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SEC Declares Bitcoin and Ether as Non-Securities

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On Thursday, June 14, 2018, the U.S. Securities and Exchange Commission's (**SEC**) Director of Corporate Finance, William Hinman (**Hinman**), announced that the commission would not be treating Ether or Bitcoin as securities. The SEC's announcement is in line with the recent comments of SEC Chairman, Jay Clayton, who recently noted the difference between cryptocurrencies and digital tokens, saying that cryptocurrencies as "replacements for sovereign currencies" were not securities, while digital assets revolving around a venture are often securities.

The SEC's announcement was delivered via a speech by Hinman at Yahoo Finance's All Market Summit: Crypto (a transcript of which can be found here), where Hinman spoke in depth about how securities laws apply to digital assets. His comments focused on how the entire economic reality of any given digital asset must be considered. In making this point, Hinman likened utility tokens to the oranges being grown on the parcels of land at issue in *Howey*[1], the landmark U.S. securities case, stating "the token…all by itself is not a security, just as the orange groves in *Howey* were not." Hinman then went on to note that *Howey* was selling an investment in orange groves with the expectation of return, not just oranges. Hinman's point with respect to digital assets was that many tokens, no matter their utility, are being purchased with an expectation of profit derived from the efforts of others.

A significant take-away from Hinman's statement regarding the analysis of a digital asset is that "the analysis of whether something is a security is not static and does not strictly inhere to the instrument," meaning that a digital asset that is originally sold as a security in the eyes of the SEC could be sold in a manner that does not constitute a security in a future offering. In connection with the SEC's previously issued report on the DAO, a digital asset is considered as a security "where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise." However, if that same digital asset progresses to a point where there is sufficient decentralization of the network or where the asset is only sold "to be used to purchase a good or service available through the network on which it was created," that digital asset that was once considered to be a security could be viewed in a significantly different light.

Following this more general discussion, Hinman focused on the SEC's analysis of Ether, the utility token used on the Ethereum network, stating that despite the fundraising that was associated with the initial launch of Ether, "current offers and sales of Ether are not securities transactions." Hinman's rationale was based in large part on the decentralized nature of the Ethereum network, which influences the economic reality around the tokens. He explained that if a cryptocurrency is decentralized enough it creates a situation "where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts." Expounding upon this analysis, Hinman noted that the disclosure regime of securities regulation as currently contemplated, if imposed upon decentralized networks, would not provide

any protection to investors. As part of his analysis, Hinman provided a non-exhaustive list of questions to consider when analyzing the extent to which a digital asset is decentralized:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
4. Are purchasers "investing," that is, seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
5. Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?[2]

While the decentralized nature of a digital asset will be a topic of emphasis for the SEC moving forward, Hinman provided a secondary, non-exhaustive, list of questions to consider regarding the structure and purpose of the digital asset – making specific note that the factors below do not necessarily need "to be present to establish a case that a token is not being offered as a security":

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
5. Is the asset marketed and distributed to potential users or the general public?

6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application
7. Is the application fully functioning or in early stages of development?[3]

While Hinman's announcement represents a significant development in the effort to establish a framework to characterize digital assets, it also raises many questions. How much decentralization is sufficient to make a token not a security? How will decentralization be measured? Will it be measured by how distributed token ownership is? Or the distribution of hashrate for proof-of-work networks? Or control of the network's code? Will the distribution of nodes be a factor?

These questions and more will start to be answered on a case by case basis as the SEC and other regulators analyze the various economic realities of digital assets moving forward.

We Can Help

For more information about how Cassels can assist with your business, please contact **Michael Weizel** or another member of our firm's cross-disciplinary **Emerging Companies and Technology Group**.

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[1] *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946)

[2] Speech by William Hinman, "*Digital Asset Transactions: When Howey Met Gary (Plastic)*", June 14, 2018.

[3] *Ibid.*

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