From Orange Groves to Cryptocurrency: How Will the SEC Apply Longstanding Tests to New Technologies?

By Troy A. Paredes & Scott H. Kimpel

Corporations, Securities & Antitrust Practice Group

About the Authors:

Troy A. Paredes is the founder of Paredes Strategies LLC. From 2008 to 2013, Paredes was a Commissioner of the U.S. Securities and Exchange Commission. Since leaving government, Paredes has had a wide-ranging consulting practice advising on financial regulation, compliance, risk management, corporate governance, and regulatory strategy and change management. His "Appetite for Disruption" podcast regularly features emerging fintech and blockchain issues.

Scott H. Kimpel is a Partner with Hunton Andrews Kurth LLP. He previously served on the Executive Staff of the SEC as Counsel to Commissioner Paredes from 2008 to 2012. Active in Hunton's capital markets and securities practices, Kimpel leads the firm's working group on blockchain and distributed ledger technology and edits its Blockchain Legal Resource blog.

Note from the Editor:

The proliferation of distributed ledger technology, also known as blockchain, has the potential to disrupt or remake large sectors of the economy and is already doing so to some degree. An early application of blockchain began in 2008 with the introduction of Bitcoin, the well-known cryptocurrency. Following the emergence of Bitcoin, ambitious entrepreneurs and others began bringing to market their own digital currencies. And so the initial coin offering (ICO) was born.

An ICO is a form of financing in which an enterprise seeks to raise capital by selling a "coin" (sometimes called a "token"); the coin in turn gives the purchaser some future right in the business or other benefit or use. The interests of the coin holder are usually reflected in an electronic smart contract, and ownership of the coin is reflected on a digital ledger. The term "ICO" is a riff on IPO, or initial public offering.

As these offerings have become more common, a wide variety of terms have been deployed to describe the underlying asset being offered: coin, token, cryptocurrency, digital currency, digital asset, and crypto asset, to name a few. In some cases, the terms are used interchangeably, and in others, people differentiate among them purposefully to highlight subtle nuances in form or substance. Indeed, even the term ICO has waned in some circles, and people have turned to the phrase "security token" (or some variant thereof) to connote an offering that is subject to, and thus must comply with, the federal securities laws. Sometimes, the term "utility token" is used if a token's value resides in its functionality, indicating that it therefore is not an investment subject to the federal securities laws and the jurisdiction of the U.S. Securities and Exchange Commission (SEC).

Whatever they are called, ICOs (a phrase we will use flexibly in this article) have spurred debate over the potential application of the federal securities laws. The SEC has asserted oversight over this burgeoning market when a security is offered. This raises the central question: When is a coin or token a security? To determine whether and how to regulate this twenty-first century innovation, the SEC has sought guidance from the past—a 1946 Supreme Court case about orange groves.

This article addresses several key regulatory developments at the SEC that are influencing the shape of the crypto market. In particular, through recent announcements and enforcement actions, the agency has indicated when it believes a coin or token is a security subject to its jurisdiction. At the end of this article, we reference some of the relevant regulatory and enforcement efforts of other federal regulators and note that state securities regulators, which share anti-fraud and other authority with the SEC, have also been active in policing ICO activity.

I. The Investment Contract

It starts with the definition of "security." If a security is involved, the federal securities laws are triggered, in toto. If there is no security, then the SEC lacks jurisdiction over the instrument.

A fundamental tenet of federal securities regulation is found in Section 5 of the Securities Act of 1933 (Securities Act). This provision requires every offer or sale of securities to be registered with the SEC or exempt from such registration under one or more statutory exemptions.[1] An "offer" is defined broadly under the Securities Act as "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." There is usually no exemption available to an issuer when securities are distributed on a wide scale to large numbers of individuals, who are referred to as "retail investors."

The definition of "security" contained in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of its companion statute, the Securities Exchange Act of 1934 (Exchange Act), includes—in addition to familiar financial instruments like stocks and bonds—"investment contracts." In the famous 1946 case, *SEC v. Howey Co.*,[2] the Supreme Court articulated the test for determining when an arrangement is an investment contract and, therefore, a security subject to the federal securities laws. The *Howey* test has been in use ever since.

The Howey Company owned land in Florida where it cultivated orange groves. To fund new development, Howey sought outside financing and turned to out-of-state tourists who visited a hotel that adjoined one of its properties. Each prospective purchaser was offered both a land sales contract and a service contract; under the service contract, a Howey affiliate would manage the land on the purchaser's behalf. Since the offerees were primarily non-residents with no wherewithal to care for orange groves, most of those who purchased an interest in the groves also accepted the service contract arrangement.

Upon payment of the purchase price, the land was conveyed to the purchaser, but individual tracts were not separately fenced and were identified by land marks intelligible only through a plat book record. The service contract granted Howey a leasehold interest and "full and complete" possession of the land. For a specified fee plus the cost of labor and materials, Howey had full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops. Without Howey's consent, purchasers had no right of entry to market the crops. Instead, Howey allocated a share of net profits to each purchaser after the harvest.

The Supreme Court was asked to determine whether the land sales contract, the warranty deed, and the service contract together constituted an investment contract under Section 2(a)(1) of the Securities Act. The lower courts found that no investment contract existed, and instead treated the contracts and deeds as separate transactions involving a sale of real estate and an agreement by the seller to manage the property for the buyer.

The Supreme Court began its analysis by considering the historical background against which the federal securities laws were adopted, as well as Congress' intent in enacting the Securities Act and including the concept of an investment contract. The Court reasoned that the term investment contract "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[3] In this view, a flexible understanding of what an investment contract is helps ensure that the reach of the federal securities laws is not unduly circumscribed. The Court then concluded:

> The transactions in this case clearly involve investment contracts as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. . . . A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.[4]

In short, the purchasers depended on Howey to run an orange business for them. The allocation of responsibility between Howey and the purchasers calls to mind the separation of ownership and control that characterizes the corporate form, where there exists a centralized management team and passive shareholders.[5] Furthermore, as the Court explains, the purchasers did not buy interests in the land so that they could eat the produce that Howey grew. The purchasers' motivation was investment, not consumption.

From this, we get the *Howey* test for determining whether an investment contract—and thus a security—exists. Under *Howey*, an investment contract exists if four factors are present:

(i) an investment of money by a person;

(ii) in a common enterprise;

(iii) where the person is led to expect profits;

1 Section 5 of the Securities Act generally requires an offeror of securities to register that offering with the SEC by means of a written filing (known as a "registration statement") and deliver each offeree a prospectus containing various required disclosures. This process is time-consuming and can be expensive, typically requiring the assistance of experienced securities counsel, public accountants, and other professional advisors.

2 328 U.S. 293 (1946).

3 *Id.* at 299.

4 *Id.* at 299-300.

5 *See generally* James D. Cox & Thomas Lee Hazen, 1 Treatise on the Law of Corporations §2.7 (3d ed. 2010).

(iv) to be derived from the entrepreneurial or managerial efforts of others.[6]

For more than seventy years, securities lawyers and the SEC, along with the courts, have applied *Howey* to analyze a wide array of financial arrangements—such as limited partnership interests,[7] condominiums,[8] sale-leasebacks of payphones,[9] and life settlements[10]—to determine whether they are subject to regulation by the SEC.

II. The SEC Issues the DAO Report

As cryptocurrencies have appeared on the scene and grown in use, the SEC has unsurprisingly tackled the question of whether ICOs should be considered offerings of securities. The SEC has looked to *Howey,* which the Supreme Court crafted to be malleable to new facts and circumstances, for the answer.

On July 25, 2017, the SEC released a Report of Investigation (the "DAO Report")[11] under Section 21(a) of the Exchange Act involving an issuer of tokens known as The DAO. Section 21(a) grants the SEC broad discretion to investigate potential violations of the federal securities laws and "publish information concerning any such violations." From time to time, the agency uses this reporting power to announce policy on an emerging enforcement issue in lieu of bringing an actual enforcement action. Here, the SEC chose to warn the market that tokens issued in ICOs may be securities under *Howey*, tacitly acknowledging that some may not have expected that result. The DAO Report amounts to high-level guidance from the SEC.

The DAO is an example of a "decentralized autonomous organization" that exists via smart contracts executed on a blockchain, described by the SEC as a "'virtual' organization embodied in computer code." The German company that created The DAO, Slock.it, automated its corporate governance structures and purported to give holders of DAO Tokens decision-making power over the business without a traditional corporate hierarchy. In 2016, The DAO completed an ICO of DAO Tokens valued at approximately $150 million.

DAO Tokens, which granted certain voting and ownership rights, were offered for sale to the general public in exchange for the cryptocurrency Ether. The DAO intended to use the Ether generated in the ICO to fund projects that would provide DAO Token holders a return on their investment. DAO Token holders had the right to vote on certain corporate governance matters of The DAO, including which projects to fund and when to make distributions of profits to holders of the tokens. After the ICO, token holders could trade their DAO Tokens on online platforms supporting secondary market transactions.[12]

The SEC applied *Howey* to these facts and found that DAO Tokens are investment contracts that qualify as securities and thus must be offered in accordance with Section 5 of the Securities Act or fall within an exemption to it. Notably, the SEC emphasized its view that case law calls for focusing on substance over form and that the economic realities of a transaction matter, not its name.

In undertaking its analysis, the SEC quickly dispensed with the first three prongs of the *Howey* test, determining that when DAO Token holders invested Ether in The DAO, they were investing money in a common enterprise with the reasonable expectation of profits. As with most cases applying *Howey* over the decades, the "efforts of others" prong was central. The SEC ultimately concluded that the *Howey* test was met—and so an investment contract, and therefore a security, was present—because the efforts of Slock.it and the so-called "Curators" of proposals were "essential" to the enterprise, and DAO Token holders' voting rights were limited.

To support its conclusion, the SEC observed that Slock.it created The DAO, maintained its coding and website, engaged in marketing, and chose individuals (the Curators) to screen investment opportunities so only the best projects were presented to DAO Token holders for a vote.[13] Additionally, the SEC determined that DAO Token holders did not have meaningful control over The DAO because their voting rights were limited to pre-selected projects and the rules of the voting structure incentivized voting in favor of proposals. Furthermore, because the DAO Token holders were so widely dispersed and anonymous, there was no way for them to join together to exercise meaningful control as a practical matter. In terms of governance, the SEC determined that token holders were more like passive corporate shareholders than partners who have real authority in a general partnership.[14] In addition, The DAO had emphasized

6 Although *Howey* uses the phrase "solely from the efforts of others," in practice it has come to mean the somewhat more flexible "predominantly" from the efforts of others. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 545-8 (D.C. Cir. 1996). Sometimes words to a similar effect are used, such as the "undeniably significant" or "essential" efforts of others. For more on *Howey*, see Louis Loss, Joel Seligman, & Troy Paredes, Securities Regulation, Vol. II at 1058-1154 (5th ed.).

7 *E.g.,* Liberty Property Trust v. Republic Properties Corp., 577 F.3d 335 (D.C. Cir. 2009).

8 Securities Act Release No. 5347 (1973).

9 SEC v. Edwards, 540 U.S. 389 (2004).

10 *Compare Life Partners, Inc.*, 87 F.3d 536 *with* SEC v. Mutual Benefits Corp., 408 F.3d 737 (11th Cir. 2005).

11 U.S. Securities and Exchange Commission, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (July 25, 2017), *available at* http://www.sec.gov/litigation/investreport/34-81207.pdf. When it released the DAO Report, the SEC staff also issued an Investor Bulletin explaining ICOs and assisting investors in evaluating a coin or token offering. *Investor Bulletin: Initial Coin Offerings*, Investor.gov (July 25, 2017), *available at* https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings.

12 The DAO Report explained that, although The DAO referred to itself as a "crowdfunding contract," it did not qualify as such under Regulation Crowdfunding, and neither the ICO nor the trading platforms in the secondary market were registered with the SEC.

13 The DAO Report stated that the Curators had significant responsibilities, including determining: (1) whether and when to submit proposals for votes; (2) the order and frequency of proposals that were submitted for a vote; and (3) whether to halve the default quorum necessary for a successful vote on certain proposals. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators.

14 Courts have consistently held that general partnership interests are not investment contracts as long as a partner has enough power to prevent

to purchasers their ability to re-sell their tokens in the secondary market, which The DAO, according to the SEC, helped facilitate.

Treating an ICO as a securities offering has consequences for secondary trading as well as the initial sale. Section 3(a)(1) of the Exchange Act defines "exchange" broadly to include any organization or group that provides a marketplace for bringing together purchasers and sellers of securities or otherwise performs the generally understood functions of a stock exchange. The SEC used the DAO Report to give notice that each of the online platforms supporting the secondary market for DAO Tokens appeared to operate as an exchange that would have to register with the SEC under Section 5 of the Exchange Act, since no exemption from registration seemed to be available.

As for the regulatory philosophy that underpins the DAO Report, the SEC was blunt: "The automation of certain functions through this technology, 'smart contracts,' or computer code, does not remove conduct from the purview of the U.S. federal securities laws."

III. *Munchee* and More

Since issuing the DAO Report, the SEC has initiated numerous enforcement actions against promoters of ICOs. A number of these actions involved old-fashioned Ponzi schemes or other frauds masquerading as token offerings and do not raise any novel securities law questions. But one notable early case involved a token issuer against which the SEC made no allegations of fraud. On December 11, 2017, the SEC issued a cease-and-desist order against Munchee Inc.[15] after finding that the company's ICO involved unregistered offers and sales of securities in violation of Section 5 of the Securities Act.

According to the SEC, Munchee sought to raise $15 million for its blockchain-based food review and social platform by selling digital tokens that could be used to buy and sell goods and services in the future through an iPhone app. At the time of the ICO, the Munchee "ecosystem" was not yet functional, but the company planned to develop it with the proceeds raised in the offering. Munchee and others promoting the ICO represented to individuals that the tokens could be expected to increase in value as the company implemented improvements to the app, and they said that the company would work to support a secondary market for the tokens. Indeed, according to the settlement order, Munchee and its agent promoted the ICO to people interested in investing in digital assets, which "primed" investors' profit expectations. Drawing on the DAO Report, the SEC concluded that the tokens were securities in the form of investment contracts under *Howey*.

After being contacted by the SEC, Munchee halted its ICO and refunded investors' money before any tokens were delivered. Due to Munchee's cooperation and its quick action to end the ICO and return funds, the SEC chose not to impose a penalty. Although the SEC sometimes brings standalone Section 5 cases where there is no allegation of fraud, such cases are infrequent. By selecting Munchee for enforcement, the SEC telegraphed that the SEC's efforts to police the ICO market would not be limited to cases involving material misstatements or omissions of information. This is noteworthy in part because, unlike fraud, violation of Section 5 is a strict liability offense.

In a pair of cases brought on November 16, 2018, the SEC settled charges with two ICO issuers who conducted unregistered securities offerings.[16] Both issuers sold tokens to investors to raise funds. The SEC found that purchasers of each issuer's tokens would have had a reasonable expectation of obtaining a future profit based on each company's respective efforts, including building out an "ecosystem" and adding new functionality using the proceeds from the sale. One of the companies also committed to support the value of its tokens by controlling the token supply. The SEC explained that each issuer made efforts to facilitate secondary trading and that their promotional communications indicated the profit potential. Consistent with *Howey* and the DAO Report, the SEC concluded that both companies had offered securities without registering them with the SEC. Unlike with Munchee, the SEC assessed $250,000 penalties against each company and required them to compensate investors, register the offerings, and begin filing periodic reports with the SEC under the Exchange Act.[17]

IV. Senior SEC Staff Weigh In

William Hinman, Director of the SEC's Division of Corporation Finance, delivered a speech on June 14, 2018, providing further insight into how the SEC analyzes ICOs under the *Howey* test.[18] He began his remarks by reiterating that Bitcoin is not a security. In a notable move, Hinman also indicated that the SEC staff does not view Ether as a security either in its "present state," saying nothing about what Ether's status might have been under *Howey* in its earlier state. Hinman emphasized that the decentralized nature of the networks underlying both Bitcoin and Ether would mean that applying the disclosure requirements

the "efforts of others" prong of the *Howey* test from being met.

15 *See* U.S. Securities and Exchange Commission, Press Release, *Company Halts ICO After SEC Raises Registration Concerns* (Dec. 11, 2017), *available at* https://www.sec.gov/news/press-release/2017-227.

16 *See* U.S. Securities and Exchange Commission, Press Release, *Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities* (Nov. 16, 2018), *available at* https://www.sec.gov/news/press-release/2018-264 (providing additional information about the cases against AirFox and Paragon Coin).

17 Some ICO promoters facing an enforcement action from the SEC have declined to settle and instead have opted to litigate, asserting that their particular tokens do not satisfy the *Howey* test. In one recent case, a federal district court initially declined to grant the SEC's request for a preliminary injunction against the issuer, Blockvest. The court ruled that, given the stage of the litigation and that there were disputed issues of material fact, the court could not determine that there was a security. *See* SEC v. Blockvest, Case No.: 18CV2287-GPB(BLM) (S.D. Cal. Nov. 27, 2018), *available at* https://www.scribd.com/document/394382912/Blockvest-Ruling#from_embed (order denying the SEC's motion for a preliminary injunction). On reconsideration, and after the introduction of new evidence that the court found supported finding a security under *Howey*, the judge reversed his earlier decision and issued the preliminary injunction. *See* SEC v. Blockvest, Case No.: 18CV2287-GPB(BLM) (S.D. Cal. Feb. 14, 2019), *available at* https://www.sec.gov/litigation/litreleases/2019/order24400.pdf.

18 *See* U.S. Securities and Exchange Commission, Speech, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (June 14, 2018), *available at* https://www.sec.gov/news/speech/speech-hinman-061418 (remarks at the Yahoo Finance All Markets Summit: Crypto).

of the federal securities laws would serve little purpose. Hinman posited, "when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede." In those circumstances, such as when a network becomes "truly decentralized," according to Hinman, "the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful." Director Hinman's comments reflect the fact that the Securities Act is designed to get material information that a promoter knows into the hands of investors so that investors can make informed decisions.

Hinman also noted that "the analysis of whether something is a security is not static and does not strictly inhere to the instrument," which seems to suggest that it is possible for a coin or token that is a security to cease being one. Does this imply that the *Howey* test should be administered periodically to see how the facts and circumstances prevailing at different times fare under the investment contract analysis? What exactly it will take, in the SEC's view, for an instrument's status to morph from security to non-security, as well as the precise regulatory and practical implications of any such change, is uncertain.

Hinman concluded his speech with two sets of questions that go to the characterization of digital assets. The first deals with whether a third party "drives" (to use Hinman's word) any expectation of profits that purchasers may have. The second set of questions is about whether a digital asset is consumable. As to factors to consider in assessing the efforts of others, Hinman asks:

- 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?
- 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?
- 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?
- 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?
- 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?
- Do persons or entities other than the promoter exercise governance rights or meaningful influence?

As to factors that speak to consumption versus investment:

- Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
- Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
- 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?
- 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?
- Is the asset marketed and distributed to potential users or the general public?
- Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
- Is the application fully functioning or in early stages of development?

All of this is summed up in one overarching question that Hinman poses to frame his speech: "But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created?"

At a November 2018 conference, Hinman remarked that, in 2019, the SEC intends to provide some clearer answers to these and other relevant questions in the form of further guidance.[19] One possibility for the guidance would be to consolidate SEC views into a sort of how-to manual for people to use in assessing the applicability of the federal securities laws.

V. On "Utility Tokens"

For decades, it has been widely acknowledged that the SEC regulates investment, not consumption. In 1975, in *United Housing Foundation v. Forman*, the Supreme Court held that an instrument, even though it was called "stock," was not a security in the form of stock or an investment contract under the federal

19 *See* Andrew Ramonas, *SEC Plans 'Plain English' Crypto Securities Guide*, Bloomberg Law, Nov. 5, 2018, *available at* https://news.bloomberglaw.com/securities-law/sec-plans-plain-english-crypto-securities-guide.

securities laws.[20] The Court came to that conclusion because of the reason an individual would have wanted to hold the stock at issue in the case—namely, because it allowed a person to occupy an apartment in a certain development at a reduced rent, not because of any potential income or capital appreciation that might result from how the promoter used purchasers' funds.[21] A purchaser's motivation, in other words, was to consume or use housing, not to earn a profit.[22]

This reasoning sets the stage for so-called "utility tokens."

Entrepreneurs may attempt to structure their digital assets as utility tokens that grant the holder the right to a good or service (or afford them some use or function), rather than emphasizing a financial return. One result of creating a utility token that is not a security is that the instrument does not fall within the federal securities laws. The second set of Hinman's questions from his speech plot a roadmap for how the SEC may assess whether a utility token exists. He emphasizes the degree to which the network upon which the token is based is up and running (i.e., the extent to which the use or function is real and present or off in the distant future) and whether the marketing of the tokens stresses profit potential or, alternatively, the utility the tokens afford. The *Forman* Court itself recognized that "difficult questions" arise when there is an expectation of both consumption and investment.[23]

Even if the profit motive predominates, there still would not be an investment contract if the "efforts of others" prong of *Howey* is not met. Some cases decided before the proliferation of digital assets have found that there is no investment contract where an increase in the price of an instrument is the result of market forces or some other extrinsic factor, and not the promoter's managerial or entrepreneurial efforts.[24] Or, as cases applying *Howey* to partnership and limited liability company interests have held, no investment contract exists where the holders of the interests exercise sufficient (even if not total) control over the enterprise or otherwise meaningfully participate in the business operations.[25]

VI. The "Airdrop"

If the instrument issued in an ICO is a security that requires SEC registration in the absence of an exemption, can an issuer avoid the registration requirements by simply giving coins or tokens away? Under certain circumstances, a bona fide gift of securities is deemed not to involve the offer or sale of those securities, and under this "no sale" theory the registration requirements of the Securities Act do not apply. In the ICO context, an "airdrop" generally refers to the widespread distribution of digital tokens to community members either for free or in exchange for performing minor tasks. The SEC addressed an airdrop used to distribute digital tokens to investors in an August 2018 enforcement action against an ICO issuer, Tomahawk Exploration LLC, and its promoter.[26]

According to the SEC, Tomahawk sought to raise $5 million through an ICO, said to fund oil drilling in California. When it failed to raise any money, the company instead made an airdrop of tokens to third parties by means of what it called a "bounty program" in exchange for online promotional and marketing services that targeted potential investors and directed them to the company's offering materials. Following its DAO Report, the SEC concluded that the Tomahawk tokens were securities. The SEC also alleged a series of materially false and misleading statements in Tomahawk's marketing documents.

The SEC then analyzed the company's bounty program. The SEC determined that the company's issuance of tokens under the bounty program constituted an offer and sale of securities because Tomahawk provided tokens to investors in exchange for services designed to advance the company's economic interests and foster a trading market for its securities. The SEC reasoned that the lack of monetary consideration for "free" shares did not mean there was not an offer or sale under the federal securities laws. Rather, according to the SEC, a "gift" of a security is a "sale" for securities law purposes when the company receives some real benefit, even if it does not involve the exchange of money.

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20 421 U.S. 837 (1975). Justices Brennan, Douglas, and White dissented, arguing that the shares were both stock and investment contracts under the federal securities laws.

21 *See id.* at 852-53 ("[W]hen a purchaser is motivated by a desire to use or consume the item purchased—'to occupy the land or develop it themselves,' as the *Howey* court put it . . . — the securities laws do not apply."); *id.* at 858 ("What distinguishes a security transaction . . . is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use.").

22 In addition, as the Court explained, the shares of stock at issue "cannot be transferred to a nontenant; nor can they be pledged or encumbered; and they descend, along with the apartment, only to a surviving spouse. No voting rights attach to the shares as such: participation in the affairs of the cooperative appertains to the apartment, with the residents of each apartment being entitled to one vote irrespective of the number of shares owned." *Id.* at 842. Stock also could not be re-sold at a profit. *Id.* at 843.

23 *Id.* at 853 n.17. For examples of cases alluding to the balance of motives, see Rice v. Branigar Organization, Inc., 922 F.2d 788, 791 (11th Cir. 1991) (in finding no investment contract, the court said "[t]he appellants have not offered any evidence to show that the majority or even a fair number of the buyers bought houses or lots as an investment"); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1040 (10th Cir. 1980) (stating "[c]learly the lots are not securities if the purchasers were induced to obtain them primarily for residential purposes" and "if the benefit to the purchasers of the amenities promised by defendants was largely in their own use and enjoyment, the necessary expectation of profit is missing").

24 *See, e.g.*, McCown v. Heidler, 527 F.2d 204, 208 (10th Cir. 1975) (explaining that "land, as such, is not a security and that a land purchase contract, simply because the purchaser expects or hopes that the value of the land purchased will increase, does not fall automatically within the confines of the Securities Acts"). *See also* Noa v. Key Futures, Inc., 638 F.2d 77, 79 (1980) (9th Cir. 1980) (finding that a Contract of Purchase and a Confirmation and Certificate of Ownership concerning the sale of silver did not create an investment contract, explaining that "[o]nce the purchase of silver bars was made, the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of Key Futures").

25 *See generally* Loss et al., *supra* note 6 at 1106-27.

26 U.S. Securities and Exchange Commission, *In re* Tomahawk Exploration LLC, et al., *Order Instituting Administrative and Cease-and-Desist Proceedings* (Aug. 14, 2018), *available at* https://www.sec.gov/litigation/admin/2018/33-10530.pdf.

The SEC found that Tomahawk received value in exchange for the bounty distributions in the form of online marketing, including the promotion of the ICO on blogs and other online forums. The company also received value in the creation of a public trading market for its securities. Accordingly, the SEC determined that the company issued tokens as part of the bounty program to generate interest in the ICO, which in turn benefited the company. Thus, the SEC concluded that a sale had occurred without registration in violation of Section 5 of the Securities Act.

This case is reminiscent of the SEC's enforcement actions against several internet companies that distributed "free stock" during the height of the dot-com era twenty years ago. In what have become known to securities lawyers as the free stock cases, investors were typically required to sign up on issuers' websites and disclose personal information in order to obtain "free" shares. Free stock recipients were also offered extra shares for soliciting additional investors or for linking their own websites to those of an issuer or purchasing services offered through an issuer. Due to these activities, the SEC similarly took the position that the issuers received value (and did not make a gift) by creating a public market for their shares, increasing their business prospects, creating publicity, increasing traffic to their websites, and generating possible interest in future securities offerings.

Call it an airdrop or call it free stock, the SEC continues to focus on a transaction's substance, not its label.

VII. Beyond the Regulation of Securities Offerings

If securities are involved, the entirety of federal securities regulation is in play, including the requirement that broker-dealers and investment companies register with the SEC.

On September 11, 2018, the SEC announced its first case charging unregistered broker-dealers for selling digital tokens. According to the SEC's order, the defendants operated a self-described "ICO Superstore" that solicited investors, took thousands of customer orders for digital tokens, processed investor funds, and handled more than 200 different digital tokens in connection with both ICOs and the defendants' own secondary market activities.[27] The defendants also promoted the sale of approximately forty digital tokens in exchange for marketing fees paid by digital token issuers. Because the digital tokens issued in the ICOs and traded by defendants included securities, the SEC concluded that the defendants' activities required broker-dealer registration with the SEC.

The same day, the SEC also announced charges against a digital asset fund manager who failed to register the fund it advised with the SEC and misrepresented the manager's status as a regulated entity.[28] The SEC's order cites the Investment Company Act of 1940 (Investment Company Act), which defines "investment company" as any issuer who:

> is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.

The SEC concluded that the fund engaged in the business of investing, holding, and trading digital assets that were securities and therefore had to register as an investment company under the Investment Company Act. The SEC also concluded that the fund manager, as an investment adviser, made material misstatements and omissions in violation of the Investment Advisers Act of 1940, as well as the Securities Act.

The Financial Industry Regulatory Authority (FINRA), which oversees broker-dealers, announced its first disciplinary action involving cryptocurrencies against a broker-dealer registered representative, again on September 11.[29] According to FINRA's complaint, the respondent attempted to attract investors into a penny stock company he controlled by offering interests in what he advertised as the "the first minable coin backed by marketable securities." FINRA alleged that, as the company's business struggled, the respondent acquired the rights to a cryptocurrency named HempCoin and attempted to repackage HempCoin as a security backed by the publicly traded penny stock. The respondent also marketed HempCoin as "the world's first currency to represent equity ownership" in a publicly traded company. FINRA said that investors mined more than 81 million HempCoin through late 2017 and traded the security on two cryptocurrency exchanges. Based on this, FINRA alleged that the respondent engaged in the unlawful distribution of HempCoin as an unregistered security, made several misrepresentations, and never disclosed these transactions to his broker-dealer employer. Thus, FINRA asserted that the individual violated not only the federal securities laws, but also several FINRA regulations, including one requiring that registered representatives must "observe high standards of commercial honor and just and equitable principles of trade."

VIII. Unregistered Token Exchanges

On November 8, 2018, the SEC announced settled charges against an unlicensed digital token platform called EtherDelta.[30] The case is the SEC's first enforcement action based on findings that such a platform operated as an unregistered national securities exchange. According to the SEC's order, EtherDelta provided online secondary market trading of ERC20 tokens, a type of blockchain-based token commonly issued in ICOs. The SEC found that almost all of the orders placed through EtherDelta were traded after the SEC issued the DAO Report, which had mentioned that the federal securities laws provide a functional

27 U.S. Securities and Exchange Commission, *In re* Tokenlot, LLC, et al., *Order Instituting Administrative and Cease-and-Desist Proceedings* (Sept. 11, 2018), *available at* https://www.sec.gov/litigation/admin/2018/33-10543.pdf.

28 U.S. Securities and Exchange Commission, *In re* Crypto Asset Management, LP, et al., *Order Instituting Administrative and Cease-and-Desist Proceedings* (Sept. 11, 2018), *available at* https://www.sec.gov/litigation/admin/2018/33-10544.pdf.

29 Financial Industry Regulatory Authority, Dep't of Enforcement v. Timothy Tilton Ayre, *Complaint* (Sept. 11, 2018), *available at* http://www.finra.org/sites/default/files/Ayre_Complaint_091118.pdf.

30 U.S. Securities and Exchange Commission, *In re* Zachary Coburn, *Order Instituting Cease-and-Desist Proceedings* (Nov. 8, 2018), *available at* http://www.sec.gov/litigation/admin/2018/34-84553.pdf.

test that could include a digital asset trading system within the definition of an "exchange" subject to the SEC's jurisdiction.[31]

The case is particularly significant because the platform operated on a decentralized basis through programming in its smart contract that runs on a blockchain. The SEC found that EtherDelta's smart contract was coded to validate the order messages, confirm the terms and conditions of orders, execute paired orders, and direct a distributed ledger to be updated to reflect a trade. The SEC also found that the individual behind EtherDelta caused the platform's Exchange Act violation because he wrote and deployed the smart contract and controlled EtherDelta's operations.

IX. Joint Statement by SEC Staff

Perhaps to highlight the growing emphasis on ICO enforcement, the SEC's three principal rule-making divisions issued a joint statement (the Staff Statement) on November 16, 2018, summarizing many of the enforcement cases discussed above.[32] The Staff Statement essentially reiterates the agency's position on issues relating to "digital asset securities," including their offer and sale, trading, broker-dealer and exchange registration, and considerations for investment vehicles investing in digital assets.[33] The Staff Statement concludes by noting that the SEC staff wishes to "encourage and support innovation and the application of beneficial technologies in our securities markets." The staff cautions, however, "that those employing new technologies [should] consult with legal counsel concerning the application of the federal securities laws and contact Commission staff, as necessary, for assistance."

X. Bitcoin Exchange-Traded Funds

An exchange-traded fund, or ETF, is a generic term people use for a security that tracks a stock index or other basket of assets such as bonds or commodities.[34] ETF shares trade on an exchange, but are otherwise very similar to mutual funds. Several entrepreneurs have recently conceived of Bitcoin-based ETFs (or other similar exchange-traded products), which under the federal securities laws cannot begin trading until they receive SEC approval.

In a lengthy order issued on July 26, 2018, by a 3-1 vote the SEC denied an application by the Bats BZX Exchange, Inc. (BZX) seeking to list and trade shares of the Winklevoss Bitcoin Trust.[35] The Winklevoss brothers had been trying for two years to launch what would have been the first Bitcoin-based ETF in the U.S.[36] As a threshold matter, BZX originally asserted that, for many investors, shares in the trust would represent a cost-effective and convenient means of gaining investment exposure to Bitcoin similar to a direct investment in Bitcoin.[37] In support of its application, and to assuage potential SEC concerns around manipulation of the market for Bitcoin, BZX also argued that:

> (i) the "geographically diverse and continuous nature of bitcoin trading makes it difficult and prohibitively costly to manipulate the price of bitcoin," and that, therefore, the Bitcoin market "generally is less susceptible to manipulation than the equity, fixed income, and commodity futures markets," and
>
> (ii) "novel systems intrinsic to this new market provide unique additional protections that are unavailable in traditional commodity markets."

In denying the application, the SEC cited various concerns about the lack of oversight in the underlying Bitcoin market and ruled that BZX did not demonstrate that Bitcoin and Bitcoin markets are adequately resistant to manipulation or that alternative means of detecting and deterring fraud and manipulation are sufficient in the absence of a surveillance-sharing agreement with a significant, regulated market related to Bitcoin.

The SEC also stated that a substantial majority of Bitcoin trading occurs on unregulated venues overseas that are relatively new and that generally appear to trade only digital assets.

31 Under the test in Exchange Act Rule 3b-16, a platform that does the following is treated as an exchange: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade. The primary exemption from registration and regulation as an exchange is for so-called alternative trading systems (ATSs). Rule 3a1-1(a)(2) under the Exchange Act exempts from the definition of "exchange" any organization, association, or group of persons that complies with Regulation ATS. Regulation ATS, in turn, requires an ATS to, among other things, register as a broker-dealer, file a Form ATS with the SEC, and establish written safeguards and procedures to protect subscribers' confidential trading information. An ATS that complies with Regulation ATS and otherwise complies with other applicable SEC regulations need not register as a national securities exchange.

32 U.S. Securities and Exchange Commission, Public Statement, *Statement on Digital Asset Securities Issuance and Trading* (Nov. 16, 2018), *available at* https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

33 The Staff Statement's discussion of exchange registration goes beyond summarizing prior enforcement actions and relevant rules and regulations. It states that "an entity that provides an algorithm, run on a computer program or on a smart contract using blockchain technology, as a means to bring together or execute orders could be providing a trading facility" and that "an entity that sets execution priorities, standardizes material terms for digital asset securities traded on the system, or requires orders to conform with predetermined protocols of a smart contract, could be" engaging in exchange activities. It continues, "Additionally, if one entity arranges for other entities, either directly or indirectly, to provide various functions of a trading system that together meet the definition of an exchange, the entity arranging the collective efforts could be considered to have established an exchange." How the staff considers treating a longstanding concept like an exchange in the context of a new technology like blockchain is instructive.

34 *See, e.g.*, U.S. Securities and Exchange Commission, Fast Answers, *Exchange-Traded Funds (ETFs)*, https://www.sec.gov/fast-answers/answersetfhtm.html; Financial Industry Regulatory Authority, *Exchange-Traded Funds*, http://www.finra.org/investors/exchange-traded-funds.

35 U.S. Securities and Exchange Commission, *In re* Bats BZX Exchange, Inc., *Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change* (July 26, 2018), *available at* https://www.sec.gov/rules/other/2018/34-83723.pdf.

36 Although colloquially referred to as an "ETF" in much of the financial press, the SEC order technically classifies it as a "commodity-trust exchange-traded product."

37 U.S. Securities and Exchange Commission, *In re* Bats BZX Exchange, Inc., *Petition for Review* (May 24, 2017), *available at* https://www.sec.gov/rules/sro/batsbzx/2017/petition-for-review-sr-batsbzx-2016-30.pdf.

Furthermore, in the SEC's view, regulated Bitcoin-related markets are still in the early stages of development, and the record did not support finding that Bitcoin derivatives markets have attained significant size. The SEC, therefore, concluded that BZX did not demonstrate that the structure of the spot market for Bitcoin is uniquely resistant to manipulation and likewise determined that current trading venues for Bitcoin are not resistant to market manipulation. More to the point, according to the SEC, BZX did not demonstrate, given the current absence of a surveillance-sharing agreement with a regulated Bitcoin market of significant size, that BZX's proposed alternative surveillance procedures—including BZX's claim that it could obtain information regarding trading in the trust shares and in the underlying Bitcoin or any Bitcoin derivative when needed—would satisfy the requirement that an exchange's rules be designed to prevent fraud and manipulation.[38]

Importantly, the SEC did not categorically rule out a Bitcoin ETF in the future. It left open the possibility that the Bitcoin market could grow and develop in ways that ameliorate the SEC's concern about fraud and manipulation, or that other surveillance techniques could adequately mitigate the risk to investors.

In a vigorous dissent, Commissioner Hester Peirce argued that the BZX application satisfied the statutory standard and that the SEC should permit BZX to list and trade the Winklevoss product.[39] She expressed deep concern that the denial of the application "undermines investor protection by precluding greater institutionalization of the bitcoin market." Commissioner Peirce argued that more "institutional participation would ameliorate many of the Commission's concerns with the bitcoin market that underlie its disapproval order." More generally, she asserted that the majority's "interpretation and application of the statutory standard sends a strong signal that innovation is unwelcome in our markets, a signal that may have effects far beyond the fate of bitcoin" ETFs.

On August 22, 2018, the SEC staff, acting under delegated authority from the Commission, denied applications for nine more Bitcoin ETFs. The orders denying applications by Cboe BZX[40] and NYSE Arca[41] are similar to each other and cite many of the same reasons for denial as those cited in the Winklevoss application. As with the Winklevoss disapproval order, the SEC staff emphasized that "its disapproval does not rest on an evaluation of whether bitcoin, or blockchain technology more generally, has utility or value as an innovation or an investment." Instead, the SEC reasoned that the exchanges failed to meet their burdens under SEC regulations to demonstrate their ability to prevent fraudulent and manipulative acts and practices in respect of the planned ETFs. The SEC staff elaborated, finding that the exchanges did not demonstrate that Bitcoin futures markets are "markets of significant size." The SEC staff explained that this is critical because the exchanges did not establish that other means to prevent fraudulent and manipulative acts and practices will be sufficient to prevent fraud; surveillance-sharing with a regulated market of significant size related to Bitcoin is therefore necessary, according to the staff, to satisfy the statutory requirement that the exchanges' rules be designed to address such misconduct. By August 24, 2018, the SEC announced that the commissioners would review the staff's findings, and the denial of the nine ETFs was stayed.

Whether the SEC will approve a Bitcoin ETF in 2019 is one of the most anticipated developments in the cryptocurrency space. Entrepreneurs continue to file new applications with the SEC as they wait to see what will happen.[42]

XI. What's Next?

The SEC has repeatedly asserted jurisdiction, in various ways, over digital assets. Rather than swim against the *Howey* tide, the most recent iteration of a coin or token offering has involved selling "security tokens." Like other securities, security tokens can have a range of attributes concerning voting rights, economic returns, and other features. In a security token offering, the issuer has recognized that the instrument is a security and attempts to comply with the wide variety of SEC regulations discussed above. There are token sales in the process of registration with the SEC, presumably because no private placement exemption is available for those offerings. In his November 2018 remarks, Director Hinman even acknowledged a backlog of filings with the SEC by parties seeking to conduct registered offerings, and he observed that the staff is processing them carefully due to the unique issues they raise.

There is still considerable regulatory uncertainty over how the particularities of federal securities regulation will apply to specific, concrete facts and circumstances. The details matter, and perhaps more than anything, market participants would like further clarity. Many would prefer that additional guidance

38 In a letter addressed to two trade associations representing the securities industry, the SEC staff has also described several criteria that, if satisfied, may persuade the staff to support the application for a cryptocurrency ETF. *See* U.S. Securities and Exchange Commission, *Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings* (Jan. 18, 2018), *available at* https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm

39 U.S. Securities and Exchange Commission, *Dissent of Commissioner Hester M. Peirce to Release No. 34-83723* (July 26, 2018), *available at* https://www.sec.gov/news/public-statement/peirce-dissent-34-83723.

40 U.S. Securities and Exchange Commission, *In re* Cboe BZX, *Order Disapproving a Proposed Rule Change to List and Trade the Shares of the GraniteShares Bitcoin ETF and the GraniteShares Short Bitcoin ETF* (Aug. 22, 2018), *available at* https://www.sec.gov/rules/sro/cboebzx/2018/34-83913.pdf.

41 U.S. Securities and Exchange Commission, *In re* NYSE Arca, Inc., *Order Disapproving a Proposed Rule Change to List and Trade the Shares of the ProShares Bitcoin ETF and the ProShares Short Bitcoin ETF* (Aug. 22, 2018), *available at* https://www.sec.gov/rules/sro/nysearca/2018/34-83904.pdf; U.S. Securities and Exchange Commission, *In re* NYSE Arca, Inc., *Order Disapproving a Proposed Rule Change Relating to Listing and Trading of the Direxion Daily Bitcoin Bear 1X Shares et al.* (Aug. 22, 2018), *available at* https://www.sec.gov/rules/sro/nysearca/2018/34-83912.pdf.

42 *See, e.g.*, Bitwise Bitcoin ETF Trust, SEC Registration Statement (Form S-1) (Jan. 10, 2019), *available at* https://www.sec.gov/Archives/edgar/data/1763415/000149315219000408/forms-1.htm. *See also* U.S. Securities and Exchange Commission, *In re* NYSE Arca, Inc., *Notice of Filing of Proposed Rule Change Relating to the Listing and Trading of Shares of the Bitwise Bitcoin ETF Trust under NYSE Arca Rule 8.201-E* (Feb. 11, 2019), *available at* https://www.sec.gov/rules/sro/nysearca/2019/34-85093.pdf.

come through channels other than enforcement actions. Speeches like Director Hinman's and pronouncements like the Staff Statement give useful insight into the staff's thinking. Indeed, the DAO Report itself provided a valuable indication of the SEC's intentions.

More guidance, whether from the staff or the Commission itself, will likely come in 2019 and beyond as the agency continues delving into nuances, getting more and more granular over time as it considers actual offerings and other real-world blockchain use cases for trading and holding securities. The big-picture challenge for the SEC is to make sure that regulatory rigidity does not impede important technological innovation that stands to benefit entrepreneurs, investors, and our capital markets overall, while ensuring that investor protection is not jeopardized. The objectives of federal securities regulation need to be met, but specific regulatory requirements also need to make practical sense for digital assets and blockchain technology. This balance is achievable through regulatory fine-tuning that is informed by constructive collaboration between the SEC and market participants, and the SEC's outreach to date is commendable.[43]

But the SEC is not the only regulator that matters to the future of cryptocurrency. Whether or not a digital asset meets the definition of a security under the federal securities laws, other regulators may regulate it under their regulatory regimes. For example, in 2014, the Commodity Futures Trading Commission classified Bitcoin and other digital currencies as "commodities" covered by the Commodity Exchange Act and subsequently has brought several enforcement actions against parties involved in the sale of digital currency.[44] The Financial Crimes Enforcement Network has issued guidance stating that digital currency is considered currency and that exchanges will be considered exchanges under the Bank Secrecy Act.[45] The Federal Trade Commission has established a blockchain working group and has brought enforcement actions against promoters of allegedly fraudulent chain referral schemes involving cryptocurrencies.[46] A Congressional Blockchain Caucus has formed, and various members of Congress have introduced bills that would either expand or contract federal oversight of the space or simply usher in different regulation. And while this article has not addressed state securities regulation, federal law often does not preempt states' authority in this area. Many states are now coordinating their enforcement efforts to pursue cases against fraudulent or unregistered ICOs.[47]

As this plays out, one concern is that entrepreneurs will conduct their offerings and other business offshore if U.S. regulation is overly restrictive and burdensome compared to the regulation in foreign jurisdictions. Making sure that the U.S. does not miss out on key blockchain developments and economic opportunity counsels in favor of ensuring that the U.S. regulatory environment, at both the federal and state levels, does not chill beneficial innovation.

For securities lawyers, this is a rare time. In the SEC's 85-year history, no other development that has evolved so quickly, been the subject of so much varied regulatory attention, and held so much promise as digital assets and blockchain technology. And it all started with Howey's orange groves.

43 In an effort to increase dialogue with the fintech community, the SEC has established a Strategic Hub for Innovation and Financial Technology (known as FinHub), with a website at https://www.sec.gov/finhub.

44 U.S. Commodity Futures Trading Commission, *CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets* (Jan. 4, 2018), *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf.

45 Financial Crimes Enforcement Network, *FinCEN Issues Guidance on Virtual Currencies and Regulatory Responsibilities* (Mar. 18, 2013), *available at* https://www.fincen.gov/news/news-releases/fincen-issues-guidance-virtual-currencies-and-regulatory-responsibilities.

46 *See generally* Neil Chilson, Federal Trade Commission, *It's time for a FTC Blockchain Working Group* (Mar. 16, 2018), *available at* https://www.ftc.gov/news-events/blogs/techftc/2018/03/its-time-ftc-blockchain-working-group.

47 Since April 2018, for example, state and provincial securities regulators across the U.S. and Canada have been coordinating their ICO enforcement actions under "Operation Cryptosweep." *See generally* North American Securities Administrators Association, Operation Cryptosweep, http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/operation-cryptosweep/.