ENTERPRISE ETHEREUM ALLIANCE

EEA Tokenization Interest Group

Key Webinar Takeaways:

Digital Asset Tokenization: U.S. Securities Laws, Rules, and Regulations

The EEA's Tokenization Interest Group has kicked off its Tokenization Webinar Series for members and non-members alike. The Webinar series features five presentations: (1) Legal/Regulatory Framework; (2) Technical Framework; (3) Token Economics Framework; (4) Ethical Framework; and (5) Case Studies for Digital Asset Tokenization.

The first webinar - covering the legal landscape for monetizing digital tokens in the United States - was held on June 7th and was presented by Benjamin Bukari, Founder, Abbaci Inc. The recording is available on the EEA YouTube Channel: https://www.youtube.com/watch?v=gEK6PSDYxAs . Here are the key takeaways:

Takeaway 1:

How is the term "security" defined under United States securities laws?

The term "security" is defined under Section 2(a)(1) of the Securities Act of 1933 (Securities Act). The Supreme Court of the United States (SCOTUS) has held that the definition of "security" under the Securities Act is virtually the same as the definition set forth in the Securities Exchange Act of 1934 (Exchange Act).

Per Section 2(a)(1) of the Securities Act, the term "security" is defined as follows—

> "Any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,

or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Takeaway 2:

What are the purposes of the Securities Act and the Exchange Act?

The Securities Act and the Exchange Act were created in the aftermath of the 1929 stock market crash to eliminate the largely unregulated securities market. The offer and sale of a security is governed by the Securities Act, which mandates full and fair disclosure of the character of securities sold in interstate and foreign commerce. Under Section 5 of the Securities Act, an offer and sale of a security in the United States must be registered with the Securities and Exchange Commission (SEC) or exempted from registration under one of the exemptions. Conversely, the Exchange Act governs securities transactions on the secondary market, post-issue, ensuring greater financial transparency and reducing fraudulent conduct and market manipulation.

In summary, United States securities laws are broad enough to encompass virtually any instrument that may be sold as an investment.

Takeaway 3:

What is the Howey test?

In *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), SCOTUS considered whether a land sale contract together, together with a service contract to cultivate orange groves, constituted an investment contract under Section 2(a)(1) of the Securities Act.

In *Howey*, a company sold small tracts of land in a citrus grove to individuals. The individuals could service the land but lacked the necessary knowledge and expertise to cultivate the citrus trees. The service contracts to cultivate the land granted the Howey company complete possession of the tracts of land, meaning the individual investors had no ownership of the land or groves. In other words, the individuals invested in the citrus grove primarily for the profit opportunity.

Based on this frame, SCOTUS opined that an "investment contract is a contract, transaction, or scheme whereby a person invests her money in a common enterprise and is led to expect profits solely from the efforts of the promoter[s] or third party[ies]." *Howey*, 328 U.S. 298-99.

From this canvas, we can discern four elements that are known as the *Howey* test—

1. An investment of money
2. In a common enterprise
3. With the reasonable expectation of profits
4. Derived from the efforts of others.

   The critical factors for each element of the *Howey* test are noted below for context.

   1. *An investment of money* means any form of consideration, such as cash, investment services, and cash-equivalent goods such as Bitcoin, Ethereum, etc.
   2. *In a common enterprise* focuses on whether the profitability of an individual's investment is dependent on the success or failure of the parties in the enterprise (otherwise known as commonality). Commonality has two measures- horizontal commonality (*i.e.,* multiple investors

3. where funds are pooled together or returns fluctuate together) and vertical commonality (*i.e.,* between the promoter and the investor).
4. *With the reasonable expectation of profits* that can be in the form of capital appreciation, cash return on investment, or other earnings such as interest or dividend distributions. An important distinction for this third prong is when a purchaser is motivated by desire to use or consume the item purchased instead of investments in profit-seeking opportunities.
5. *Derived from the efforts of others* where the principal focus is on the economic realities of the underlying transaction. Important factors under this fourth prong include adequacy of financing, level of speculation and business risks, and investor control over profitability (*i.e.,* contribution of time and effort to the success of the enterprise, access to information regarding the investment, and any powers under the investment agreement).

What is the Reves test?

In *Reves v. Ernst & Young*, 494 U.S. 56 (1990), SCOTUS considered if an instrument denominated as a note fell within the definition of a security. SCOTUS did not apply the *Howey* test; rather, it adopted the Family Resemblance Test, which includes the following elements—

1. The motivation of the parties to enter into the transaction
2. The plan of distribution
3. The reasonable expectations of the investing public
4. The presence of an alternative regulatory scheme.

Under the Family Resemblance Test, a note is presumed to be a security unless it bears a strong family resemblance to one of the categories of instruments that are not securities to include—

1. Notes secured by a mortgage
2. Notes delivered in consumer financings
3. Notes evidencing unsecured bank loans to individuals
4. Short-term notes secured by an assignment of accounts receivables
5. Notes evidencing loans by commercial banks for current business operations
6. Notes that formalize open account debt incurred in the ordinary course of business.

The Exchange Act and SEC specifically exclude from the definition of “security” notes with a term of less than nine months and the proceeds of which that are used for a current transaction. Key considerations in determining whether an instrument is a security or a note include—

1. Investment motivation indicates a security
2. Commercial or consumer motivation indicates a non-security

Takeaway 4:

What are different types of financial instruments are considered securities?

Examples of instruments that may be considered securities include—

1. Stock
2. Notes
3. Certificates of Deposit
4. Guarantees
5. Partnership Interests and Joint Ventures
6. Limited Liability Company (LLC) interests

Takeaway 5:

How do federal regulators determine if an instrument is a security?

Commodity Futures Trading Commission (CFTC)
The CFTC has regulatory authority over most categories of derivative transactions—depending on their structure and use, digital assets may constitute a commodity, swap, or other derivative.

Per the CFTC, the efficacies of digital asset markets can be evaluated by considering, among other things, the number of users, digital asset values relative to currency and conventional assets, value of cash markets and derivative transactions, transaction volumes in cash and derivative markets, overall market liquidity, prevalence of digital asset derivative contracts, and the number of tokens and or total value locked in smart contracts.

Securities and Exchange Commission (SEC)
SEC is an independent agency whose stated purpose and purpose is the regulation of securities markets. The events listed below frame the SEC's mission regarding digital assets.

-SEC DAO Report dated 25 July 2017 (Report)
According to its plain text, the Report is meant to facilitate fundamental principles of U.S. securities laws and describes their applicability to the new paradigm of Web3; namely, virtual organizations or capital raising entities that use distributed ledger technology (DLT) to facilitate capital raising and or investment and the related offer and sale of securities. Notably, according to the SEC, the automation of certain functions through DLT, smart contracts, and the like, does not remove conduct from the purview of federal securities laws.

-SEC Framework for "Investment Contract" Analysis of Digital Assets (Framework)
The Framework is a guidance memorandum for the general public to assess whether a digital asset is an investment contract and whether offer and sale of a digital asset are securities transactions.

Some of the critical factors in the Framework include—

1. The active participants (*i.e.,* founders, promoters, sponsors, or other third parties)
2. If the funds from token sales are used to develop the network, platform, app, etc.
3. If tokens are immediately usable for their intended functionality.
4. If tokens are restricted to the platform and not otherwise available to external wallets.
5. Token repurchase settlements discounted from face value.
6. The scope of marketing and promotional activities (*i.e.,* whether or not active participants place emphasis on token functionality or value appreciation).

-*SEC v. Wahi, et al.*, Case No. 2:22-cv-01009, Dkt. #1 (filed 07/21/2022 USDC WD WA)
According to Gurbir S. Grewal, Director of the SEC's Division of Enforcement, the SEC "is not concerned with labels, but rather the economic realities of [an] offering." See SEC Press Release 2022-127, *SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action* (dated 07/21/2022).

Notable excerpts from the Complaint are cited below to contextualize the SEC's position.

"A digital token or crypto asset is a crypto asset security if it meets the definition of a security, which the Securities Act defines to include an 'investment contract,' *i.e.,* if it constitutes an investment of money,

in a common enterprise, with a reasonable expectation of profits derived from the efforts of others." (Complaint, ¶ 24).

"[E]ach of the [] crypto asset securities were offered and sold by an issuer to raise money that would be used for the issuer's business. In the offerings, the issuers directly sold crypto asset securities to investors in return for consideration (most commonly Bitcoin, Ether, U.S. dollars, or toher fiat currency, or processed through the use of smart contracts). The crypto asset securities then were raised and distributed to the investors' blockchain addresses . . . . [T]he issuers and their promoters solicited investors by touting the potential for profits to be earned from investing in these securities based on the efforts of others. These statements focused on, among other things, the value of the token at issue and the ability for investors to engage in secondary trading of the token, with the success of the investment depending on the efforts of management and others in the company. The issuers and their agents used websites, social media, and messaging systems to make these representations. Some issuers wrote 'white papers' describing the project and promoting the offering, often in highly technical (or pseudo-technical) terms and jargon . . . ." (Complaint, ¶¶ 90-91).

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The EEA welcomes additional input on this important work and participation in the Tokenization Interest Group. Here's more about who should join and how to get involved:

Non-EEA Members:

If you are interested in the work of the EEA Tokenization Interest Group and would like to contribute, please contact james.harsh@entethalliance.org and visit the EEA Tokenization Interest Group page: https://entethalliance.github.io/tokenization/ .

EEA Members:

Please contact the EEA Secretariat or your member council representative. You can also log into the Member Collaboration site and join the working group to receive future meeting invitations.

Learn more about becoming an EEA Member and be sure to follow us on Twitter, LinkedIn and Facebook for all the latest.