proof-of-work systems generally indicate that users do not rely on the efforts of any particular miner to provide her profits… Proof-of-stakesystems may be less robust at distributing trust and avoiding an outcome where users rely on a single third party for their profits." *Id.* at 50–51.

[58] *See generally* John Edward Silva, *An Overview of Cryptographic Hash Functions and Their Use*, SANS Institute (Jan. 15, 2003), available at https://www.sans.org/reading-room/whitepapers/vpns/overview-cryptographic-hash-functions-879 (discussing the similarities and differences between cryptography and hash functions).

[59] *Id.*

[60] *Id.*

[61] Peter Van Valkenburg at 5–6 (examining blockchain "forks," which mean "that for some period there exist two alternative versions of the transaction history"). There are "hard" forks, which share the same transaction history as present in the original cryptocurrency, and "soft" forks, where consensus rules are changed such that fewer blocks will be recognized as valid. *Id.* at 14.

[62] BURNISKE at 33.

[63] *Id.*

[64] *See generally* STEVEN LEVY, CRYPTO: HOW THE CODE REBELS BEAT THE GOVERNMENT, SAVING PRIVACY IN THE DIGITAL AGE (Penguin Books 2001) (describing the developments of cryptography in the 1970s and the surrounding public and private controversy).

[65] *Id.* at 1, 3–6 ("We think we're whispering, but we're really broadcasting").

[66] "Encryption" refers to the conversion of a private message into an altered state or "mystery language," while "decryption" is the process of translating the message into readable material, requiring the "rules of transformation" or the secret "keys." *Id.* at 5–6.

"private" keys are known only by their holder and unscramble message content.[67] Use of the public-private keys confers authority to transact and participants, or "nodes," collaborate to reach a consensus about the validity of the transactions using cryptographic puzzles, thus maintaining the ledger's integrity.[68]

c. Distinguishing Virtual Currencies, Coins, and Tokens

While bitcoin premiered as the first decentralized currency, its underlying infrastructure allowed for the development of a new class of complex virtual assets based on protocol embedded in code.[69] In 2013, the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) defined virtual currencies as "digital representations of value" that can function as mediums of exchange, units of account, and stores of value.[70] The terms virtual currency or cryptocurrency may be inherently misleading, as some of these new products function like a currency, while others look nothing like actual currency, representing access rights to goods or services, voting mechanisms, equity stakes, consumable commodities, or a hybrid-mix of all of the above.[71]

Whereas true cryptocurrencies utilize their own native blockchains, tokens are typically developed on top of existing networks and possess little to no value outside of their respective network.[72] The development of the Ethereum network provided an infrastructure upon which any number of "smart contracts" and decentralized applications (dApps) could be programmed.[73] The scalability of the network allowed for the development of tokens on Ethereum's public blockchain, typically using the ERC-20 infrastructure.[74]

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[67] *Id.* at 356 (discussing that public keys can also be used to verify digital signatures and widely distributed with no compromise in security, while private keys must be closely held and can be used to "sign" messages to verify that the holder actually sent them). In symmetric key encryption, the code to encrypt and decrypt is the same. *Id.*

[68] "Mining," a variation of this used by cryptocurrencies, is the process by networks of computers expounding resources validate transactions by finding the cryptographic key. European Securities and Markets Authority, *The Distributed Ledger Technology Applied to Securities Markets* 8 (Feb. 6, 2016), available at https://www.esma.europa.eu/sites/default/files/library/2016-773_dp_dlt_0.pdf.

[69] "Bitcoin is the internet of money. Currency is just the first application." ANDREAS M. ANTONOPOULOS, THE INTERNET OF MONEY, Vol. 1 (March 20, 2017).

[70] Financial Crimes Enforcement Network, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN-2013-G001 (March 18, 2013). FinCEN alerted Congress that it perceives many ICO issuers to be unlicensed money transmitters, violations punishable by criminal sanctions. FinCEN, Drew Maloney, Assistant Secretary of Legislative Affairs, Letter to Senator Ron Wyden (Feb. 13, 2018).

[71] Cryptocurrencies that operate as currencies include bitcoin, litecoin, dogecoin, dash, monero, and zcash. Each currency emphasizes varying principles valued when engaging in transactions, like anonymity, privacy, and speed.

[72] ANTONOPOULOS at 109 ("Bitcoin isn't what you think it is. It's a platform. It's not a payment network. It's not a currency. It's not a banking system. It's a platform that guarantees certain trust functions."). Additionally, bitcoin serves different purposes for different individuals—recent research reveals that approximately two-thirds of bitcoin is held as a store of value, whereas only one-third is used as a means of exchange. *See* Jeff John Roberts and Nicolas Rapp, *Nearly 4 Million Bitcoins Lost Forever, New Study Says*, FORTUNE (Nov. 25, 2017), available at http://fortune.com/2017/11/25/lost-bitcoins/. *See* Peter Van Valkenburg, *Framework for Securities Regulation of Cryptocurrencies*, COIN CENTER, 1–2 (Jan. 2016).

[73] *Id.* at 52 (describing "smart contracts" as "conditional transactions" based on logic written into code).

[74] Dmitry Khovratovich, Mikhail Vladimirov, *Secure Token Development and Deployment,* University of Luxembourg and ABDK Consulting (2015).

d. Initial Coin Offerings

ICOs are comparable to IPOs in that organizers raise capital from investors in order to fund future business development and expansion. Instead of issuing shares, investors in an ICO receive a virtual token in exchange for their investment.

Token developers typically announce their sale through "whitepapers," akin to the piece that introduced Bitcoin in 2008, which usually describe the team behind the project, the business's operations, the offering's goals and limits, the duration of the sale, and the technology behind the product.[75]

Some tokens will clearly constitute securities,[76] though most do not purport to confer any equity or dividend rights. In some instances, tokens serve a "functional use that is unregulated, such as prepayment for access to a product or service that is to be developed using funds raised in the ICO."[77] Many argue that this utility distinguishes certain tokens from securities, though purchasers may still seek return on their investment through increased adoption of the network or the value of exchange on the secondary market.[78]

IV. INITIAL COIN OFFERINGS UNDER SCRUTINY

a. Getting Ahead of Regulators

In response to the legal uncertainty surrounding ICOs, industry participants have taken various steps at proactive compliance.[79] Issuers, such as Kodak and Overstock, have opted to

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[75] *See e.g.,* Protocol Labs, Filecoin: A Decentralized Storage Network (Aug. 14, 2017). Developers may also face liability for statements in whitepapers—for example, participants in the "ATB Coin" ICO filed a class action lawsuit alleging violations of Sections 12(a)(1) and 15(a) of the 1933 Act. ATB's whitepaper promised "the fastest blockchain-based cryptographic network in the Milky Way galaxy" that would "deliver blazing fast, secure and near-zero cost payments to anyone in the world. While ATB's blockchain did eventually launch, it failed to live up to the hype of the promoters with minimal adoption and slow speeds. *See* Complaint, Raymond Balestra v. ATBCOIN LLC, et al., No. 17-10001 (Dec. 21, 2017). Between June 12, 2017 and September 15, 2017, the unregistered offering purportedly raised over $20 million in cryptocurrencies from investors through multiple rounds of funding. *Id.* at 2.

[76] *See* Overstock Registration Statement (Form S-3), at 34 (Nov. 10, 2015) (describing how the shares will have the same rights, but be settled differently).

[77] Gibralter Financial Services Commission, Statement on Initial Coin Offerings (Sept. 22, 2017), available at http://www.gfsc.gi/news/statement-on-initial-coin-offerings-250.

[78] *See e.g.,* Complaint, Jacob Zowie Thomas Rensel v. Centra Tech, Inc. et al., 20 (S.D. Fla. Dec. 13, 2017) (addressing how Centra's whitepaper described the CTR Tokens as utility tokens such that they are not securities). *See* Mike Orcutt, *2017 Was the Year of the ICO—Now What?*, MIT TECHNOLOGY REVIEW (Dec. 28, 2017), available at https://www.technologyreview.com/s/609633/2017-was-the-year-of-the-ico-now-what/.

[79] Some have sought to avoid the application of securities law through a strategy known as an "airdrop," which involves distributing tokens to an amount of existing cryptocurrency holders for free with the intention of spreading awareness or as a perk. Peter Van Valkenburgh, *A token airdrop may not spare you from securities regulation*, COINCENTER (Sept. 20, 2017), available at https://coincenter.org/link/a-token-airdrop-may-not-spare-you-from-securities-regulation (describing how issuers tried airdropping stocks in the 1990s to the dismay of the SEC). *See also* SEC, SEC Brings First Actions To Halt Unregistered Online Offerings of So-Called "Free Stock," No. 99-83 (July 22, 1999), available at https://www.sec.gov/news/headlines/webstock.htm. "Through these techniques, issuers received value by spawning

conduct token sales pursuant to the regulatory safe harbor of Rule 506 of Regulation D.[80] Some have forwarded novel frameworks through which token sale have been conducted, though their legality is uncertain.[81]

The "Simple Agreement for Future Tokens" (SAFT) promotes that the sale of pre-functional utility tokens to accredited investors through the SAFT does not implicate registration under securities laws—though SAFT itself would be a security, the post-functional utility tokens would not constitute securities and thus be freely-transferrable.[82] Some have similarly attempted to limit liability and the applicability of securities laws through terms and conditions included in token sale documents.[83]

b. The SEC Targets ICOs

ICOs represent the most pervasive, open and notorious violation of federal securities laws since the Code of Hammurabi.[84]

The SEC initially observed a restrained approach to token products, opting to not proceed with an enforcement action in light of its view that the tokens issued by The DAO, the virtual organization that raised over $150 million from April to May 2016, were unregistered securities pursuant to the *Howey* test.[85] Subsequently, the SEC expressed its view that most ICOs involve flagrant violations of securities laws.[86]

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a fledgling public market for their shares, increasing their business, creating publicity, increasing traffic to their websites, and, in two cases, generating possible interest in projected public offerings." *Id.*

[80] "I'm perfectly happy for these people to do private placements, but do it the right way. Don't do a private placement and promise secondary public markets." *See* Molly Jane Zuckerman, *Overstock Sees Share Price Drop After Subsidiary Becomes Target Of SEC Probe,* CoinTelegraph (Mar. 2, 2018), available at https://cointelegraph.com/news/overstock-sees-share-price-drop-after-subsidiary-becomes-target-of-sec-probe. Some suggest that legally complaint security token offerings (STOs) will replace unregistered ICOs. *See* Anthony Pompliano, *The Official Guide To Tokenized Securities*, Medium (Feb. 25, 2018), available at https://medium.com/@apompliano/the-official-guide-to-tokenized-securities-44e8342bb24f.

[81] *See* Howard Marks, *For ICOs StartEngine Introduces RATE: Real Agreement for Tokens and Equity* (Jan. 11, 2018), available at https://howardmarks.com/for-icos-startengine-introduces-rate-real-agreement-for-tokens-and-equity-2379e017ee76 (describing the the "Real Agreement for Token and Equity" (RATE)).

[82] Juan Batiz-Benet, Jesse Clayburgh, Jesse Clayburgh, The SAFT Project: Toward a Compliant Token Sale Framework, Cooley LLP, Protocol Labs (Oct. 2, 2017). SAFT is modeled after the "Simple Agreement for Future Equity" (SAFE) frequently used by start-ups.

[83] For example, the Tezos project's terms described the purchases as "non-refundable donations." It also purported that the terms document "does not constitute a prospectus of any sort" nor is it "a solicitation for investment" pertaining "in any way to an offering of securities in any jurisdiction." *See* Tezos Contribution and XTZ Allocation Terms and Explanatory Notes, 3 (2017).

[84] Nathaniel Popper, *Initial Coin Offerings Horrify a Former SEC Regulator*, NY Times (Nov. 26, 2017), available at https://www.nytimes.com/2017/11/26/business/initial-coin-offering-critic.html?_r=0.

[85] SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207(July 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.

[86] Jay Clayton, SEC Chairman, Testimony on "Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission," Before the Committee on Banking, Housing, and Urban Affairs United States Senate (Feb. 6, 2018).

While not specifically commenting on structures like SAFT, Clayton described the conduct of attorneys in the space as "disturbing," reminding them of their position as "gatekeepers" and summoning them to reform their behavior in relation to token sales.[87] Clayton called upon lawyers to re-focus on the "key issues," introduce skepticism into their clients' proposed conduct, and refrain from providing equivocal legal advice that contravenes the principles of investor protection and full disclosure.[88]

Clayton implied that, as the SEC continues to "vigorously" pursue ICO-related violations of securities laws, token counsel will not be immune from prosecution.[89] Lawyers who advise clients in using ICOs to defraud investors provide "low-hanging fruit" to regulators.[90] In fact, lawyers are allegedly among some the recipients of the reported 80 subpoenas and information requests sent by the SEC pursuant to its recent cryptocurrency probe, heralded by a former SEC attorney as one of the broadest regulatory sweeps he has seen and clear evidence of the SEC intent to crack down on ICOs.[91]

c. Challenging the Utility Token Argument

Several regulatory bodies have explicitly excluded utility tokens from securities regulation.[92] Switzerland's financial regulator released guidelines in which it provided that utility tokens will not be treated as securities when "their sole purpose is to confer digital access rights to an application or service" and the token can be used in that way at the point of issue.[93] Similarly, Wyoming enacted state legislation exempting utility tokens, calling them "open blockchain tokens," from the definition of a security when they are not marketed as investments, exchangeable for goods or services when issued, and the seller does not actively promote a secondary market for their trading.[94]

The SEC casted doubt on the utility token argument in a cease-and-desist order against Munchee, a California-based company who raised about $15 million from its token sale to fund the development of its blockchain-based food review app.[95] Munchee's whitepaper asserted that the MUN tokens would not "pose a significant risk of implicating federal securities laws" because of their utility.[96] The SEC found the tokens to constitute as "investment contracts" based upon the investors' expectations that the tokens would appreciate in value based upon

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[87] *See* SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017).
[88] "These lawyers appear to provide the 'it depends' equivocal advice, rather than counseling their clients that the product they are prompting likely is a security." *Id.*
[89] *Id.*
[90] Michaela Ross, Andrew Ramonas, and Lydia Beyoud, *The SEC Man Cometh for ICO Attorneys,* BLOOMBERG LAW (Feb. 5, 2018), available at https://biglawbusiness.com/the-sec-man-cometh-for-ico-attorneys/.
[91] Nathaniel Popper, *Subpoenas Signal S.E.C. Crackdown on Initial Coin Offerings,* NY TIMES (Feb. 28, 2018), available at https://www.nytimes.com/2018/02/28/technology/initial-coin-offerings-sec.html.
[92] *See e.g.,* Swiss Financial Market Supervisory Authority (FINMA), *Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)*, 4–5 (Feb. 16, 2018); H.B. 0070, 2018 Gen. Sess., Buget Sess. (Wyo. 2018).
[93] FINMA at 4–5. FINMA stated that, in that case, the tokens function to grant access rights and the link to capital markets typically present in the case of securities is missing. *Id.*
[94] H.B. 0070, 2018 Gen. Sess., Buget Sess. (Wyo. 2018).
[95] In the Matter of Munchee Inc., No. 3-18304 (Dec. 11, 2017).
[96] It also referred to its token sale as a "token generation event" as opposed to an ICO. *Id.* at 5.

Munchee's efforts in improving the app, creating the MUN "ecosystem," and promoting a secondary market for the tokens.[97] Though the tokens were pre-functional, the SEC stated that even if the tokens were functional at the time of their sale, they would not be precluded from being categorizes as securities.[98]

V. PROBLEMATIC ASPECTS OF TOKENIZATION UNDER THE LAW

a. Contending With Conflict Among Authorities

Contrary to the assertion that virtual currencies operate largely unregulated, the industry contends with a multitude of regulators, inconsistent in their views, attempting to exercise jurisdiction over blockchain-based products.[99] If tokens are commodities, markets contend with the "principles-based" approach utilized by the CFTC.[100] If tokens are securities, participants encounter the chiefly "prescriptive-based" approach of the SEC.[101] Further, the CFTC operates with exclusive authority over regulated commodities, whereas the securities laws hail from the SEC as well as state regulators.[102]

In addition to regulatory enforcement, the token market faces growing liability from the increasing number of civil suits being filed across the nation by investors alleging violations of securities laws in connection with ICO schemes.[103] Considering that almost half of 2017's ICOs have reportedly failed, more and more investors will seek redress from the courts.[104] Courts must answer imperative questions and conflicts.[105] Courts holdings could potentially conflict with the views of regulators—the Eastern District of New York agreed with the CFTC that bitcoin qualifies as a commodity, though the extent of the holding is unclear.[106]

b. Pre-Judging Tokens

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[97] *Id.* at 2.
[98] *Id.*
[99] Securities and Exchange Commission, Release No. 34-80206, Order Disapproving a Proposed Rule Change (March 10, 2017) (rejecting an ETF proposal on the basis that bitcoin is too unregulated).
[100] *See* RONALD H. FILLER AND JERRY W. MARKHAM, REGULATION OF DERIVATIVE FINANCIAL INSTRUMENTS (SWAPS, OPTIONS, AND FUTURES)61–68 (West Academic 2014) (describing the "principles-based" approach which promotes general principles and allows for flexibility in attaining general regulatory goals).
[101] *Id.* at 68 (describing how it was proposed that the SEC adopt a more principles-based regulatory approach like that of the CFTC).
[102] See 7 USC § 2(a)(1)(A) (2015) (the CFTC "shall have exclusive jurisdiction" providing for exclusive CFTC jurisdiction over commodities).
[103] Complaint, Raymond Balestra v. ATBCOIN LLC, et al., No. 17-10001 (Dec. 21, 2017); StormsMedia, LLC v. Giga Watt, Inc., et al., No. 17-00438-SMJ (E.D. Wa. Dec. 28, 2017); Complaint, Jacob Zowie Thomas Rensel v. Centra Tech, Inc., et al., No. 17-24500-JLK (S.D. Fla. Dec. 13, 2017).
[104] *See* Aaron Hankin, *Nearly Half of all 2017 ICOs Have Failed*, MARKETWATCH (Feb. 26, 2018), available at https://www.marketwatch.com/story/nearly-half-of-all-2017-icos-have-failed-2018-02-26#false.
[105] *See e.g.,* Chicago Mercantile Exchange v. SEC, 883 F.2d (7th Cir. 1989).
[106] CFTC v. McDonnell, et al., No. 18-cv-361, ECF No. 29 (E.D.N.Y. Mar. 6, 2018).

A former SEC Chairman emphasized the SEC's purpose in creating enterprise and reestablishing confidence, stating that it shall not pre-judge, but rather investigate.[107] In proclaiming that most tokens qualify as securities, the SEC impermissibly pre-judged an entire class of emerging products without sufficient efforts concentrated on developing an informed framework for classification, evidencing a neglect for the agency's directive to facilitate capital formation with principled regulatory restraint.[108] Clayton avowed that the SEC's targeted approach was purposed on protecting innovation; however, mounting liability and regulatory uncertainty effectively deter domestic innovation, leading to the frequent exclusion of American investors from desirable opportunities.[109]

c. More Liability, Less Certainty in Advising Token Sales

The contemporary regulatory obscurity leaves market professionals without the relative certainty necessary to conduct their business, forgoing the principle that the law should be ascertainable and a reasonable response to perceived necessities of an efficient market.[110] The SEC stressed that anyone considering conducting a token sale should employ competent securities counsel at the onset of deliberations to consider whether the token is a security.[111] Presently though, attorneys cannot confidently opine as to a token's legal status and are unable to provide assurance that a particular structure involves a proper interpretation of the law.[112]

d. "Unless the Context Appears Otherwise"

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[107] *See* Linda Chatman Thomsen, Speech by SEC Staff: True to Our Mission: Why We Need the SEC, Remarks at the Ninth Annual A.A. Sommer, Jr. Corporate, Securities and Financial Law Lecture, Fordham University Law School (Nov. 6, 2008).

[108] *See* SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017).

[109] *Id.*

[110] *See e.g.,* Stephen L. Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudent and Ethics of Lawyering*, 104 YALE L.J. 1545 (1995) ("Our legal system is premised on the assumption that the law is intended to be known or knowable, that law is in its nature public information."). *See* Oliver Wendell Holmes Jr., *The Path of Law*, 10 HARVARD LAW REVIEW 457 (1897) (describing the need for certainty in the business of law). "When we study law we are not studying a mystery but a well-known profession… it becomes a business to find out when this danger is to be feared. The object of our study, then, is prediction, the prediction of the incidence of the public force through the instrumentality of the courts." *Id.*

[111] Jay Clayton, SEC Chairman, Testimony on "Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission," Before the Committee on Banking, Housing, and Urban Affairs United States Senate (Feb. 6, 2018) (describing how most structures of ICOs that he has witnessed directly implicate securities registration requirements and other securities laws aimed at protecting investors).

[112] "You can't responsibility issue a legal opinion that says a token is not a security, based on the facts we know today from the regulators." Josh Garcia, Yvette Valdez, Cooley, Latham and Watkins, Blockmatics (Jan. 24, 2018). *See also* Jerry Brito, *The SAFT Is a Symptom of Regulatory Uncertainty*, COINCENTER (Nov. 13, 2017), available at https://coincenter.org/entry/the-saft-is-a-symptom-of-regulatory-uncertainty (describing how SAFT is not guaranteed to work and still depends on "the facts and circumstances and the economic reality surrounding a particular token"). Though the SEC has not specifically commented on SAFT, some promote that the framework "rests on a fundamentally flawed interpretation of U.S. securities laws." Not So Fast – Risks Related to the Use of a 'SAFT' for Token Sales, The Cardozo Blockchain Project (Nov. 2017).

> *What happens when, for the first time ever, there is a system that can evaluate rules without human intervention and be trusted without having to put trust in any single human? [W]e call this the removal of counterparty risk*.[113]

A former CFTC commissioner asserted that virtual currencies do not fit within the definition of a security or commodity.[114] He asserted that they do not exhibit the usual characteristics of stock in that there is typically no board of directors, business headquarters, employees, or company assets—it is inherently more difficult to ascertain the "issuer" of tokens distributed through decentralized networks.[115] He argued that cryptocurrencies do not function like typical commodities in that there is no underlying physical asset that is inherently valuable like oil, gold, or corn, though they may be mined and consumed.[116]

In some instances, tokens could provide the context that suggests that securities laws do not apply.[117] Unlike traditional securities which are processed through multiple levels of distributors, blockchain-based assets require less third-party interferences because the cryptographic algorithms and consensus features converge the clearing and settlement process, eliminating the risk intermediaries were put in place to mitigate.[118] Distributed systems offer "network effects" without the control of a centralized party, necessitating a modified degree of regulation and leading some to argue that the application of the *Howey* test to all new tokens "is to miss the forest for the trees."[119] Existing regulatory safe harbors that limit participation to high net worth individuals, frustrate the need for decentralized systems to be widely-distributed.[120]

e. Neglecting Modern Challenges

Former SEC Commissioner Al Sommer discussed the SEC's duty to remain relevant in the wake of quickly evolving securities markets:

> Every institution, every traditional practice has been called before the court of public opinion and compelled to justify itself in terms of today's needs. It is no longer enough to say that we should do it this way because it was done that way

[113] ANTONOPOULOS at 1.
[114] Bart Chilton*, It's time to address bitcoin's big blind spot*, CNBC (Sept. 21, 2017), available at https://www.cnbc.com/2017/09/21/its-time-to-address-bitcoins-big-blind-spot-bart-chilton-commentary.html (last visited Nov. 15, 2017).
[115] *Id.*
[116] *Id.*
[117] *See supra* Section II(b) (describing the definition of a security, which includes a phrase "unless the context appears otherwise").
[118] Gareth Peters & Efstathios Panayi, *Understanding Modern Banking Ledgers through Blockchain Technologies: Future of Transaction Processing and Smart Contracts on the Internet of Money*, 28 (Nov. 19, 2015) (describing trades that clear bilaterally on a private blockchain in less than 17 seconds).
[119] David Siegel, *Blockchain Tokens and ICOs: An Open Letter to the SEC*, INTERNATIONAL BUSINESS TIMES (Feb. 2, 2018), available at http://www.ibtimes.co.uk/blockchain-tokens-icos-open-letter-sec-1658469.
[120] *See* Albert Wenger, *Crypto/Blockchain Safe Harbor*, CONTINUATIONS (Feb. 21, 2018), available at http://continuations.com/post/171125433630/cryptoblockchain-safe-harbor (arguing that requirements like Rule 144's holding period frustrate the development of decentralized systems).

> yesterday. . . . There is the compelling need of rejustification by every role player in society of his role and the manner in which it is played.[121]

The SEC must rationalize its role in terms of the challenges facing markets today. When Congress enacted the 1933 and 1934 Acts, investors lacked adequate information to instruct their investments.[122] Modern investors, however, suffer from divergent ailments—namely, information overload.[123] Regulators have been presented with an opportunity to modernize financial regulation so that it is more effective in protecting American investors in the wake of new technologies that present distinct challenges and opportunities. To foreclose the chance at clarifying murky regulatory waters would be a disservice to the investing public.

VI. DEVELOPING TOKEN LAW THROUGH UNIFIED SELF-REGULATION AND REFORM

a. Endorsing a Self-Regulatory Body

Regulators have established their own respective intra-agency organizations dedicated to the researching and regulating virtual currencies.[124] This continuation of the bifurcated systems of oversight, however, complicates jurisdictional uncertainty rather than clarifying it. A unified self-regulatory body focused on blockchain-based assets could help bridge the gap between contemporary regulatory uncertainty and future government action, aid in the development of a unified global framework, and replace bifurcated approaches to regulation.[125] The organization could include entrepreneurs, lawyers, academics, and industry participants, forming a meaningful partnership with regulators and lawmakers. A unified self-regulatory group would allow for both market participants and federal agencies to represent their concerns and values in shaping reasoned regulation, providing the industry will the clarity it needs to flourish.

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[121] *The SEC and the Accounting Profession: "Creative Tension,"* Remarks of A. A. Sommer, Jr., Commissioner, U.S. Securities and Exchange Commission, before the 25th Annual Meeting of the Northeast Regional Group of the American Accounting Association, Philadelphia, Pennsylvania (Apr. 19, 1974), available at http://www.sec.gov/news/speech/1974/041974sommer.pdf.

[122] *See* Randallv. Loftsgaarden, 478 U.S. 647,648-49 (1986); Doran v. Petroleum Management Corp., 545 F.2d 893, 904 (5th Cir. 1977); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

[123] *See* Brian Bloch, *Information Overload: How It Hurts Investors*, INVESTOPEDIA (Jan. 6, 2018), available at https://www.investopedia.com/articles/financial-theory/11/negative-impact-of-information-overload.asp; Eleanor Bloxham, *Do Investors Have Too Much Information?*, FORBES (Oct. 29, 2013), available at http://fortune.com/2013/10/29/do-investors-have-too-much-information/. Investors are presented with whitepapers that describe token projects, viewable open source code uploaded to sites like GitHub, opinions and commentary on social media, and other endless resources online.

[124] The CFTC established LabCFTC to study cryptocurrencies and promote responsible innovation and informed legislation. *See* CFTC, LabCFTC Overview, available at http://www.cftc.gov/LabCFTC/Overview/index.htm. The SEC formed its DLT Working Group with the goal of analyzing how existing rules address the challenges presented by the technology. Mary Jo White, Comm'r Chair, SEC, Panel at SEC's FinTech Forum (Nov. 14, 2016).

[125] "So if the community takes advantage of that time and that ambiguity there's the potential for a global framework to apply to everyone if there's enough buy-in from the community to do that, since there aren't jurisdictional questions as to which entity has to do what, or rules that necessitate a bifurcation or separate approaches to the regulation." Annaliese Milano, *Crypto Industry Should Self Regulate, Says CFTC Commissioner*, COINDESK (Mar. 8, 2018), available at https://www.coindesk.com/crypto-industry-should-self-regulate-says-cftc-commissioner/?utm_content=buffer9c01f&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer.

b. *Developing a Reasonable Framework for Evaluating Tokens*

A comprehensive and timely framework that considers the nuances of tokenization in light of the founding principles of securities laws would focus on the "key issues" facing token sales, advised by history, industry attempts at self-regulation, and early enforcement actions. Such a framework would outline the standards to which market professionals must abide, aiming to clarify token products under the law and the applicable body of oversight, considering factors such as the nature of the token's value and value creator.[126]

Additional basis for the framework can be extracted from the traditional treatment of business partnerships under federal securities laws—if the nature of the enterprise looks more like a general partnership, where investors can actively participate in the development of token protocol and code, the product may avoid security classification, whereas if no code exists and investors are presented only with the promise of future development, the token will presumptively be designated as a security.[127]

c. *Future Regulatory Action Focusing on Fraud*

Just as Internet companies had exceptions built and formed around their necessity, tokens may warrant an exclusionary remedy.[128] Regulators could ease prevalent uncertainty and leave no excuse for compliance by adopting the framework proposed by the self-regulatory body after sufficient collaboration, investigation, comment, and review. By codifying the framework into a regulatory rule, the SEC can still adhere to a traditional case-by-case analysis of securities transactions while forwarding some accepted guidelines of practice.

Former SEC Chairman Joseph Kennedy succinctly explained the role of his agency as "neither coroners nor undertakers . . . not prosecutors of honest business, nor defenders of crookedness."[129] He stated that the SEC shall curtail "only the senseless, vicious, and fraudulent activities."[130] Future regulation should reflect this purpose by granting the SEC explicit authority to prosecute fraud in token transactions in a similar manner to which Wyoming's utility token exclusion fails to operate in the face of fraud.[131] This would allow the agency's finite resources to best effectuate the policies of the securities laws. Further, regulation could provide for modified and sensible disclosures depending on the nature of the product and grant authority to the

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[126] *See* Peter Van Valkenburgh, *How Do Tokens Sales Fit With Securities Regulation?*, CoinCenter (Nov. 14, 2017) (discussing how a token's value—investment or utility—and the basis of that value—a network or an issuer—offers a reasonable guide for regulating tokens as securities or not).

[127] *See supra* Section II(b) (describing the treatment of business partnerships under federal securities laws).

[128] Albert Wenger, *Crypto/Blockchain Safe Harbor*, Continuations (Feb. 21, 2018), available at http://continuations.com/post/171125433630/cryptoblockchain-safe-harbor. David Weild IV, proclaimed "Father of the JOBS Act" whose research into IPO inefficiencies formed the basis for the Act, believes that blockchain-based funding can achieve the goals the JOBS Act failed to fully accomplish. *See* Michael del Castillo, *The Father of the JOBS Act is Helping Build a Next-Generation ICO*, CoinDesk (Mar. 5, 2018), available at https://www.coindesk.com/father-jobs-act-helping-build-next-generation-ico/.

[129] *See* Linda Chatman Thomsen, Speech by SEC Staff: True to Our Mission: Why We Need the SEC, Remarks at the Ninth Annual A.A. Sommer, Jr. Corporate, Securities and Financial Law Lecture, Fordham University Law School (Nov. 6, 2008).

[130] *Id.*

[131] *See* H.B. 0070, 2018 Gen. Sess., Buget Sess. (Wyo. 2018).

self-regulatory body review data from token issuers and permit exemptions from registration or schemes of substituted compliance.[132]

VII. CONCLUSION

Token sales and other aspects of blockchain technologies will continue to challenge the parameters of existing laws, regulations, and jurisprudence before the emergence of settled standards of practice. Regulators can aid in reducing prevalent regulatory uncertainty by endorsing a self-regulatory body and a reasonable framework, informed by investigation and industry comment, for evaluating blockchain-based tokens under the law.

[132] *See* CFTC, Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market, Release: pr6439-12 (Dec. 4, 2012). The Commission described the process of substituted compliance:

> In permitting the use of substituted compliance, the authority must first determine that the entities are already subject to comparable regulation, supervision and comprehensive oversight of compliance, by virtue of the fact that: (i) the foreign regulation and oversight meet the same regulatory objectives; and (ii) the foreign regulator has the authority and means to support and enforce compliance by relevant foreign participants, intermediaries and infrastructures. It should be noted that in some jurisdictions' regulatory systems, this registration process is characterized as "recognition." *Id.*