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SEC Deems 23 More Tokens Securities

U.S. TECH LAW UPDATE[1]

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On April 17, 2023, the United States Securities and Exchange Commission (the "SEC") charged digital assets trading platform Bittrex, Inc. ("Bittrex") for operating an unregistered exchange, broker, and clearing agency, alleging that six digital assets listed on Bittrex constituted unregistered securities (the "Bittrex Complaint"). Shortly after, on June 5, 2023, the SEC filed 13 charges against Binance Holdings Ltd. ("Binance"), which operates the largest digital assets exchange based on daily trading volume, including for operating unregistered exchanges, broker-dealers, and clearing agencies, and the offer and sale of 12 digital assets that the SEC alleges constitute unregistered securities (the "Binance Complaint"). And then, on June 6, 2023, only one day after its complaint against Binance and exactly 85 years after President Franklin Delano Roosevelt signed the Securities Exchange Act into law, the SEC charged Coinbase, Inc. ("Coinbase"), the largest digital assets exchange in the US, for operating as an unregistered securities exchange, broker, and clearing agency, alleging that 13 digital assets, some also cited in the Bittrex Complaint and Binance Complaint, constituted unregistered securities (the "Coinbase Complaint", together with the Bittrex Complaint and the Binance Complaint, the "Exchange Complaints").

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In the three Exchange Complaints, the SEC alleged that 23 unique digital assets are securities, consisting of SOL, ADA, MATIC, FIL, ATOM, SAND, MANA, ALGO, AXS, CHZ, FLOW, ICP, NEAR, VGX, DASH, NEXO, COTI, BNB, BUSD, OMG, TKN, NGC, and IHT (together, the "23 Complaint Tokens" or the "Tokens"). This flurry of enforcement actions against the most prominent digital asset exchanges available in the US signals the SEC's shift toward targeting key intermediaries and away from its previous strategy of bringing individual actions against specific fungible tokens, which presented a challenge to the SEC's limited capacity given the 22,932 fungible tokens in existence as of March 2023.[2] If the SEC is successful, these new actions could force the exchanges to close their US operations and move offshore, potentially pushing a great deal of the digital asset industry outside of the US. This is especially salient in the context of a growing US – China technology rivalry, given Hong Kong's efforts towards becoming a digital asset trading hub with the opening of its digital asset exchange licensing regime on June 1, 2023; just days before the SEC crackdown on the two largest digital asset exchanges available in the US.

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[2] Coryanne Hicks, Michael Adams, *Different Types of Cryptocurrencies*, FORBES (March 15, 2023).

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In this legal update, we build on our previous analysis of the nine digital assets the SEC declared to be securities in *SEC v. Ishan Wahi, Nikhil Wahi, and Sameer Ramani* (the "Wahi Complaint"),[3] filed July 21, 2022, and settled on May 30, 2023, and analyze the 23 Complaint Tokens[4] to identify key characteristics that the SEC cites when arguing these digital assets are securities. In addition, at the end of this article, we provide regulatory risk mitigation strategies that digital asset projects can consider based on insights gained from the Exchange Complaints.

I. The Exchange Complaints – Overview and Context

Before we address the key characteristics identified by the SEC in digital assets that it alleges constitute securities, we first provide additional context regarding (i) trends in SEC enforcement relating to digital assets, (ii) the sweeping scope of the Exchange Complaints, and (iii) recent events impacting the legal status of digital assets in the US.

A. Enforcement Against Intermediaries Rather than Issuers

The SEC typically identifies a digital asset as a security through administrative actions or litigation against the issuer of the digital asset, which provides the issuer, as a party to the enforcement action, with an opportunity to challenge the SEC's characterization of their digital asset.[5] However, in the Exchange Complaints and in the prior Wahi Complaint, the SEC characterizes digital assets as securities in legal actions that did not include the issuers of those digital assets as parties. This is controversial because the issuers may not have the opportunity to formally dispute the SEC's characterizations. As nonparties, issuers have primarily two options for asserting their interests before the court:

1) the issuers may attempt to join as parties to the claim but must first convince the court of their eligibility in a motion to intervene,[6] or

2) at the court's discretion, the issuers may be permitted to file *amicus curiae* briefs to offer the court supplemental information, which the court may heed or ignore at its discretion.[7]

Neither path ensures that the issuers will be able to present their views because both require the issuers to successfully justify their presence in the claim prior to presenting any defense to the SEC's characterizations of their digital assets as securities.

Unlike in the Wahi Complaint, in the Exchange Complaints the SEC had a much larger number of tokens to choose from. Where the Wahi Complaint only involved the alleged insider

[3] For more information, please see our US Tech Law Update, *SEC Deems Nine Tokens Securities*.
[4] We have excluded BUSD from our analysis, as BUSD is a stablecoin, or a fungible token designed to have a relatively stable price, typically through being pegged to a fiat currency or having its supply regulated by an algorithm. As such, it's unlike other digital assets identified by the SEC, and the SEC's Howey analysis of BUSD is less relevant to tokens that are not stablecoins. Nevertheless, we identify the Tokens as the 23 Complaint Tokens throughout, including the 22 Tokens that we analyze below.
[5] *See* Cornerstone Research, *SEC Cryptocurrency Enforcement: 2021 Update* (January 19, 2022).
[6] Federal Rules of Civil Procedure, *Rule 24. Intervention*, LEGAL INFORMATION INSTITUTE (accessed August 19, 2022); see also Wex Definitions, *intervene*, LEGAL INFORMATION INSTITUTE (last updated June 2020).
[7] *See* Federal Rules of Appellate Procedure, *Rule 29. Brief of an Amicus Curiae*, LEGAL INFORMATION INSTITUTE (accessed August 19, 2022); *see also* D.D.C. Local Civil Rule 7(o), *Brief of an Amicus Curiae*; *see also* Gibson Dunn, *Proposal for Federal Rule of Civil Procedure on District Court Amicus Briefs*, addressed to the Committee on Rules of Practice and Procedure in the Administrative Office of the United States Courts (March 17, 2021).

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trading of 25 fungible tokens, here the SEC could choose from any number of the 300 fungible tokens traded on Bittrex, the 150 fungible tokens traded on Binance's US platform, and the over 16,000 fungible tokens available to trade on Coinbase via Coinbase's digital wallet product. According to a May 28, 2023, snapshot of CoinMarketCap, 17 of the 23 Complaint Tokens were within the top 100 tokens by market capitalization, suggesting that the SEC may have decided to target higher-value tokens that have not been previously subject to enforcement actions.[8]

B. Other Elements of the Exchange Complaints

The key allegations made in the Exchange Complaints are that Bittrex, Binance, and Coinbase operated as unregistered exchanges, unregistered brokers, and unregistered clearing agencies; an element of each is the sale and offer of unregistered securities. According to a Petition for Rulemaking filed by Coinbase with the SEC on July 21, 2022, registering a trading platform for digital asset securities surfaces a series of significant challenges that make the current system of SEC registration for exchanges, brokers, and clearing agencies ill-suited for digital asset exchanges.[9] The three primary challenges identified by Coinbase include:

1. Lack of clarity regarding how to determine whether a digital asset is a security;
2. Requirements that are fundamentally incompatible with the operation of digital asset securities; and
3. Requirements that are technically possible but unnecessary or overly burdensome as compared to potential alternative and more efficient rules.

Towards the lattermost challenge, Coinbase asserts that because both retail and institutional traders have direct access to platforms that execute transactions that settle in real time 24 hours a day, seven days a week, broker-dealer and clearing house intermediaries are no longer needed. Instead, Coinbase's position is that the digital asset market infrastructure has developed so that exchange and trading services, clearing, settlement, and custody can be provided effectively and more efficiently by the same entity; and that by forcing digital asset exchanges into the SEC's existing models of registration, the SEC is eliminating much of the instant settlement gains provided by digital assets. Unless the SEC engages in rulemaking that addresses the specific infrastructure of the digital asset market, Coinbase asserts that SEC enforcement risks forcing the digital asset market offshore, where US regulators will not be able to extend their jurisdiction, but in which markets US purchasers will still participate by other means, such as VPNs.[10] Thus, without adjusting the current rules, the SEC could expose US investors to undue risk rather than protect them, in opposition to the SEC's core mission.

In addition to Coinbase's claims regarding US investors, if blockchain technology and web3 are the next frontier of technological innovation, then should SEC enforcement drive the digital asset market overseas, the US risks surrendering leadership to offshore jurisdictions more

[8] *Historical Snapshot - 28 May 2023*, CoinMarkCap.
[9] Coinbase, *Petition for Rulemaking—Digital Asset Securities* Regulation (July 21, 2022).
[10] A VPN, or virtual private network, is an online service that provides a mobile app, desktop app or other software that encrypts your internet traffic and prevents your internet service provider from tracking which websites or apps you're using. VPNs also stop most of those websites and apps from seeing your actual geographic location, allowing you to access content that may otherwise be blocked in your country.

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friendly to the digital asset industry, including the European Union and Hong Kong. In the context of a growing US – China technology rivalry, ceding blockchain technological leadership to Hong Kong is tantamount to ceding that leadership to China since although digital assets are currently banned in mainland China, Hong Kong provides the mainland with a regulatory sandbox for digital assets that is economically insulated from China's Renminbi. The impact of the SEC's actions may thus reverberate well beyond the domestic market should Congress fail to pass blockchain technology legislation and the SEC fail to consider the broader policy implications of regulating the digital asset industry through the enforcement of existing rules.

Additional allegations in the Binance Complaint and the Coinbase Complaint include:

- Illegal securities offering for Binance-issued tokens and for various products and services offered by Binance and Coinbase that include their staking services;
- Fraud conducted by Binance against investors and customers related to Binance's claims of having instituted monitoring systems in place to detect and prevent market manipulation tactics like wash sales;
- A scheme by Binance's parent company to evade US regulation by establishing a US exchange that the parent company controlled completely while enabling key large customers to continue to trade at the Binance parent company.

Although these claims are outside of the scope of this US Tech Law Update, the expansive allegations against the exchanges further emphasize the severity of the SEC's approach to intermediaries like digital asset exchanges in its ongoing efforts to reign in the digital asset industry.

C. *SEC v. Ripple Labs Inc.*

On December 22, 2020, the SEC filed an action against Ripple Labs, Inc. ("Ripple"), alleging that Ripple engaged in three categories of unregistered securities sales related to Ripple's fungible token, XRP:

(1) Institutional sales to sophisticated individuals and buyers under written contracts ("Institutional Sales") for which it received US$728 million;
(2) Programmatic sales on digital asset exchanges ("Programmatic Sales") for which it received US$757 million; and
(3) Other distributions under written contracts ("Other Distributions") for which it recorded US$609 million in "consideration other than cash."

Unlike other actions levied against digital asset issuers, the SEC filed the complaint in court rather than through an administrative action. This is relevant because while administrative actions do not create legally binding precedents, court opinions are binding within the court's jurisdiction. According to Ripple's Chief Executive Officer, Brad Garlinghouse, Ripple declined to settle throughout the litigation process to seek precedent challenging the SEC's approach to regulating digital assets, stating:

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> "I think it's very clear…the facts are on our side, and I think it's very— more and more clear that the law is on our side... [In] my opinion, the SEC bullies companies into settlements because they can't afford to fight. And the reason why I think this fight is so important isn't just for Ripple, it's really for the whole industry."[11]

On July 13, 2023, the US District Court in the Southern District of New York affirmed in part and denied in part each party's cross-motion for summary judgment. According to the court, Ripple's Institutional Sales did constitute unregistered securities offerings, but the Programmatic Sales did not because purchasers did not realize that they were buying XRP from Ripple and because the Programmatic Sales also "lacked other factors present in the economic reality of the Institutional Sales," such as contracts containing lock-up provisions, resale restrictions, indemnification clauses, or statements of purpose.

Additionally, the court noted that promotional brochures widely circulated among institutional investors were not distributed to those who purchased XRP on digital asset exchanges ("Programmatic Buyers") and that there was no evidence that Programmatic Buyers understood that statements made by Ripple executives were representations of Ripple and its efforts. The court also ruled that the Other Distributions also did not constitute the offer or sale of unregistered securities because recipients of Other Distributions did not pay money or "some tangible and definable consideration" to Ripple.

Although the ruling suggests that the sale of fungible tokens on digital asset exchanges might not constitute the sale of securities in some circumstances, the court's analysis depends on the specific facts related to XRP, and other US district courts may not hold similarly. Regardless, many digital asset projects cannot afford to endure years of litigation with the SEC to reach clarity on the status of their digital assets like Ripple did, as Brad Garlinghouse acknowledged. Thus, the SEC's analyses of the 23 Complaint Tokens remain relevant for companies seeking to mitigate regulatory risk.

II. Applying the Howey Test to the 23 Complaint Tokens

The SEC and federal courts analyze whether unique instruments like digital assets are securities by applying the Howey test.[12] The Supreme Court of the United States established this test in *SEC v. W. J. Howey Co*. when it held that securities called investment contracts exist where parties agree to invest money in a common enterprise with the reasonable expectation of profits derived from the efforts of others.[13] In applying the Howey test to digital assets, the test is typically broken into four prongs, all of which must be present for a digital asset to be deemed a security: (a) an investment of money, (b) in a common enterprise, (c) with the reasonable expectation of profits, (d) derived from the efforts of others.[14]

In reviewing the Exchange Complaints, documentation published by the individual projects, and previous guidance from the SEC, we identified several characteristics that appeared

[11] Brad Garlinghouse, in a conversation with CoinDesk at Consensus 2022, Austin, Texas (July 15, 2022).
[12] SEC, *Framework for "Investment Contract" Analysis of Digital Assets* (last modified April 3, 2019).
[13] *SEC v. W.J. Howey Co*., 328 U.S. 293, 298-99 (1946).
[14] SEC, *Framework for "Investment Contract" Analysis of Digital Assets* (last modified April 3, 2019).

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most relevant to the SEC's determination that the 23 Complaint Tokens constitute securities. Through the SEC's analyses, we can infer the circumstances under which the SEC believes project management and development teams issuing fungible tokens (hereafter, "Issuers") are distributing securities. Below we discuss each element of the Howey test, noting the key characteristics that the SEC highlighted in the Exchange Complaints in support of its determination that the 23 Complaint Tokens are securities. The table in Annex I illustrates which of the SEC highlighted characteristics are present or absent for each of the 23 Complaint Tokens.[15]

A. Investment of Money

The first prong of the Howey test is typically satisfied whenever a digital asset is purchased or acquired in exchange for value.[16] The SEC's view is that value need not be money. According to the SEC's DAO Investigation Report, "investment of money" encompasses an investment of *any* value, whether fiat currency, "goods and services," another digital asset, or some other type of consideration.[17]

In our observations of the 23 Complaint Tokens:

i. Token Sale: The Issuers of most of the 23 Complaint Tokens launched those tokens through (a) an initial coin offering (an "ICO"), which refers to the first sale of a fungible token conducted for the purpose of raising funds; (b) an initial exchange offering (an "IEO"), which refers to a fundraising event that is administered by an exchange; or (c) a simple agreement for future tokens (a "SAFT"), a framework developed in 2017 by Cooley LLP and Protocol Labs that involves issuing a security purporting to be exempt from registration as a private placement to accredited investors, which is later exchangeable for digital assets that are distributed both to those original investors and to users of the network or project.[18] For the purposes of the table below, "Token Sale" refers to ICOs, IEOs, and SAFTs, inclusive of public token sales, private token sales to accredited investors, and strategic token sales to select purchasers—basically, any initial token sale for the purpose of raising funds, regardless of the purchaser, could constitute a Token Sale.

ii. Mining. Some tokens, like DASH, do not appear to have been offered in a Token Sale. Purchasers can obtain DASH either through a secondary exchange or by mining blocks

[15] As stated in footnote 4, we have excluded BUSD from our analysis, as BUSD is a stablecoin, or a fungible token designed to have a relatively stable price, typically through being pegged to a fiat currency or having its supply regulated by an algorithm. As such, it's unlike other digital assets identified by the SEC, and the SEC's Howey analysis of BUSD is less relevant to tokens that are not stablecoins. Nevertheless, we identify the Tokens as the 23 Complaint Tokens throughout, including the 22 Tokens that we analyze in Annex I.

[16] *Id.* at Section II(A).

[17] SEC Release No. 81207, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: the DAO*, 11 (July 25, 2017); *see Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991).

[18] For more information on the SAFT framework, please see *The SAFT Project: Toward a Compliant Token Sale Framework*. Based on the SEC's guidance thus far, the SAFT framework is not compliant with the SEC's interpretation of the Howey test. Further, the SAFT framework contained notable risks even before the SEC issued formal guidance. For more information, please see *Not So Fast--Risks Related to the Use of a "SAFT" for Token Sales*, a report by the Cardozo Blockchain Project at Cardozo School of Law dated November 21, 2017.

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for the DASH layer one blockchain. Although mining does not involve making any purchase, the SEC has previously indicated that the distribution of a security is a "sale" within the meaning of the Securities Act when contributions of value are rewarded with some real benefit.

B. Common Enterprise

Federal courts require that there be either horizontal commonality or vertical commonality in a project to satisfy the common enterprise prong of the Howey test.[19] Horizontal commonality exists where each individual investor's fortunes are tied to the fortunes of other investors by the pooling of assets, often combined with the *pro-rata* distribution of profits.[20] Vertical commonality, which focuses on the relationship between an asset's promoter[21] and the asset's investors, exists in two variants: broad vertical commonality and strict vertical commonality. To establish broad vertical commonality, the fortunes of the investors need be linked only to the *efforts* of the promoter.[22] To establish strict vertical commonality, the fortunes of the investors must be tied to the *fortunes* of the promoter.[23]

The SEC asserts that investments in digital assets nearly always constitute investments in a common enterprise because the fortunes of digital asset purchasers are linked either to each other, thus establishing horizontal commonality, or to the success of the promoter's efforts, thus establishing broad vertical commonality.[24]

In its analysis of the 23 Complaint Tokens, the SEC frequently implies the existence of both horizontal commonality and strict vertical commonality:

i. Proceeds Fund Development. In its analysis of the 23 Complaint Tokens, the SEC frequently implies the existence of horizontal commonality by noting that purchaser funds were pooled together and used to develop a project that was not yet functional or had limited functionality at the time of the Token Sale. For example, as the SEC cites in the Binance Complaint, the "Purchase Agreement" for the COTI IEO stated that "proceeds from the Token Sale will be deployed to fund the development of the COTI Project, for the development of the COTI technology and the COTI eco-system." This same characteristic also supports the SEC's analysis of a project's reliance on the efforts of others in satisfying the fourth element of the Howey test.

ii. Tokens to Team. For each Token except for DASH, the relevant Issuer distributed a portion of their Token supply to the Issuer's team, sometimes with vesting, thus linking the Issuer's fortunes with purchasers' fortunes in strict vertical commonality. For example, the SEC noted in the Binance Complaint and the Coinbase Complaint that Sky

[19] *Revak v. SEC Realty Corp.*, 18 F.3d. 81, 87-88 (2d Cir. 1994); SEC, *Framework for "Investment Contract" Analysis of Digital Assets*, n. 10.
[20] *Id.*
[21] "Promoter" is broadly defined in the Securities Act of 1933 as (i) any person who directly or indirectly takes initiative in founding and organizing the business or enterprise of a securities issuer, or (ii) any person who, in connection with the founding and organizing of the enterprise of a securities issuer, directly or indirectly receives in consideration of services 10% or more of any class of securities of the issuer, or 10% or more of the proceeds from the sale of those securities. *See* Securities Act of 1933, Rule 405, 17 C.F.R. § 230.405.
[22] *Long v. Shultz Cattle Co., Inc.*, 881 F.2d 129, 140-41 (5th Cir. 1989).
[23] *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978).
[24] SEC, *Framework for "Investment Contract" Analysis of Digital Assets*, n. 11.

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Mavis issued 21% of the total AXS tokens—56.7 million AXS—to the Sky Mavis team, which will be gradually unlocked over a 4.5-year period to ensure that "the team, community and investors have aligned incentives."

C. Reasonable Expectation of Profits

Purchasers of a digital asset must have a reasonable expectation of profits for the digital asset to constitute a security under the Howey test.[25] "Profits" can include an increase in the digital asset's trading price or participation in earnings from the project underlying the digital asset.[26] Price appreciation resulting solely from external market forces (such as general inflationary trends or macroeconomic factors) impacting the supply and demand for the underlying digital asset is generally not considered "profit" under the Howey test.[27] As a result, if a project raises funds through a token sale and then uses those funds to further development of the project, which results in an increase in the trading price of the token, then those tokens might be securities. Additionally, a token may be a security if the token gives its purchasers rights to share in the underlying project's income or profits.[28]

In the Exchange Complaints, the SEC cited three key characteristics common to most of the 23 Complaint Tokens that supported its conclusion that purchasers have a reasonable expectation of profits.

i. Investment Marketing. For every single one of the 23 Complaint Tokens the SEC alleges that the Issuer led purchasers to view the Token as investments through its marketing of the Token. Each Issuer promoted its Token in a way that suggested the value would rise due to a variety of factors, including the efforts that the promoters would put into developing the project, which would in turn increase the demand for and the value of the Token. The SEC looked at every type of Issuer communication to potential Token purchasers, including Twitter, blog posts, whitepapers, and project websites. For example, the CHZ whitepaper indicated that the Chiliz team would use the proceeds from CHZ sales to fund the development, marketing, business operations, and growth of the Chiliz protocol and, consequently, to increase the demand for CHZ in connection with the protocol. As another example, in a Medium post leading up to funding rounds, the Issuer of ICP said: "DFINITY has received inbound interest from hundreds of private accredited entities such as hedge funds." Most examples cited by the SEC emphasize the Tokens' value and the Issuers' efforts to increase that value. Interestingly, this includes efforts towards advancing some Tokens' utility, such as Dash's efforts to advance DASH as a medium of payment. The SEC cites statements on Dash's website that DASH can be spent at thousands of retailers through the "DashDirect" consumer app as an example of Issuer investment marketing of its Token.

ii. Token Supply Management. The Issuers of nearly all 23 Complaint Tokens implement some type of Token Supply Management, such as a supply cap, meaning the Issuer will

[25] *Id.* at Section II(C)(2).
[26] *Id.*
[27] *Id.*
[28] *Id.*

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not create any more tokens after a ceiling number of tokens has been issued; or a supply reduction activity, such as periodic "burnings" and "buybacks" of tokens in which the Issuer either destroys tokens or buys tokens back from holders on the open market. For instance, in an ICP whitepaper released in January 2022, DFINITY promotes that it burns ICP tokens as a mechanism to support the price of ICP by reducing the total supply. In another example, the SEC noted that Decentraland expressed intent to increase the MANA token supply by eight percent in the first year, followed by a lower rate in subsequent years to accommodate new users of its platform while preserving the value of MANA. However, the latter mechanism is an outlier compared to other examples of Token Supply Management cited by the SEC, which are often supply caps and token burnings.

iii. Financial Incentives. Several of the 23 Complaint Tokens advertise additional financial incentives to purchasers and thus opportunities for profit. For most of the Tokens, incentives include interest on staked Tokens or loans made by the purchaser to the Issuer of Tokens. In the Bittrex Complaint, the SEC also referenced that the OmiseGo website advertised that OMG token purchasers could anticipate receiving a share of the fee revenue generated on the platform. Thus the financial incentive trait can take many different forms.

D. Reliance on the Efforts of Others

Satisfaction of this element of the Howey test is determined by whether a purchaser of a Token relies on a promoter, sponsor, or another party that provides significant managerial efforts affecting the failure or success of the enterprise.[29] This element is satisfied when a third party (such as an Issuer) is responsible for the development, improvement, operation, or promotion of the project, especially when the project is not yet operable for its intended functionality, or not yet operable without efforts from the Issuer.[30] Another relevant characteristic of a security includes an Issuer and/or the team having interests in enhancing the value of the digital asset by allocating a portion of the digital assets to itself.[31] Fully decentralized projects that do not rely on the efforts or decision-making of a core development or management team and instead disperse decision-making authority among the community are less likely to satisfy this element of the Howey test.

The SEC repeatedly cites three key characteristics in the Exchange Complaints in its analysis of whether purchasers rely on the efforts of others to fulfill an expectation of profits with respect to the Tokens.

i. Exchange Listing. The SEC noted that Issuers of some of the 23 Complaint Tokens either (i) made efforts to list the Tokens on secondary exchanges, or (ii) promoted and announced their Tokens' listing on secondary exchanges, the latter of which also cultivates a reasonable expectation of profits. For example, in a July 7, 2021, blog post on its website, Nexo stated, "[o]ne of the Nexo community's repeated requests has been that

[29] SEC, *Framework for "Investment Contract" Analysis of Digital Assets*, Section II(C)(1).
[30] *Id.*
[31] *Id.*

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we list our native asset [NEXO] on more and more bigger exchanges. Our team wasted no time addressing these requests."

ii. Team Efforts. The SEC emphasized that Issuers of all 23 Complaint Tokens highlighted the efforts of their team to develop and maintain the underlying projects, which would in turn increase the value of the Tokens that users generally must purchase to engage with the underlying projects.

iii. Touting Team. Similar to Team Efforts above, the SEC also noted where Issuers advertised their team's experience and ability as a key selling point for their Token since the success of the project depended on the execution ability of their team, and thus the value of the Token also depended on their team's ability to perform.

III. Risk Mitigation Strategies

The Exchange Complaints provide key insights for blockchain companies seeking to design and launch digital assets that are not securities under the four prongs of the Howey Test. Some companies may find that the concessions required to comply with securities regulations strip away much of the value blockchain technology offers to projects. Unfortunately, in many instances, there is a fundamental conflict between blockchain companies' desired use of digital assets and the SEC's framework for identifying securities.

As SEC Commissioner Hester Peirce referenced in her address to the 2020 International Blockchain Congress[32] and in her 2021 token safe harbor proposal,[33] there are not that many options for companies that want to distribute digital assets without inviting SEC intervention. Generally, they must choose between:

i. decentralization;
ii. providing immediate, functional utility to purchasers; or
iii. severing ties with the United States to avoid US securities law entirely.

For a project to mature into a decentralized network that is not dependent upon a single person or group to carry out the essential managerial efforts, the tokens must be distributed to and freely tradeable by potential users, programmers, and participants in the network.[34] The SEC's current application of federal securities laws to the primary distribution of tokens and secondary transactions frustrates most projects' ability to achieve maturity, rendering decentralization nearly impossible.[35] Most projects must instead rely on providing immediate functional utility in order to remain in the US without risking SEC enforcement actions.

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[32] Commissioner Hester M. Peirce, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization*, address before the International Blockchain Congress in Chicago, IL (February 6, 2020).
[33] In her proposal, initial development teams, meaning any persons or entity that provides the essential managerial efforts for the development of a blockchain network or application, would have three years to establish their network as functional or decentralized such that the digital assets used on the network would no longer be deemed securities under the Howey test. This proposal is just one SEC commissioner's suggestion, which has not been adopted or proposed by the SEC. Commissioner Hester Peirce, Token Safe Harbor Proposal 2.0 (April 13, 2021).
[34] *Id*.
[35] *Id*.

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Digital assets that provide immediate utility are sold for a consumptive purpose on an already functional network. In other words, digital assets that are not securities are like arcade tokens: they have value only because they can be spent to play arcade games. There is no incentive to buy them to hold because their price does not fluctuate absent the arcade raising the price of gameplay. The economic reality of arcade tokens is that they're designed to be consumed. The same is true for digital assets structured for utility.

Thus, based on the key characteristics identified by the SEC in the Exchange Complaints, below we have listed several strategies for structuring digital assets based on utility and in a manner to reduce securities regulatory risk, while recognizing that regulatory best practices do not reflect current market practices and may not be achievable for many companies in this space.[36]

A. Investment of Money

Token Sales: Don't conduct ICOs or NFT Pre-Sales. Blockchain companies should avoid fundraising through initial token offerings, NFT pre-sales, and any other similar crowdfunding activities that involve the sale of digital assets to fund the development of an underlying project. This type of fundraising generally satisfies each prong of the Howey test, in particular reasonable reliance on the efforts of others since the value of the digital asset would generally be dependent upon the issuer's work to create and release the project. In addition, this type of fundraising activity is the SEC's longest and most enforced position related to digital assets— from 2013 to 2022, 55% of the SEC's digital asset enforcement actions focused on ICOs.[37]

B. Common Enterprise

Proceeds Fund Development: Don't fund the underlying project with proceeds from issuing tokens. If project development is funded by Token Sales, then there is horizontal commonality between the purchasers. Thus, companies should offer digital assets that provide value to purchasers at the time the digital assets are sold through immediate utility in projects that have already been funded, developed, and launched.

Tokens to Team: Don't compensate project teams with the same digital assets as those being distributed to purchasers. Compensating developers and other team members with the same tokens distributed to purchasers links the fortunes of purchasers to the project's team in strict vertical commonality. Although team members may choose to purchase tokens, tokens should not be provided to team members to incentivize their efforts on the underlying project.

C. Reasonable Expectation of Profits

Investment Marketing: Establish strong marketing policies and implement them strictly, even in typically informal channels such as a Discord server. Marketing policies should reflect the

[36] For more information in the blockchain game vertical, please see our US Tech Law Update, *Is Your Blockchain Game Digital Asset a Security?*

[37] Cornerstone Research, *SEC Cryptocurrency Enforcement* (2022 Update).

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economic realities of the digital asset's design: if a token is designed for utility, it is imperative that marketing materials reflect the token's utility. The SEC considers every aspect of a digital asset's marketing, including blog posts, interviews, whitepapers, social media posts, public images of key company executives at industry events, and company websites, to determine whether purchasers had a reasonable expectation of profits. Thus, blockchain companies need to manage purchaser expectations through strict marketing policies that consistently communicate a digital asset's utility.

Token Supply Management: The supply of tokens should correlate with the demand for such tokens based on their utility. Managing the supply of tokens to preserve the tokens' market value cultivates a reasonable expectation of profits. However, a digital asset is less likely to be a security if the trading volume for the digital asset corresponds to the level of demand for the good or service for which it may be exchanged or redeemed.[38] Thus, Issuers should sell in amounts and at prices that correspond to what purchasers will use.

Financial Incentives: Structure incentives to reward and attract consumers or participants in the underlying project, not investors. Offering financial rewards to purchasers who provide liquidity to the in-project economy generates an expectation of profits. Instead, incentivize the project's target market to participate in the project based on what the project has to offer. For example, blockchain games may choose to incentivize gameplay with rewards that have in-game utility rather than rewards that have out-of-game value. Like in the above strategy, digital asset incentives should be offered only to those who are expected to use the digital assets in the underlying project, in the amounts and at prices that correlate to such use.

[38] SEC, *Framework for "Investment Contract" Analysis of Digital Assets* (last modified April 3, 2019).

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ANNEX I: KEY CHARACTERISTICS OF THE 23 COMPLAINT TOKENS

This table illustrates which of the SEC highlighted characteristics described above are present or absent for each of the 23 Complaint Tokens. In Section II (Applying the Howey Test to the 23 Complaint Tokens) we describe each of these characteristics and provide examples from the Exchange Complaints.

Token	Investment of Money	Common Enterprise		Reasonable Expectation of Profits			Reliance on the Efforts of Others		
	Token Sale	Proceeds Fund Development	Tokens to Team	Investment Marketing	Token Supply Management	Financial Incentives	Exchange Efforts	Team Efforts	Touting Team
SOL	**X**	**X**	**X**	**X**	**X**		**X**	**X**	**X**
ADA	**X**	**X**	**X**	**X**	**X**		**X**	**X**	**X**
MATIC	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	
FIL	**X**	**X**	**X**	**X**	**X**			**X**	**X**
ATOM	**X**	**X**	**X**	**X**				**X**	**X**
SAND	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**
MANA	**X**	**X**	**X**	**X**	**X**	**X**		**X**	
ALGO	**X**		**X**	**X**	**X**	**X**		**X**	**X**
AXS	**X**	**X**	**X**	**X**		**X**	**X**	**X**	**X**
CHZ	**X**	**X**	**X**	**X**	**X**		**X**	**X**	**X**
FLOW	**X**		**X**	**X**	**X**	**X**		**X**	**X**
ICP	**X**	**X**	**X**	**X**	**X**	**X**		**X**	**X**
NEAR	**X**	**X**	**X**	**X**	**X**			**X**	
VGX			**X**	**X**	**X**	**X**		**X**	**X**
DASH				**X**	**X**			**X**	**X**
NEXO	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**
COTI	**X**	**X**	**X**	**X**				**X**	**X**
BNB	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**
OMG	**X**	**X**	**X**	**X**	**X**			**X**	**X**
TKN	**X**	**X**		**X**	**X**			**X**	
NGC	**X**	**X**	**X**	**X**	**X**		**X**	**X**	**X**
IHT	**X**	**X**	**X**	**X**		**X**		**X**	**X**