



PILLAR LEGAL

Is Your Blockchain Game Digital Asset a Security?

U.S. TECH LAW UPDATE¹

March 23, 2023

By: Greg Pilarowski | Magdalene Bedi

Vitalik Buterin was an avid player of the massively multiplayer online roleplaying game World of Warcraft until a content patch released in April 2009 removed the damage component from his “beloved” warlock’s Siphon Life spell.² According to Buterin, he cried himself to sleep having realized “what horrors centralized services can bring.”³ It was in the throes of his grief that he discovered Bitcoin, and shortly thereafter co-founded Ethereum, the second largest digital assets project by market capitalization, and the first to introduce smart contract⁴ functionality to the industry.⁵ Buterin’s grief is not unique, however groundbreaking his particular outcome; online game forums are overflowing with stories of missing in-game items, lost story progress, or sudden changes to player character abilities that harm the experience for players like Buterin. And it’s no coincidence that Buterin turned to blockchain in the aftermath of his warlock’s demise. Blockchain technology has the potential to provide some security to players who dedicate significant time and money to a game and currently do so with very little control over the digital assets they acquire.

Blockchains are decentralized, distributed digital ledgers of verified transactions, which blockchain games often incorporate by using non-fungible tokens (“NFTs”) as in-game virtual items, and fungible tokens as in-game virtual currencies.⁶ NFTs and fungible tokens are virtual assets created, traded, and stored on a blockchain, which we collectively refer to herein as “digital assets.”⁷ Blockchain games often reward player engagement by offering players verifiable ownership of unique, scarce in-game NFTs that can be transferred, bought, and sold outside the game, and opportunities to earn fungible tokens that can be used as in-game virtual currency or traded on exchanges outside the game.

Although cryptocurrency companies continue to grapple with an industry downturn compounded by the closures of Silvergate Bank and Silicon Valley Bank, both of which were

¹ This U.S. Tech Law Update is provided by Pillar Legal, P.C. (the “Firm”) as a service to clients and other readers. The information contained in this publication should not be construed as legal advice, and use of this memorandum does not create an attorney - client relationship between the reader and the Firm. In addition, the information has not been updated since the date first set forth above and may be required to be updated or customized for particular facts and circumstances. This U.S. Tech Law Update may be considered “Attorney Advertising” under applicable law. Questions regarding the matters discussed in this publication may be directed to the Firm at the following contact details: +1-925-474-3258 (San Francisco Bay Area office), +86-21-5876-0206 (Shanghai office), email: info@pillarlegalpc.com. Firm website: www.pillarlegalpc.com. © 2023 Pillar Legal, P.C.

² Owen S. Good, *NFT mastermind says he created Ethereum because Warcraft nerfed his character*, POLYGON (October 4, 2021).

³ *Id.*

⁴ “Smart contracts” refer to computer code stored on a blockchain that runs when predetermined conditions are met, automating actions required in an agreement or contract. Nick Szabo, *Smart Contracts: Building Blocks for Digital Market* (1996).

⁵ *History of ETH: The rise of the Ethereum Blockchain*, COINTELEGRAPH.

⁶ Cryptopedia, *Digital Assets: Cryptocurrencies vs. Tokens*, GEMINI (May 17, 2021).

⁷ *Id.*



popular partners for crypto companies, blockchain games have proven unexpectedly resilient.⁸ According to DappRadar, blockchain games experienced a 94.17% year-over-year transaction count increase to reach 7.4 billion transactions in 2022, accounting for nearly half of all activity on blockchain-based applications.⁹ Play-to-earn games, or games in which players earn digital assets with real-world value by completing tasks, faced a significant downturn, with most major projects losing over 90% of their market capitalization in 2022, although the top games managed to increase their activity.¹⁰ Funding in the latter quarters of 2022 was mixed, with an increase in deals but a decrease in the total deal value.¹¹ Still, blockchain game development continues to evolve; in February 2023, Unity, the cross-platform game engine developed by Unity Technologies, released a “decentralization” category in its online asset storefront, adding support for 13 different blockchain-based software developer kits.¹² Virtual worlds have also experienced significant growth in 2023, reaching a trading volume of US\$145 million in February, an increase of 226% from January 2023.¹³ Further, in January 2023, blockchain game investments amounted to US\$156 million, with another US\$148 million raised in February 2023.¹⁴

While excitement around blockchain games persists, developers face a fragmented, confusing, and ill-defined US regulatory environment. Absent comprehensive digital assets legislation from Congress, US federal and state agencies have been tasked with adapting existing legal frameworks to the emerging digital assets industry, with the US Securities and Exchange Commission (the “SEC”) emerging as a prominent, industry-shaping source of regulatory enforcement.¹⁵ This legal update, the first in a series that will explore the boundaries of US regulations impacting blockchain games, untangles US securities law by analyzing guidance from the SEC’s ongoing regulation of digital assets to provide a list of ‘Dos and Don’ts’ for reducing regulatory risk in blockchain games.

1. The Legal Framework

On March 28, 2022, the SEC released its annual Congressional Budget Justification, in which it requested a budget of US\$2.15 billion, \$214 million more than sought the year prior,¹⁶ on the grounds that, “[a]s more Americans are accessing the capital markets, we need to be sure that the Commission has the resources to protect them.”¹⁷ As the SEC’s Congressional Budget Justification suggests, the SEC seeks to address the unprecedented accessibility of financial markets brought forth by the advent of the internet and the emergence of novel financial instruments that aren’t being bought and traded by the archetypal Wall Street investment bank,

⁸ See Maria Gracia Santillana Linares, [Broken Banks Silvergate And SVB Put Pressure On Crypto, Leaders End Week Down 10%](#), FORBES (March 10, 2023).

⁹ [DappRadar x BGA Games Report – 2022](#) (January 26, 2023).

¹⁰ *Id.*

¹¹ *Id.*

¹² Sara Gherghelas, [Unlocking Exciting Developments: Why a Down Month for Blockchain Gaming is Misleading](#), DAPP RADAR (March 9, 2023).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ See Ciaran Lyons, [US crypto regulation happening ‘behind closed doors’ — Blockchain Association CEO](#), COINTELEGRAPH (February 22, 2023).

¹⁶ SEC, [Congressional Budget Justification](#) (FY2022).

¹⁷ SEC Chair Gary Gensler, [Testimony Before the United States House of Representatives Committee on Financial Services](#) (October 5, 2021).



but by “the college graduate paying off her student loans; the parents-in-waiting saving for that new house with a crib; the grandparents living off their nest egg,” with the beguiling ease of tapping a screen.¹⁸ To the SEC, charged with protecting investors, facilitating capital formation, and maintaining fair, orderly, and efficient markets, the accessibility and informal distribution of digital assets foster disparities between individual, nonprofessional investors and predatory investment professionals (sometimes even algorithms) that may harbor undisclosed conflicts of interest to the detriment of individuals and market competition.¹⁹

Meanwhile, blockchain games rely on accessibility and the in-game distribution of transferable digital assets so that players who invest money, time, and emotional engagement into games can trade digital assets earned or minted in-game on out-of-game secondary markets for real-world value.²⁰ Further, the increased transparency provided by blockchain technology may combat the black-market trading common to traditional games in which players pay real money off-platform to purchase especially rare in-game assets in violation of the underlying games’ terms of service.²¹ Not only does such illicit trading reroute revenue from game companies, but sometimes in-game assets traded illicitly are stolen from other players or misrepresented to appear scarcer than they are to increase their market value.²² Because digital assets are traded on tamper-resistant, verifiable, public digital ledgers, players and game companies can trace the provenance of digital assets even when digital assets are traded out-of-game.²³ Some digital assets may also be coded with smart contracts that automate percentage-based royalties for game developers when the digital asset is traded, ensuring revenue for game developers proportionate to their players’ ability to reap real-world returns from in-game engagement.²⁴ Thus, by integrating blockchain technology, developers aim to create innovative in-game economies that open novel routes to monetization for both players and game companies.

However, a fundamental conflict emerges from blockchain game companies’ use of digital assets to monetize while providing players with real-world value and the SEC’s framework for identifying securities: the characteristics of digital assets that appeal to blockchain game companies are some of the same characteristics that inform the SEC’s securities findings, placing blockchain game companies at risk of becoming subject to not only securities registration requirements, but a cascading litany of other securities regulations, such as rules governing custody of securities and securities exchanges. The costs of violating U.S. securities laws can be extremely high but registering in-game digital assets as securities is also prohibitively expensive and ultimately impracticable. Nor can blockchain game companies act on the hope that they go unnoticed: SEC Chair Gary Gensler has prioritized digital assets regulation, illustrated by marked efforts to strengthen the SEC’s enforcement team, enlist outside agencies and organizations to assist the SEC’s digital assets investigations, and pursue legal and

¹⁸ SEC Chair Gary Gensler, [Investor Protection in a Digital Age](#), Remarks Before the 2022 NASAA Spring Meeting & Public Policy Symposium (May 17, 2022).

¹⁹ *Id.*

²⁰ See Sasha Shilina, [What are Web3 games, and how do they work?](#) COINTELEGRAPH (February 28, 2023).

²¹ See Stardust, [Why publishers and developers need to embrace digital asset ownership and collaboration across studios](#), VENTUREBEAT (October 24, 2022); see also Nicole Carpenter, [Neopets is reckoning with black market pet trading](#), POLYGON (March 8, 2021).

²² *Id.*

²³ See Sasha Shilina, [What are Web3 games, and how do they work?](#) COINTELEGRAPH (February 28, 2023).

²⁴ *Id.*



administrative actions against individuals and companies that the SEC deems to be distributing unregistered securities.²⁵ Thus, it is imperative that blockchain game companies either structure in-game digital assets to preempt a security finding or manage their risk by assessing their digital assets for the characteristics of a security.

1.1 Howey Test

The SEC and federal courts analyze whether unique instruments like digital assets are securities by applying the Howey test, referring to the Supreme Court of the United States' holding in *SEC v. W. J. Howey Co.* that a type of security called an investment contract exists where parties agree to invest money in a common enterprise with the reasonable expectation of profits derived from the efforts of others.²⁶ The SEC breaks the Howey test into three prongs, all of which must be present for a digital asset to be deemed a security: (i) an investment of money, (ii) in a common enterprise, (iii) with the reasonable expectation of profits derived from the efforts of others.²⁷ Below, we outline each prong, and how blockchain games might inadvertently meet each prong.

(a) Investment of Money

The first prong of the Howey test is typically satisfied when a digital asset is purchased with or acquired in exchange for value.²⁸ That value need not be money. According to guidance from the SEC, an “investment of money” means an investment of *any* value, whether fiat currency, goods and services, another digital asset, or some other type of consideration.²⁹ The SEC has previously clarified that “the lack of monetary consideration for digital assets, such as those distributed via a so-called ‘airdrop,’ does not mean that the investment of money prong [of the Howey test] is not satisfied.”³⁰ The SEC defines an “airdrop” as the distribution of a digital asset to holders of another digital asset, typically to promote its circulation.³¹

Blockchain games most obviously satisfy the investment prong of the Howey test when players purchase in-game digital assets with cash or other digital assets. But, even if a blockchain game company distributes digital assets without a requisite “purchase,” that distribution could still satisfy the investment prong of the Howey test if the recipient exchanges some other value for the digital asset, like marketing efforts.

For example, during the Super Bowl on February 12, 2023, DigiDagaku, an NFT collection by blockchain game company Limit Break, aired an ad that displayed a QR code, which viewers could scan to mint one of 10,000 free “digital collectibles” from its Dragon Eggs

²⁵ Andrew R. Chow, [The U.S. Crypto Crackdown Could Reshape the Industry](#), TIME (March 2, 2023).

²⁶ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

²⁷ SEC, [Framework for “Investment Contract” Analysis of Digital Assets](#).

²⁸ *Id.* at Section II(A).

²⁹ See 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).

³⁰ SEC, [Framework for “Investment Contract” Analysis of Digital Assets](#), fn. 9.

³¹ *Id.*



collection.³² The QR code redirected viewers to the Twitter profile of Gabriel Leydon, the co-founder and CEO of Limit Break, whose Twitter banner was emblazoned with the words “FOLLOW TO WIN.”³³ Additionally, Leydon shared the ad in a tweet with instructions to win a free DigiDagaku digital collectible that included retweeting his tweet, liking the tweet, and following his account.³⁴

In an interview with VentureBeat, Leydon explained why blockchain game companies might give away free digital assets prior to the game becoming available: “The developer builds a big audience of people who are excited about the game and owning part of it. They become advocates for the game way before the game comes out. They all hope it succeeds because of these assets.”³⁵ Leydon then explained that the game’s developers make money by retaining a percentage of digital assets for themselves, to sell at market prices later, and that new players can purchase digital assets from either the early players or the company.³⁶

Based on the SEC’s guidance, the model Leydon described is an airdrop in that NFTs are distributed for free, but only after the recipients perform requisite tasks to promote the NFT collection (such as retweeting the ad). However, it remains unclear whether a court would agree that an NFT air drop constitutes an “investment of money.”

(b) Common Enterprise

Federal courts have previously held that an undertaking must include either horizontal commonality or vertical commonality to satisfy the common enterprise prong of the Howey test.³⁷ Horizontal commonality exists when 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.³⁸ Vertical commonality, which focuses on the relationship between an instrument’s promoter³⁹ and the instrument’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.⁴⁰ To establish strict vertical commonality, the fortunes of the investors must be tied to the *fortunes* of the promoter.⁴¹

The SEC, however, asserts that investments in digital assets nearly always constitute investments in a common enterprise because the fortunes of digital asset purchasers are linked

³² Dean Takahashi, [Limit Break’s 10K NFTs for DigiDaigoku were gone ‘instantly’ after Super Bowl ad](#), VENTUREBEAT (February 13, 2023).

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *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](#).

³⁸ *Id.*

³⁹ “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.

⁴⁰ *Long v. Shultz Cattle Co., Inc.*, 881 F.2d 129, 140-41 (5th Cir. 1989).

⁴¹ *Brodts v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978).



either to each other, thus establishing horizontal commonality, or to the success of the promoter's efforts, thus establishing broad vertical commonality.⁴² Although game developers distributing digital assets intended for use in-game or within a broader game ecosystem may not consider those digital assets "investments," the SEC's emphasis on promoter efforts⁴³ implicates the role developers have in creating, maintaining, and expanding game content. Unlike blockchain projects capable of peer-to-peer decentralization, such as on-chain stores of value like Bitcoin,⁴⁴ blockchain games generally require developers to support game operations and sustain player enjoyment. Thus, blockchain games almost always involve a common enterprise, satisfying the second prong of the Howey test.

(c) Reasonable Expectation of Profits Derived from the Efforts of Others

The third prong of the Howey test is often further split into two elements: (i) reasonable expectations of profits, and (ii) reliance on the efforts of others.⁴⁵

Reasonable Expectations of Profits

Satisfaction of the third prong's first element, reasonable expectations of profits, is determined by whether the digital asset is designed for functionality or investment.⁴⁶ The degree to which a digital asset is functional depends on a variety of factors, including, but not limited to:

- i. the digital asset's in-game utility;
- ii. the target market audience for the digital asset, such as players or investors;
- iii. the digital asset's transferability and tradability on a secondary market, like an exchange;
- iv. whether the digital asset is marketed as functional or as an investment;
- v. the quantities of the digital asset sold relative to expected usage quantities, in other words, whether the supply makes sense for expected demand based on the digital asset's in-game utility;
- vi. the timing of the digital asset's sale with respect to availability of the underlying game; and
- vii. the sale price of the digital asset relative to the value of other purchasable in-game assets.⁴⁷

Although game developers could design digital assets in a manner that limits the likelihood of profits, digital assets in blockchain games must be available for purchase, sale, and trading on exchanges outside of the game to fulfill the true player ownership element of blockchain games. However, once digital assets are freely tradable on exchanges, there is generally an ability to profit from any appreciation in the value of those digital assets, which

⁴² SEC, [Framework for "Investment Contract" Analysis of Digital Assets](#), n. 11.

⁴³ The importance of non-investor efforts to a security finding arises again in the third prong of the Howey test.

⁴⁴ "On-chain" meaning digital assets on blockchains, and "stores of value" meaning assets that neither depreciate nor expire over long periods of time. See [Store of Value](#), COINMARKETCAP (accessed November 17, 2022).

⁴⁵ *Id.*

⁴⁶ SEC, [Framework for "Investment Contract" Analysis of Digital Assets](#).

⁴⁷ *Id.*



dramatically increases the likelihood that the digital assets satisfy the “reasonable expectation of profits” element of the Howey test.

As a result, there exists a conflict between the fundamental goal of blockchain games and the SEC’s current application of the Howey test. Blockchain games aspire to monetize while providing players with meaningful ownership over in-game items by minting those items into NFTs that have value outside the game. Similarly, blockchain games often implement fungible tokens as in-game currency. However, once in-game digital assets are tradable on secondary markets, where their value may fluctuate based on the efforts of game developers and publishers, there is a much higher risk that those digital assets would be deemed securities under the Howey test.

Reliance on the Efforts of Others

Satisfaction of the third prong’s second element is determined by whether a purchaser expects to rely on the efforts of a promoter, sponsor, or another party that provides significant managerial efforts affecting the success or failure of the enterprise.⁴⁸ A blockchain game generally relies on centralized game development publishing teams to create the game and manage the game’s ongoing operation. Additionally, the value of in-game digital assets is generally linked to the success of the underlying game. If the game is never completed or otherwise unsuccessful, then the game’s digital assets provide neither utility nor sentimental value. Even blockchain games aspiring to decentralize, like Axie Infinity, intend to maintain a central team of developers for upkeep while extending non-technical governance decisions to players.⁴⁹ As a result, digital assets in blockchain games generally satisfy the “reliance on the efforts of others” element of the Howey test.

1.2 Implications of Security Finding

All securities, including digital assets deemed securities under the Howey test, must either be registered with the SEC under Section 5 of the Securities Act of 1933 (the “Securities Act”) or qualify for an exemption from registration.⁵⁰ For securities sold without registration or meeting the requirements for an exemption from registration, Section 12 of the Securities Act provides purchasers with a rescission remedy, which is a “put right” allowing a purchaser to return the security to the issuer in exchange for a refund of the purchase.⁵¹ If the purchaser doesn’t own the security at the time of initiating litigation, then the purchaser would be entitled to money damages equal to the purchase price, less any proceeds received upon the sale of the security.⁵² When digital asset values decline, like in the current market environment, rescission rights could result in crippling liability for digital asset creators and ultimately bankruptcy.

If the SEC determines that a particular digital asset is a security, then the SEC also has regulatory and enforcement jurisdiction with respect to market manipulation for that digital

⁴⁸ *Id.*

⁴⁹ [Axie Infinity Whitepaper](#).

⁵⁰ [15 U.S.C. § 77e](#); [15 U.S. Code § 78l\(a\)](#).

⁵¹ *Id.*

⁵² *Id.*



asset.⁵³ Market manipulation includes insider trading, such as was alleged in the Wahi Complaint, meaning the defendant used material nonpublic information to trade securities.⁵⁴ Other types of market manipulation that are subject to SEC jurisdiction when securities are involved include wash trading, in which an investor simultaneously sells and buys the same financial instruments to create artificial activity in the marketplace; pump and dump schemes, in which an individual or a group pools funds to inflate a security's price; scalping, which is recommending a security to drive up the price and then selling the security at inflated prices to generate profits; and touting, which is promoting a security without properly disclosing compensation received for promoting the security.⁵⁵ Several high-profile enforcement actions against influencers like Kim Kardashian in recent weeks have emphasized that the SEC is prioritizing not only issuers of unregistered securities, but also promoters of unregistered securities.⁵⁶

2. The Enforcement Framework

The SEC has thus far declined to issue regulations that establish new rules tailored to digital assets. Instead, the SEC has used the existing Howey test to evaluate on a case-by-case basis whether particular digital assets are securities. The SEC's consistent application of the Howey test to digital assets in publications, commissioners' speeches, and enforcement actions has created a body of materials that provide insight into the SEC's view on what characteristics and contexts most often lead to the conclusion that a particular digital asset is a security.

2.1 The DAO Report

On July 25, 2017, the SEC issued its first detailed guidance on digital assets in the form of an investigative report into virtual organizations called decentralized autonomous organizations (“DAOs”) and crowdfunding token sales called initial coin offerings (“ICOs”).⁵⁷ The SEC concluded that tokens offered and sold by DAOs were securities and thus subject to federal securities laws absent a valid exemption.⁵⁸ The preamble of the SEC's analysis in the DAO report outlines the foundational principles of federal securities laws, which continue to frame the SEC's approach to regulating digital assets:

- i. An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.⁵⁹
- ii. This definition embodies a “flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those

⁵³ Anndy Lian, [Market Manipulation in the Cryptocurrency Industry](#), SECURITIES IO (February 25, 2022).

⁵⁴ *Id.*

⁵⁵ [Crime and NFTs: Chainalysis Detects Significant Wash Trading and Some NFT Money Laundering In this Emerging Asset Class](#), CHAINALYSIS (February 2, 2022).

⁵⁶ [In the Matter of Kimberly Kardashian](#), File No. 3-21197.

⁵⁷ SEC, [Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934: The Dao](#).

⁵⁸ *Id.*

⁵⁹ *Id.* at 11.



who seek the use of the money of others on the promise of profits.” [emphasis in original.]⁶⁰

- iii. The test “permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of ‘the many types of instruments that in our commercial world fall within the ordinary concept of a security.’”⁶¹
- iv. In analyzing whether something is a security, “form should be disregarded for substance.”⁶²
- v. “[Emphasis] should be on economic realities underlying a transaction, and not on the name appended thereto.”⁶³

The first principle is a restatement of the Howey test, and each proceeding principle informs the lens through which the SEC reviews digital assets under the Howey test. The principles provide valuable context as to why the SEC has not, for example, engaged in formal rulemaking despite petitions for the same, like that issued by Coinbase on July 21, 2022,⁶⁴ and instead “regulates by enforcement”⁶⁵ through actions that interpret the Howey test on a case-by-case basis. Based on these principles, the SEC may favor a case-by-case approach because analysis under the Howey test necessitates a “flexible rather than a static principle” to fulfill the spirit of securities laws when there is an exploitable asymmetry between a purchaser’s knowledge and an issuer’s knowledge, such that the purchaser must rely on the issuer for information. Securities laws aim to balance that inherently lopsided relationship by compelling full and fair disclosure so that purchasers may make informed decisions relative to risks they otherwise might not recognize. In the DAO Report, the SEC thus postulates that public interest and the relevance of existing investor protections to economic realities underlying transactions involving a digital asset inform whether the digital asset is a security under the Howey test.

The SEC has reiterated the above principles in subsequent guidance, actions, and public statements regarding digital assets, indicating they remain relevant to understanding when digital assets, including in-game digital assets, could be deemed securities.

2.2. Framework for Investment Contract Analysis of Digital Assets

On April 3, 2019, the SEC released its Framework for Investment Contract Analysis of Digital Assets (the “Investment Contract Framework”), which set forth in more comprehensive detail the SEC’s approach to analyzing blockchain projects under the Howey test.⁶⁶ The Investment Contract Framework is the SEC’s most current guidance on evaluating digital assets for securities characteristics. The SEC raises and dismisses the first two prongs of the Howey test, (i) investment of money, and (ii) common enterprise, as “typically satisfied” by offers and sales of digital assets:

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Coinbase, *Re: Petition for Rulemaking – Digital Asset Securities Regulation* (July 21, 2022).

⁶⁵ Ryan Deffenbaugh, Ben Brody, *The three words driving the crypto policy debate*, PROTOCOL (August 5, 2022).

⁶⁶ SEC, [Framework for “Investment Contract” Analysis of Digital Assets](#).



- i. *The Investment of Money.* The first prong of the Howey test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or another type of consideration.⁶⁷
- ii. *Common Enterprise.* Courts generally have analyzed a "common enterprise" as a distinct element of an investment contract. In evaluating digital assets, we have found that a "common enterprise" typically exists.⁶⁸

However, the SEC separates the third prong, “reasonable expectation of profits to be derived from the efforts of others,” into two elements, (i) reliance on others (such others “Active Parties” or “AP” in the Investment Contract Framework), and (ii) reasonable expectations of profits. Several of the relevant characteristics for each are noted in the table below.⁶⁹

Reliance on Others	Reasonable Expectation of Profits
<ul style="list-style-type: none"> - <u>AP Responsibility.</u> An AP is responsible for the development, improvement (or enhancement), operation, or promotion of the network, particularly if purchasers expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality. - <u>AP Tasks.</u> There are essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users (commonly known as a "decentralized" network). - <u>AP Market Role.</u> An AP creates or supports a market for, or the price of, the digital asset. This can include, for example, an AP that: (1) controls the creation and issuance of the digital asset; or (2) takes other actions to support a market price of the digital asset. - <u>AP Governance Authority.</u> An AP has a lead or central role in the direction of the ongoing development of the network or 	<ul style="list-style-type: none"> - <u>Owner Can Sell.</u> The digital asset gives the holder rights to share in the enterprise's income or profits or to realize gain from capital appreciation of the digital asset. - <u>Secondary Market.</u> The digital asset is transferable or traded on or through a secondary market or platform or is expected to be in the future. - <u>Anticipated Appreciation.</u> Purchasers reasonably would expect that an AP's efforts will result in capital appreciation of the digital asset and therefore be able to earn a return on their purchase. - <u>Targeted Buyers.</u> The digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network. - <u>Price vs Value.</u> There is little apparent correlation between the purchase/offering price of the digital asset and the market price of the particular goods or services that can be acquired in exchange for the digital asset.

⁶⁷ *Id.* at II(A).

⁶⁸ *Id.* at II(B).

⁶⁹ *Id.* at II(C).



<p>the digital asset, particularly related to governance and the digital asset’s code.</p> <ul style="list-style-type: none"> - <u>AP Managerial Role</u>. An AP has a continuing managerial role in making decisions about or exercising judgment concerning the network or the characteristics or rights the digital asset represents. - <u>AP Interests</u>. Purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset. 	<ul style="list-style-type: none"> - <u>Amount Raised</u>. The AP has raised an amount of funds in excess of what may be needed to establish a functional network or digital asset. - <u>Team Retained Assets</u>. The AP is able to benefit from its efforts as a result of holding the same class of digital assets as those being distributed to the public. - <u>Ongoing Development</u>. The AP continues to expend funds from proceeds or operations to enhance the functionality or value of the network or digital asset. - <u>Marketed as Investment</u>. The digital asset is marketed, directly or indirectly, using language indicating that the digital asset is an investment, that the digital asset’s value relies on ongoing development, or that the digital asset is transferable and thus tradeable on secondary markets.
--	---

2.3 Chair Gensler’s Public Statements

In speeches and public statements, SEC Chair Gary Gensler has positioned blockchain regulation as a focus for the SEC since he took up his mantle on April 17, 2021.⁷⁰ According to Chair Gensler’s remarks on digital assets before the Aspen Security Forum on August 3, 2021, investor protection remains the SEC’s primary prerogative: “This asset class is rife with fraud, scams, and abuse in certain applications. There’s a great deal of hype and spin about how crypto assets work. In many cases, investors aren’t able to get rigorous, balanced, and complete information.”⁷¹ On September 8, 2022, Chair Gensler elucidated his stance on the SEC’s role in regulating digital assets in the Practising Law Institute’s The SEC Speaks program, stating, “Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities.”⁷²

2.4 The Complaint in SEC v. Wahi

On July 21, 2022, the SEC alleged that nine digital assets constituted securities in its first insider trading claim involving digital assets, *SEC v. Ishan Wahi, Nikhil Wahi, and Sameer Ramani* (the “Wahi Complaint”).⁷³ In the Wahi Complaint, the SEC charges a former Coinbase manager and two others with perpetrating a scheme to trade nine digital asset securities ahead of Coinbase announcing that those assets would be listed on its trading platform.⁷⁴ To establish jurisdiction, the SEC analyzes nine fungible tokens under the Howey test (the “Nine Complaint”).

⁷⁰ SEC Press Release, [Gary Gensler Sworn in as Member of the SEC](#) (April 17, 2021); see also SEC Press Release, [SEC Nearly Doubles Size of Enforcement’s Crypto Assets and Cyber Unit](#) (May 3, 2022).

⁷¹ Gary Gensler, [Remarks Before the Aspen Security Forum](#) in Washington, DC (August 3, 2021).

⁷² Gary Gensler, [Kennedy and Crypto](#), delivered at SEC Speaks in Washington, DC (September 8, 2022).

⁷³ It is just as likely that the SEC was constrained by its limited capacity and the available facts. The SEC’s silence regarding the remaining 16 tokens should not be interpreted as an admission by the SEC that those tokens do not constitute securities.

⁷⁴ Complaint, [SEC v. Ishan Wahi, Nikhil Wahi, and Sameer Ramani](#).



Tokens”), identifying key characteristics material to whether a digital asset constitutes a security.⁷⁵

Also on July 21, 2022, the United States Department of Justice (the “DOJ”) unsealed an indictment for Ishan Wahi, Nikhil Wahi, and Sameer Ramani in the same matter (the “Wahi Indictment”).⁷⁶ Parallel to the Complaint’s civil charges, the DOJ criminally charged the three named individuals with wire fraud conspiracy and wire fraud for participating in a scheme to trade digital assets that were listed or were under consideration for listing on Coinbase.⁷⁷ However, the DOJ named only six digital assets, four of which were not named by the SEC.⁷⁸ The Wahi Complaint and the Wahi Indictment provide 13 specific digital asset examples, nine that the SEC named as securities and four that it did not.⁷⁹ The SEC’s silence on the four tokens named in the Wahi Indictment provides an additional point of reference for defining digital asset securities.⁸⁰

When we compared the Nine Complaint Tokens to the four tokens named in the Wahi Indictment,⁸¹ five characteristics emerged as most relevant to the SEC’s determination regarding the Nine Complaint Tokens:

- i. *Token Supply Caps.* The SEC indicated that the issuers of five of the Nine Complaint Tokens purposely limit supply to bolster the value of the tokens.⁸² Five issuers of the Nine Complaint Tokens also engaged in or had engaged in periodic “burnings” and “buybacks” of tokens, in which issuers either destroy tokens or buy tokens back from holders of those tokens on the open market.⁸³
- ii. *Marketing as Investment.* The SEC noted that when marketing the Nine Complaint Tokens each issuer advertised the relevant token’s profitability to potential purchasers, including through social media posts, through documents explaining the projects, in blog posts, and on the projects’ websites.⁸⁴ The SEC also noted that issuers promoted the availability of secondary markets for trading the Nine Complaint Tokens through social media posts, blog posts, and the projects’ websites.⁸⁵
- iii. *Pool Financial Rewards.* The SEC also highlighted that four of the Nine Complaint Tokens advertised financial rewards, and thus opportunities for profit,

⁷⁵ For more information on the characteristics identified by the SEC in the Wahi Complaint, please see Pillar Legal’s US Tech Law Update, [SEC Deems Nine Tokens Securities](#).

⁷⁶ Indictment, [US v. Ishan Wahi, Nikhil Wahi, and Sameer Ramani](#).

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ For more information, please see Pillar Legal’s US Tech Law Update, [SEC Deems Nine Tokens Securities](#) (August 26, 2022).

⁸² Complaint, [SEC v. Ishan Wahi, Nikhil Wahi, and Sameer Ramani](#).

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*



to purchasers who deposited their tokens in pools.⁸⁶

- iv. *Token Price Volatility.* The SEC indicated that the trading prices for each of the Nine Complaint Tokens have experienced substantial volatility.⁸⁷

These are inferences based on the SEC’s analysis of the Nine Complaint Tokens, not rules stated explicitly by the SEC. As the SEC stated in the DAO Report, the Howey test is a “flexible rather than a static principle,” and so any attempt at deriving precise rules is flawed on its premise. However, for now, the SEC’s analysis of the Nine Complaint Tokens provides helpful guidance for the SEC’s current understanding of when a digital asset is a security.

3. Risk Reduction

Taken together, guidance from the SEC provides key regulatory insight for blockchain game companies seeking to integrate digital assets without implicating the three 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 video games. Unfortunately, in many instances, there is a fundamental conflict between blockchain game companies’ desired use of digital assets and the SEC’s framework for identifying securities.

Nevertheless, below we have listed several Dos and Don’ts for structuring digital assets 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. Further, because the Howey test embodies a flexible principle based on economic realities, the following risk reduction suggestions are imperfect but intelligible standards based on the SEC’s patchwork guidance, intended to facilitate, not supplant, informed decision-making.

(a) Digital Assets in Games DON’Ts

- i. *DON’T conduct ICOs or NFT Pre-Sales.* Blockchain game 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 game. 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 game developer’s work to create and release the game. 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 assets enforcement actions focused on ICOs.⁸⁸

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ Cornerstone Research, [SEC Cryptocurrency Enforcement](#) (2022 Update).



- ii. *DON'T offer digital assets broadly to all potential purchasers.* Offering digital assets in quantities significantly greater than any likely player would reasonably need, or in quantities so small as to make actual in-game use of the digital asset impractical, suggests an investment opportunity rather than a functional in-game digital asset.
- iii. *DON'T issue digital assets at prices that have little apparent correlation to the in-game value of such digital assets.* If a digital asset's in-game value is divorced from the digital asset's purchase price, then purchasers have a reasonable expectation that the digital asset's purchase price reflects its potential for appreciation rather than its in-game utility
- iv. *DON'T compensate developers with the same in-game digital assets as those being distributed to players.* Purchasers reasonably expect game developers to take steps to build the market value, rather than the in-game value, of digital assets where the game developers' compensation is tied to the price of the digital asset in the secondary market.
- v. *DON'T limit the supply of fungible tokens used as in-game currency.* Ideally, fungible tokens used as in-game currency should have a fixed price and an unlimited supply; much like off-chain virtual currencies. While players would not be able to profit from fungible tokens anymore, such expectations of profit implicate securities regulation.
- vi. *DON'T market digital assets for their investment potential.* Advertising in-game digital assets' profitability to potential purchasers, including through social media posts, documents explaining the in-game economy, blog posts about the game, and on the game's platforms or websites, engenders an expectation of profits in purchasers.
- vii. *DON'T be lax with communication between staff and players, even in informal channels such as a Discord server.* The SEC considers every aspect of a digital asset's marketing, including blog posts, interviews, whitepapers, social media posts, public statements of key company executives at industry events, and company websites, to determine whether purchasers had a reasonable expectation of profits. Thus, efforts to eliminate formal marketing of digital assets for their investment potential can be undercut by informal statements that emphasize digital asset profitability.

(b) Digital Assets in Games DOs

- i. *DO structure digital assets to have in-game utility at the time of issuance.* The SEC has repeatedly emphasized that digital assets without immediate in-network



utility may be securities.⁸⁹ Thus, companies should offer digital assets that provide value to players at the time of players' purchases through in-game utility for games that have already been funded, developed, and launched.

- ii. *DO target digital assets to actual and potential players of the underlying game.* Issuing digital assets in quantities necessary to meet the needs of players or to reach potential players is unlikely to induce an expectation of profits since purchasers will be expected users of the underlying game.
- iii. *DO issue digital assets at prices that correlate with the digital assets' in-game value.* If a digital asset's in-game value is consistent with its offer price, purchasers are more likely to be players seeking in-game value, not investors expecting out-of-game profits.
- iv. *DO structure in-game digital assets to meet the in-game needs of players, rather than to feed speculation.* Designing digital assets to appeal to players rather than investors necessitates choices that might diminish the potential for players to profit but in service of enriching gameplay, eliminating speculation, and retaining engaged players.
- v. *DO market digital assets for their in-game utility.* Advertising in-game digital assets' in-game utility provides incentives for players to engage with a game ecosystem outside of the financial incentives that foster speculation.
- vi. *DO establish strong marketing policies and implement them strictly, even in typically informal channels such as a Discord server.* 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 game companies need to manage player expectations through strict marketing policies that consistently communicate a digital asset's in-game utility rather than the digital asset's profit-generating potential.

⁸⁹ Complaint, [SEC v. Ishan Wahi, Nikhil Wahi, and Sameer Ramani](#); SEC, [Framework for "Investment Contract" Analysis of Digital Assets](#).