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SEC Director Hinman's Remarks Confirm that Ether and Bitcoin Are Not Securities

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On June 14, 2018, speaking at the Yahoo Finance All Markets Summit: Crypto event in San Francisco, William Hinman, Director of the SEC's Division of Corporation Finance, made news when he definitively stated that neither bitcoin (BTC) nor ether (ETH) are securities and that offers and sales of these cryptocurrencies are not securities transactions. He also indicated that even though the initial issuance of a digital asset may have represented a securities offering, once the asset is no longer controlled by a central authority or used primarily to purchase goods or services on a functioning network, it may not make sense to regulate the digital asset as a security.

Discussing ether, Hinman emphasized the decentralized structure of the Ethereum Network, which creates and transmits ether tokens amongst its users worldwide and is not controlled or maintained by a central authority. The SEC reached these conclusions after observing that ether does not have a "key third-party actor" making decisions and noting that the SEC does not see the types of "information asymmetries" that might exist with investment contracts that rely upon the efforts of a sponsor or promoter. He added that ether's highly decentralized governance structure and the openness of ether developer conferences reinforces this view. Hinman confirmed that this analysis and conclusion also apply to bitcoin, and provided a series of factors to be used to analyze whether any particular digital asset offering should be considered an "investment contract" under the test outlined in *SEC v. W.J. Howey Co.*[1]

Hinman's remarks provide clear criteria for when a digital asset offering may not be an "investment contract" under the *Howey* test. In contrast to the majority of SEC comments and news releases about cryptoassets over the last year, beginning with the DAO Investigative Report in July 2017,[2] Hinman's remarks did not focus on what market participants must not do. Instead, he provided a relatively optimistic summary of the SEC's efforts to encourage financial innovation and capital formation in this space while the agency also maintains its enforcement focus on potentially fraudulent offerings. He also noted that the disclosure regime of the U.S. federal securities laws remains a valuable tool to eliminate significant informational asymmetries between promoters of digital asset offerings and potential investors.

Among our other primary takeaways from the remarks were:

1. A digital asset that was part of an offering of securities may become, over time, something other than a security. Hinman distinguished the initial funding phase of a project, which could take the form of an exempt offering of securities, from later sales of digital assets that represent currency or otherwise have utility value for a functioning network. This second phase of a digital asset's development would not benefit from regulation as a security if it is sold to be used only to purchase a good or service available through the network on which it was created.

[1] 328 U.S. 293 (1946).
[2] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC Release No. 81207 (July 25, 2017).

2. A digital asset will be a security under the *Howey* test if it was offered as part of an investment contract in which a central enterprise maintains the asset and its network and promotes its value.

3. When analyzing a digital asset offering as a potential security, the inquiry should primarily focus on (i) how the efforts of others affect the value of the digital asset and (ii) the manner in which the promoters marketed and sold the investment.

4. Hinman confirmed that the *Howey* test is essential for the SEC's efforts to regulate the ICO market and that most coins or tokens offered in ICOs should be regulated as securities. He added that a detailed facts and circumstances analysis of the economic realities of any potential securities offering, including ones using a simple agreement for future tokens (SAFT), will be necessary.

Hinman did not explain what specific criteria should be used to determine whether a digital asset is "decentralized" or "not controlled by a central authority," but he did indicate that the SEC is "prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use."

Hinman's published remarks included a non-exhaustive list of factors that should be considered when assessing whether a particular digital asset transaction is a securities offering. The primary consideration under the *Howey* test, whether a third party drives the expectation of a return, always depends on the facts and circumstances at hand, but Hinman's published speech suggested that promoters and their counsel should also ask questions such as the following:

1. Is there a person or group whose efforts play a significant role in the development and maintenance of the digital asset and its potential increase in value?

2. Has this person or group retained a stake in the digital asset and are they motivated to expend efforts to cause an increase in value in the digital asset?

3. Has the promoter raised more than what is needed to establish a functional network, and will it use those funds to support the value of the tokens or to increase the value of the enterprise?

4. Are purchasers seeking a return on their investment? Is the instrument marketed and sold to the general public or to potential users of the network at a reasonable market price?

5. Does application of the federal securities laws make sense? Do informational asymmetries exist between the promoters and purchasers of the digital asset?

6. Does anyone other than the promoter exercise governance rights or exert influence?

Hinman's published remarks include more comprehensive versions of these questions, as well as a list of illustrative questions to determine whether a network or platform is more like a consumer item than a security, which could serve as the basis for an argument that its coin or token has significant utility value and, therefore, is not a security. These questions are available here.

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