ANYTHING BUT SIMPLE: A CRITIQUE OF THE PROPOSED SIMPLE AGREEMENT FOR FUTURE TOKENS

RYAN STRASSMAN*

Abstract

The advent of the initial coin offering has allowed issuers to quickly and efficiently raise capital through the distribution of digital tokens. The ease and success of these offerings have led to a staggering increase in popularity for the methodology. With such a rapid rise in the utilization of this new offering vehicle, the Securities and Exchange Commission (SEC) remains a step behind in creating the regulatory parameters within which these offerings are to be bound. In light of the ambiguity surrounding the regulation of initial coin offerings, one group, the SAFT Project, has proposed a framework, the Simple Agreement for Future Tokens (SAFT, SAFT framework), by which they claim issuers can be confident that their digital token sales remain legally compliant. The SAFT framework utilizes a distinction between "securities tokens" and "utility tokens" in establishing a four-step issuance process aimed at failing the Howey test, thus placing the offering firmly outside the purview of traditional securities regulation. In support of its proposed framework, the SAFT Project has published the SAFT whitepaper which details the four-step process and the legal reasoning that justifies it.

This note first presents an overview of the technical and legal landscape surrounding initial coin offerings before moving to an in-depth analysis of the SAFT framework itself. Through a critique of the legal reasoning supporting the SAFT framework, as well as an analysis of recent SEC enforcement actions, this note ultimately argues that the SAFT framework fails to meet its goal of creating an issuance process that escapes securities regulation. The SAFT four-step process creates an investment contract under the Howey test and is thus subject to securities regulation.

Table of Contents

I. Introduction

In 2017, Initial Coin Offerings (ICOs) burst onto the scene as the newest, easiest, and fastest way for a company to raise capital.[1] That growth has anything but slowed. As of 2018, ICOs have raised nearly $14.3 billion dollars across 460 offerings.[2] The capital raised

---

* Boston University School of Law (J.D. 2019).

[1] *See* Nathaniel Popper, *Virtual Currency Offerings May Hit a New Peak with Telegram Coin Sale*, N.Y. TIMES (Mar. 4, 2018), https://www.nytimes.com/2018/03/04/technology/telegram-initial-coin-offering.html (stating that compared to previous methodologies, ICOs allow for larger and quicker raising of capital).

[2] *ICO Tracker*, COINDESK, https://www.coindesk.com/ico-tracker/ (last visited Aug. 23, 2018) (showing a summary table of statistics by year for

over the course of less than eight full months in 2018 represents a near 300% increase over that same figure for the entirety of 2017 and a near 5,600% increase over 2016's figure.[3] The problem with this pattern of exponential growth is that it has put regulators at a distinct disadvantage as they scramble to keep pace with the technology's meteoric rise in popularity.[4] The main concern of regulators is that the ease of these ICOs—and the lack of concrete regulations to guide them—is allowing companies to circumvent securities laws and take advantage of unsuspecting and inexperienced investors in the process.[5] While the Securities and Exchange Commission (SEC) attempts to keep pace in its regulatory capacity, a group has proposed an ICO strategy aimed specifically at keeping these issuances outside of the SEC's purview, the Simple Agreement for Future Tokens (SAFT).[6]

The SAFT framework proposes a legal methodology by which utility token issuers are able to conduct ICOs without first registering said issuances with the SEC.[7] The SAFT Project, a group led by attorney Marco Santori, introduced this issuance strategy when it published the SAFT Whitepaper (Whitepaper).[8] The purpose of the Whitepaper was to implement the widespread adoption of the SAFT

ICOs, which reflects that in 2018, there were 460 ICOs that raised $12.295 billion).

[3] *See id.* (showing in 2017 ICOs raised $5.482 billion, and in 2016 ICOs raised $256 million).

[4] *See* Popper, *supra* note 1 ("[H]ow existing laws may apply remains unclear.").

[5] *Id.* ("Regulators worry this novel fund-raising method is allowing people to flout the rules that are supposed to protect investors.").

[6] *See* SAFT PROJECT, https://saftproject.com [https://perma.cc/YHC4-QVNK] ("The tokens . . . should be fully-functional, and therefore not securities under U.S. law.").

[7] Juan Batiz-Benet, Jesse Clayburgh, & Marco Santori, THE SAFT PROJECT, THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK 1 (Oct. 2, 2017), https://saftproject.com/static/SAFT-Project-Whitepaper.pdf [hereinafter: SAFT Whitepaper] ("The SAFT is a security. It demands compliance with the securities laws. The resulting tokens, however, are already functional, and need not be securities under the Howey test.").

[8] *See* SAFT PROJECT, *supra* note 6 (discussing how "Protocol Labs, Cooley, AngelList, and CoinList collaborated extensively," to create a framework before publishing it in the whitepaper).[ES: I think this source is okay but would suggest quoting the whitepaper cited in FN007 instead, or in addition to this one, because that includes the name Marco Santori, whereas the general homepage does not.]

methodology in conducting ICOs.[9] The frequency of adoption suggests the Whitepaper has been successful as major ICOs are being conducted according to this methodology.[10] For example, digital storage network Filecoin raised over $200 million dollars in a little over a month by utilizing the SAFT framework.[11]

The problem, as this note will articulate, is that the SAFT framework is likely not securities regulation-compliant. The SAFT Project, the group that posited the SAFT framework, attempted to support the legality of their framework by offering a thin line of case precedent.[12] However, it is the contention of this note that by virtue of a misunderstanding and misapplication of the case law upon which it bases its framework, the SAFT Project has delivered a recipe for the commission of securities regulation violations—and not the regulation-compliant offering they intended.

It is necessary to first provide background information sufficient to understand the aims of the SAFT Project before exploring how the SAFT Project has woefully misconstrued its legal analysis. The remainder of Part I will lay out the background information necessary to grasp the issues at hand; Part II will introduce the SAFT Whitepaper's four-step ICO process and expand upon the legal arguments it puts forward; Part III will offer a legal critique of those arguments, positing that on the whole they are without merit; Part IV explores current actions taken by the SEC to combat the unruly and largely unregulated ICO arena; Part V will expand upon that SEC action with a brief case study examining a cease and desist order issued by the SEC; finally, Part VI will conclude.

---

[9] *See* SAFT PROJECT, *supra* note 6 ("To become a global standard, The SAFT Project relies on the international collaboration. . . [and] [c]onsider this an open call for participation.").

[10] *See* Stan Higgins, *$257 Million: Filecoin Breaks All-Time Record for ICO Funding*, COINDESK (Sept. 7, 2017, 8:45 PM), https://www.coindesk.com/257-million-filecoin-breaks-time-record-ico-funding [https://perma.cc/35PC-SG34] (finding that large scale ICOs are employing SAFTs as their main capital raising methodology).

[11] *Id.* ("Today, the ICO ended with approximately $205.8 million raised . . . .").

[12] *See* SAFT PROJECT, *supra* note 6.

A. Initial Coin Offerings

In much the same way that a traditional company issues new securities such as stocks or debt to the public in order to raise capital, companies participating in ICOs are issuing a new product to the public in order to raise capital. With an ICO, the product being offered to the public is a digital token.[13] A digital token is a highly customizable blockchain-based indicator of an asset or a right.[14] That right may be to the use of a future online service, a reward for maintaining the block-chain based token network, or simply the right to collect on appreciated earnings like in a traditional investment vehicle.[15] In an ICO, a digital token is issued to the public as a means of raising capital to support, maintain, or even to create the network upon which the token is based.[16] After the ICO, a highly volatile and active secondary market begins to speculate and trade in these digital tokens.[17] Much like a traditional initial public offering, the hope of any investor putting money into an early stage platform via ICO is that the secondary market will develop a strong demand for their digital token, leading to a high price, and, in turn, high profits.[18]

The ICO's place in the capital-raising market is polarizing at present. Proponents of the ICO praise the capital-raising method for its speed, efficiency, and breadth, while skeptics condemn the ICO for flying in the face of securities regulations and failing to protect

---

[13] Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, 70 HASTINGS L.J. 463, 463 (2019) ("In a token sale, also referred to as an 'initial coin offering' or 'ICO,' organizers of a project sell digital tokens to members of the public . . . .").

[14] *See id*.

[15] *Id*. at 475–76 ("Certain app tokens . . . grant holders the right to access, use, and enjoy a given technology or participate in an online organization. . . . Other app tokens . . . are not only functional in nature but provide holders with economic rights, such as a share of profits generated by a project or organization.").

[16] *Id*. at 463 ("In a token sale, also referred to as an 'initial coin offering' or 'ICO,' organizers of a project sell digital tokens to members of the public to finance the development of new technological plat(orms and services.").

[17] *Id*. ("After the initial sale, cryptocurrency exchanges scattered across the globe list tokens for trading and facilitate an active secondary market in which wild price fluctuations are common.").

[18] SAFT Whitepaper, *supra* note 7, at 1 ("The investors may then resell the tokens to the public, presumably for a profit, and so may the developers.").

investors.[19] In spite of their polarizing status, there is no disagreeing that ICOs are rapidly increasing in both frequency and value, growing from a market in the tens of millions of dollars in 2016 to a multi-billion-dollar market as of October 2017.[20]

B. Utility Tokens

The digital tokens at the heart of the ICO process can be further broken down into utility tokens and securities tokens.[21] The main difference between utility and securities tokens is what possession of each token will afford its holder.[22] Securities tokens function much like a traditional investment good in that they provide the holder with economic rights, such as access to future profits generated by the token network or the project.[23] These tokens, functioning exclusively as investment vehicles, fall incontrovertibly within the purview of the SEC as securities and are not a focal point of this note.[24] Utility tokens differ from securities tokens, however, in that they provide the holder with access to a consumptive good.[25] This consumptive good can be as simple as online storage space or as

---

[19] Nathaniel Popper, *Easiest Path to Riches on the Web? An Initial Coin Offering,* N.Y. TIMES: DEALBOOK (June 23, 2017), https://www.nytimes.com/2017/06/23/business/dealbook/coin-digital-currency.html ("Proponents of initial coin offerings hail them as a financial innovation that empowers developers and gives early investors a chance to share in the profits of a successful new enterprise. But where some see a new method of crowd-funding online projects, critics say the phenomenon is ripe for abuse and, in many cases, a violation of American securities law.").

[20] Rohr & White, *supra* note 13, at 4 ("In 2016, less than $100 million in tokens were sold. By October of 2017, that number had swelled to over $3.7 billion . . . .").

[21] SAFT Whitepaper, *supra* note 7, at 1 (finding that tokens can come in two varieties, utility tokens and securities tokens).

[22] *Id.* ("Tokens leverage computation and cryptography to represent consumptive goods (known as 'utility tokens') or replacements for traditional investments (known as 'securities tokens').").

[23] Rohr & White, *supra* note 13, at 24 ("[I]nvestment tokens . . . provide holders with economic rights, such as a share of profits generated by a project or organization.").

[24] SAFT Whitepaper, *supra* note 7, at 1–2 (conceding that securities tokens fall within the purview of the SEC by their nature).

[25] Rohr & White, *supra* note 13, at 22 ("[U]tility tokens—grant holders the right to access, use, and enjoy a given technology or participate in an online organization.").

complex as access to the use of Ethereum based smart contracts.[26] The main point, however, is that utility tokens entitle their holder to functional use beyond the profit seeking investment structure that defines securities tokens.

C. Howey Test

The SAFT proposal attempts to circumvent securities laws by providing a framework in which the resulting utility token product is not considered a security under the SEC's definition.[27] The relevant portion of the SEC definition of a security asks whether or not the utility token resulting from the SAFT framework process in an "investment contract."[28] This inquiry has long been guided by the *Howey* test, which asks "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[29] Any offering that passes this test is considered an investment contract—and therefore a security—subject to the rules and regulations of the SEC.[30] Courts have long understood this test to comprise four prongs; (i) an investment of money (ii) into a common enterprise (iii) with the expectation of profits (iv) deriving primarily from the efforts of others.[31] It is the goal of the SAFT Project to create

---

[26] *Id.* at 18 ("On more advanced blockchains, protocol tokens have additional functional utility. On Ethereum, for example, a blockchain is used not just to store information about the transfer of a digital token (in the case of Ethereum, a token called ether), but also to coordinate a decentralized virtual machine—a parallelized computing system—that enables anyone participating on the network to execute programs called "smart contracts.").

[27] SAFT Whitepaper, *supra* note 7, at 6 ("[T]he utility token by itself, once issued, imbued with genuine functionality and circulating on its network, rarely possesses qualities that would satisfy the requirements for an investment contract.").

[28] 15 U.S.C. §§ 78c(a)(10), 77b(1) (2012).

[29] SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

[30] Miriam R. Albert, *The Howey Test Turns 64: Are the Courts Grading this Test on a Curve?*, 2 WM. & MARY BUS. L. REV. 1, 5–6 (2011) ("Under the Howey test, any interest that 'involves an investment of money in a common enterprise with profits to come solely from the efforts of others' is an investment contract, thereby included within the definition of 'security' and subject to the rules and regulations of the federal securities laws.").

[31] SAFT Whitepaper, *supra* note 7, at 6 ("Courts often break the Howey test into four prongs to determine (i) whether there exists an investment of money, (ii) whether there exists a common enterprise, (iii) whether there exists an

an offering that falls firmly outside of the prongs of this test and therefore falls outside of SEC regulation.[32] The focus of the SAFT framework rests primarily within the last two prongs of the *Howey* test, asking whether the expectation of profits in this process can truly be deemed to have been dependent primarily on the efforts of others.[33]

D. Section 5 of the Securities Act

Section 5 of the Securities Act of 1933 (Section 5) requires that the offer or sale of a security take place only once the requisite registration statement has been put into effect.[34] The aim of this provision is to provide ample disclosures to any party looking to invest, so as to protect the investing public from fraudulent behavior.[35] It is the view of some that, while this investor protection law has the capacity to do good, it often presents overly burdensome costs, especially for new market entrants.[36] It is for this reason that the SAFT framework

---

expectation of profits, and (iv) whether the expectation of profits is solely from the efforts of others.").

[32] *Id.* at 2 ("Sellers of already functional tokens have likely already expended the 'essential' managerial efforts that might otherwise satisfy the Howey test.").

[33] *Id.* at 9 ("Sellers of already-functional utility tokens have very strong arguments against characterization as a security: Such tokens rarely satisfy both the 'expectation of profits' and 'from the efforts of others' prongs of the Howey test.").

[34] 15 U.S.C. § 77e(a)(1) (2012) ("Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise . . . .").

[35] SEC. & EXCH. COMM'N, RELEASE NO. 81207, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO (2017) ("The registration provisions of the Securities Act contemplate that the offer or sale of securities to the public must be accompanied by the 'full and fair disclosure' afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision.").

[36] SAFT Whitepaper, *supra* note 7, at 15 ("Applying investor protection laws (like accreditation rules, numerical investor limits, and registration requirements) throughout the token sale process is just as troublesome. The investor protection laws, when improperly calibrated, can prevent capital formation, stifle innovation by preventing new financial models from accessing market resources, and shut out the economically disenfranchised.").

aims to help issuers out from under a designation as a security: if your product is not a security, there is no need to comply with the securities regulations, which saves the issuer a lot of time, money, and trouble.[37] However, with the SEC having not yet taken a formal position on what ICOs must do to be securities regulation compliant, operating an ICO without registration presents significant risk.[38] Because Section 5 does not require scienter, each issuer conducting an ICO without proper Securities Act registration opens itself up to the possibility of committing securities fraud.[39] While the Whitepaper outlined below offers a path by which new issuers can dive headfirst into the robust ICO market, it also presents a potential pitfall in which an issuer may be liable to commit a securities regulation violation on the basis of taking its advice.

II. SAFT Whitepaper

In an effort to provide a financial maneuver that fails the *Howey* test, and subsequently frees itself from the requirements of federal securities regulation in the process, the SAFT Project published a four-step guide to conducting the ICO of a digital utility token.[40] It is the belief of the SAFT Project that following these four steps precisely will deliver the investor a token that definitively fails the *Howey* test, allowing for immediate resale upon secondary markets and thus allowing for a pathway to a far cheaper, easier, and more lucrative offering.[41]

---

[37] *Id*.

[38] Denis Vinokourov, Saft—*The Not so 'Simple Agreement for Future Tokens,'* BITCOINIST (Apr. 15, 2018, 3:00 AM), http://bitcoinist.com/saft-the-not-so-simple-agreement-for-future-tokens [https://perma.cc/29V7-BHSY] ("There is also the matter of regulation. Most ICOs have operated under the assumption that the associated tokens are a utility, and should not be categorized as securities. Selling security tokens without appropriate registration with the relevant regulatory body risks jeopardizing the entire project.").

[39] *See* SEC. & EXCH. COMM'N, *supra* note 35, at 10 (citing SEC v. Universal Major Indus. Corp., 546 F.2d 1044, 1047 (2d. Cir. 1976) ("Violations of Section 5 do not require scienter.").

[40] SAFT Whitepaper, *supra* note 7, at 15 ("The SAFT is a framework which seeks to navigate the federal securities [laws] . . . it works for utility tokens, not securities tokens.").

[41] *Id.* at 9–11 (identifying several reasons that the outlined framework would not satisfy all of the prongs of the *Howey* test).

A. The SAFT Four-Step Process

At the beginning of the SAFT four-step ICO process, nothing more than an idea exists.[42] Step one consists of the issuer preparing its whitepaper and beginning to market said whitepaper to accredited investors.[43] There are, of course, reasons why the issuer can only market its whitepaper to accredited investors, but they are beyond the scope of this note.[44] At this stage, the issuer has begun to secure investments, but has not yet issued anything in return.[45]

Step two is the crux of the issuer/investor exchange. Here, the issuer and the investor enter into a SAFT form contract.[46] This is an investment contract between the issuer and the investor stating that in exchange for funds from the investor right now, the investor is guaranteed the right to purchase tokens at a later date in time from the issuer.[47] The SAFT form contract operates like a futures contract for the tokens.[48] It is important to note that this investment contract would in fact fall under SEC purview; it is the ensuing tokens being produced that would ultimately fail the *Howey* test according to SAFT.[49]

---

[42] *Id.* at 16 ("At the outset, the developers in our example have little more than a whitepaper in hand.").
[43] *Id*.
[44] An accredited investor is a specialized category of investor carved out by federal regulation as being especially adept within securities markets. Set out through a number of qualifying standards, accredited investors can be large financial institutions, repeat players in the market, high net worth individuals, or some combination of the foregoing criteria. For further information on accredited investors, *see* 17 C.F.R § 230.501(a) (2018) (defining an accredited investor as used in Regulation D); *see* generally Matthew Frankel, *What is an Accredited Investor?*, MOTLEY FOOL (Feb. 14, 2018, 10:03 AM), https://www.fool.com/investing/2018/02/14/what-is-an-accredited-investor.aspx [http://perma.cc/W8Q8-FDA9].
[45] SAFT Whitepaper, *supra* note 7, at 16 (stating that this step concerns marketing the whitepaper and seeking investments, but no actual transaction has yet taken place).
[46] *Id.* at 16–17 ("After confirming through affirmative representations (or verification, as required) by investors that they are accredited, Developers Inc. enters into a SAFT with the accredited investors.").
[47] *Id.* at 17.
[48] *Id.* ("The SAFT is, at heart, a forward contract, but for tokens.").
[49] *See generally id.* (finding the SAFT, as an investment contract, qualifies as a security while the tokens themselves fail to constitute securities under the *Howey* test).

Step three is the actual creation of the network upon which the tokens will be premised.[50] This step requires that the developers of the platform build a network that supports a fully functional product.[51] It is this actual functionality of the token upon which the SAFT framework is built.[52] Because of supposed differences in delivering a pre-functional token and a post-functional token, this functionality allows the SAFT Project to believe that these tokens will fail the *Howey* test.[53]

Step four is the delivery of the tokens to the investors from the issuers and the concrete end to any futures contract between the two parties.[54] At this stage, the investor has a fully functional token and, according to SAFT, is now free to explore secondary markets in order to flip this token for a profit.[55] That is, the issuer at this point has all of the capital raised in the ICO and each of the initial investors has a digital utility token that is not considered a security. Because the digital utility token is not considered a security, the initial investor is now free to sell that token to the investing public for a profit without limitation from securities regulations.[56]

B. Failing the Howey Test

The SAFT framework puts forth the argument that following the four-step process above will ultimately lead to the issuance of a digital utility token that fails the *Howey* test.[57] The reasoning is based on a subtle distinction in the timing of the offering process and the difference between a post-functional and a pre-functional utility token, as explained below. In the view of the SAFT Project, issuing a utility token only once it is fully functional means with near certainty that said token is not a security.[58] While this note will ultimately not agree with that legal reasoning, the SAFT argument is first presented free of

---

[50] *Id.* at 17.
[51] *Id.* ("By this we mean that by the end of this step, the network and the token must be *genuinely useful* such that they are actually used on a functional network.").
[52] *See id*.
[53] *Id*.
[54] *Id*.
[55] *Id.*
[56] *Id.*
[57] *See generally id.*
[58] *Id*. at 9 ("Sellers of already-functional utility tokens have very strong arguments against characterization as a security . . . .").

any commentary as to its merit, after which a section follows critiquing that argument.

Specifically, the last prong of the *Howey* test states that a financial device is an investment contract, and thus a security, where the investor's expectation of profits is dependent predominantly on the managerial and entrepreneurial efforts of others.[59] This last prong of the *Howey* test was further clarified by the holding in *SEC v. Life Partners*.[60] In this case the court held that to satisfy the "efforts of others" prong of the Howey test, post-purchase efforts by issuers must be material and non-ministerial as relating to the expectation of profits.[61] The SAFT Project posits that the timing of the delivery of already functional utility tokens minimizes the "efforts of others" in deriving profits from the tokens.[62] It points to a series of cases in which contracts securing future resources were ruled not to be investment contracts because the collection of profits on such contracts was dependent on the fluctuations of national and international commodity markets as much as, if not more than, the efforts of others.[63] The argument holds that where the price of the resource underlying the contract fluctuates based on market supply and demand forces, the

---

[59] SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) ("In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . .").

[60] *See generally* SEC v. Life Partners, Inc., 87 F.3d 536, 545–49 (1996) (assessing the applicable bounds of the *Howey* test as relating to viatical settlements).

[61] *See id*. at 548 ("Nor is the combination of [Life Partners, Inc.'s] pre-purchase services as a finder-promoter and its largely ministerial post-purchase services enough to establish that the investors' profits flow predominantly from the efforts of others.").

[62] SAFT Whitepaper, *supra* note 7, at 9 ("Sellers of already-functional utility tokens have very strong arguments against characterization as a security: Such tokens rarely satisfy both the 'expectation of profits' and 'from the efforts of others' prongs of the Howey test.").

[63] *Id.* at 10. *See also* SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. 1986) (affirming the district court that profits to the coin buyer depended upon the fluctuations of the gold market); Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980) (finding no investment contract was created because profits of the investor depended upon fluctuations of the silver market).

efforts of others cannot be held to be the primary driver of profit expectations, and as such, these contracts fail *Howey*.[64]

The SAFT Project believes that their token issuance framework operates in the same manner.[65] Once the functional utility token has been created and turned over to the investor, it can no longer be said that any ensuing profit is due to the managerial efforts of the issuers.[66] By the time profits are created on the secondary market, the major contributory efforts of the digital token developer and issuer—the actual development of the token and supporting network—have long since ceased.[67] Secondly, where profits are driven primarily by the fluctuations of an active secondary market, it cannot be said that the developer is driving the creation of profits as this surely is due to supply and demand factors beyond the developers' control.[68] Ultimately, the SAFT Project concludes that where an investor is purchasing a fully functional utility token, any expectations of profit held in conjunction with this purchase are driven primarily by market forces and not the managerial efforts of others.[69]

III. Legal Critique

The Whitepaper would have a reader believe that the legal analysis it has put forth is ironclad, and that as long as one follows the

---

[64] SAFT Whitepaper, *supra* note 7, at 9 ("Because there is no central authority to exert "monetary policy," the secondary market price of a decentralized token system is driven exclusively by supply and demand."). *See also Belmont Reid & Co.*, 794 F.2d at 1391 ("To the extent the purchasers relied on the managerial skill of CMC they did so as an ordinary buyer, having advanced the purchase price, relies on an ordinary seller. We therefore agree with the district court . . . that the profits in this case did not come 'solely' from the efforts of others, and that this transaction was not a security within the meaning of the federal security laws."); *Key Futures*, 638 F.2d at 79 ("[W]e hold that no investment contract was created. Once 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.").

[65] SAFT Whitepaper, *supra* note 7, at 9 ("So should utility tokens really be treated similarly? For already-functional utility tokens, we think so.").

[66] *Id*.

[67] *Id.* at 17.

[68] *Id.* at 9 ("Because there is no central authority to exert 'monetary policy,' the secondary market price of a decentralized token system is driven exclusively by supply and demand.").

[69] *Id.* at 10.

SAFT directions precisely as they are laid out, one can conduct an ICO without any need for registration pursuant to securities laws. However, this note submits that this is not the case. As is argued, the legal principles upon which the SAFT Project hangs its metaphorical hat are misconstrued, misrepresented, and often misapplied. It is likely dangerous for an issuer to follow the legal guidance of the SAFT framework for this reason.

A. Economic Reality

The Whitepaper presents the terms of the *Howey* test as if they are entirely dispositive in nature.[70] However, the it fails to mention the couching within which the initial *Howey* test was posited.[71] The *Howey* case, as well as numerous decisions that have followed its precedent, clarify that in defining the word "security," the courts are to prioritize substance over form as they adjudicate with an eye towards the "economic reality" of the situation.[72] The definition of a "security," as laid out by *Howey*, was specifically envisioned as being malleable enough to encapsulate any investment, no matter its name or form, so long as it was one in which a consumer was likely to need securities regulation protection.[73]

As presented, the SAFT framework takes great comfort in the fact that it is able to step around one of the prongs of the *Howey* test in securing its status as a non-security through the details of its timing.[74]

---

[70] *Id.* at 6 ("If all prongs are satisfied, then a contract, scheme, or arrangement passes the Howey test and constitutes a security. If any one of the prongs is not met, the arrangement fails the Howey test and there is no security.").

[71] *Id.* (presenting the four prongs of the *Howey* test and failing to mention the applicability of the "economic reality" component of *Howey*).

[72] SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) ("Form was disregarded for substance and emphasis was placed upon economic reality."). *See* United Hous. Found., Inc., 421 U.S. 837, 851–52 (1975) ("Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."); Tcherepnin v. Knight, 389 U.S. 322, 336 (1967) ("[F]orm should be disregarded for substance and the emphasis should be on economic reality.").

[73] *Howey*, 328 U.S. at 299 ("It 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.").

[74] SAFT Whitepaper, *supra* note 7, at 9.

The SAFT Project continues to encourage investors to secure these utility tokens with an eye towards profits on the secondary market because of its confidence in the framework established.[75] However, based on the flexible application of the *Howey* test within the overall economic reality of the transaction at hand, the likelihood that the SAFT framework is able to successfully weave around the *Howey* test may not be as sure as promised.[76] Simply splitting the ICO process into individual components and compartmentalizing each component into its own segmented time frame does not change the overall economic reality of that ICO process.[77] Courts and the SEC will not be fooled by subtle differences in timing, and likely will see this ICO process as the profit-seeking mechanism that it is.[78]

While the Whitepaper did not pay much attention to the economic reality component of the *Howey* test, the SEC has spoken directly on this issue.[79] The SEC, in publishing a response to the hacked cryptocurrency platform DAO, went out of its way to take note of the economic reality component of the *Howey* test, stating that securities laws will potentially apply to ICOs based on transactional

---

[75] *Id.* at 17 ("To be sure, some purchasers may still purchase the tokens primarily to resell them on a secondary market for a profit. For the reasons set forth in the above section on already-functional utility tokens, this should not endanger the model.").

[76] CARDOZO BLOCKCHAIN PROJECT, NOT SO FAST — RISKS RELATED TO THE USE OF A "SAFT" FOR TOKEN SALES 6 (2017), https://cardozo.yu.edu/sites/default/files/Cardozo%20Blockchain%20Project%20-%20Not%20So%20Fast%20-%20SAFT%20Response_final.pdf [https://perma.cc/7GBZ-CZNH] ("Many readers of the Whitepaper are left with the impression that U.S. federal securities laws recognize something akin to a bright-line test, namely, that the question of whether a utility token will be deemed a security will generally turn on whether the token is 'functional.' However, courts and the SEC have repeatedly, and unambiguously, explained that the test for whether a particular instrument will be deemed a security depends not on bright-line rules but rather on the relevant facts, circumstances, and economic realities.").

[77] *Id.* at 5 ("Bifurcating the purchase of tokens through a SAFT from the delivery of underlying transaction is merely form over substance and likely will do little to cloud the transaction's economic reality.").

[78] *See id.* ("Artificially dividing the overall investment scheme into multiple events does not change the fact that accredited investors purchase tokens (albeit through SAFTs) for investment purposes, and likely will not prevent a court from considering these realities when assessing whether these tokens are securities.").

[79] SEC. & EXCH. COMM'N, *supra* note 35 (speaking on the applicability of U.S. federal securities laws to ICOs).

substance and not their transactional form.[80] In examining the flaws that occurred with the DAO offering, the SEC stated that the Commission will consider the facts and circumstances surrounding an offer to ascertain the applicability of the securities laws.[81] While this is not an explicit statement from the SEC regarding the treatment of ICOs in general, and does leave open the possibility that the SAFT framework will be successful in its aims, it seems far more likely that the SEC will not be fooled by the timing differences upon which the Whitepaper premises its four-step process.

B. The Natural Resource Analogy

In support of its claim that a functional token is not a security, the Whitepaper points to a series of cases concerning the sales of natural resource futures contracts.[82] The crux of its argument states that where a national market for a product or resource exists, and that market experiences fluctuations, the managerial efforts of others cannot be the predominant factor in the expectation for profits and as such fails the *Howey* test.[83] In drawing on these comparative cases, however, the Whitepaper vastly oversimplifies—and possibly altogether misstates—the level of similarity.[84]

For example, while the *Noa* case referenced in the Whitepaper does support the premise that an investment contract does not exist where market demand factors predominate over seller efforts in creating profits, it does so with a caveat that is inapplicable to the SAFT

---

[80] *Id.* at 10 ("These offers and sales have been referred to, among other things, as 'Initial Coin Offerings' or 'Token Sales.' Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale.").

[81] *Id.*

[82] SAFT Whitepaper, *supra* note 7. *See* SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. 1986); Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980).

[83] SAFT Whitepaper, s*upra* note 7, at 9 (finding that in drawing a parallel to silver and gold, where market demand factors determine the existence of profits the *Howey* test fails and there is no resulting security).

[84] *See* CARDOZO BLOCKCHAIN PROJECT, *supra* note 76, at 7 ("Unlike physical commodities—such as gold, silver, or sugar—utility tokens are not homogenous and carry with them various rights, features, and obligations.").

framework.[85] The *Noa* court relied on a fluctuating national market for silver already existing independent from the efforts of the sellers when it determined that the seller's efforts did not predominate the expectations of profits.[86] The same simply cannot be said of the SAFT framework. A national market for these particular digital tokens does not exist nationally prior to investment and issuer creation, and can only exist because of the efforts of the developer in having created these digital tokens in the first place.[87] *Noa* specifically distinguishes as factually dissimilar another case in which the ensuing secondary market was dependent on the promoter's activities.[88]

Additionally, to draw a comparison between natural resources (such as gold, silver or sugar) and utility tokens ignores a fundamental difference between the two.[89] Natural resource commodities are elementarily identical and utility tokens are far from that.[90] Where any contract for gold will always be concerning the same underlying metal, the utility token underlying each new SAFT will carry its own rights, services, or goods upon issuance.[91] To hold that because contracts for gold and other commodities are not securities necessarily implies that the tokens underlying SAFTs are not securities is simply too broad to be true.[92] Further, because the underlying token will be different in

---

[85] *Noa*, 638 F.2d at 79 ("Applying these standards to the facts here, we hold that no investment contract was created. Once 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.").

[86] *Id.* at 80 ("There is a national market for silver which is not dependent upon Key Futures.").

[87] SAFT Whitepaper, *supra* note 7 (using the four-step process to make it explicitly clear that the digital tokens and the platform upon which they rest do not exist until the developer/issuer creates them).

[88] *Noa*, 638 F.2d at 80 (distinguishing *Noa* from Miller v. Cent. Chinchilla Grp, Inc., 494 F.2d 414 (8th Cir. 1974) in that *Miller* involved a resale market dependent upon promoter activity whereas *Noa* did not).

[89] *See* CARDOZO BLOCKCHAIN PROJECT, *supra* note 76, at 7.

[90] *Id.* ("Unlike physical commodities—such as gold, silver, or sugar—utility tokens are not homogenous and carry with them various rights, features, and obligations.").

[91] *Id.*

[92] *Id.* ("Likewise, while a sale agreement for gold may not convert gold into a security, that says nothing about whether a SAFT may alter the facts, circumstances, and economic realities surrounding the SAFT's underlying utility token in a way that implicates federal securities laws.").

each instance, it is improper to assume that any one token seen as a non-security relates to any other token's status.[93]

However, even without the arguments above, it is not clear that the proposed commoditization of the token underlying the SAFT would preclude such tokens from being seen as securities. There is considerable case law holding that even where a contract concerns the sale of a commodity, the form of said sale and contract may still create a security.[94] One such case is *Glen-Arden Commodities, Inc. v. Constantino*. This case involves a scheme in which investors would pay money to managers in order to use the funds to purchase Scotch whisky which was then expected to significantly appreciate in value over the course of four years.[95] It was understood that the managers of the Scotch whisky purchases would use their personal expertise to select which variants had the best chances for appreciation and would then store the purchases in a warehouse facility.[96] The court grappled with the question of whether investors were purchasing a commodity (and not subject to securities laws) or an investment contract, which of course would be subject to securities laws.[97] The court found that the investors had in fact purchased investment contracts largely due to finding that the scheme was necessarily dependent on the expertise of the Scotch whisky purchasers.[98] Where the investor is purchasing the instrument solely, or primarily, in reliance on the expertise of the issuer, courts consistently hold that the investor's expectation of profits comes predominantly from the efforts of others, thus satisfying this element of the Howey test and creating an investment contract.[99] A

---

[93] *Id*.

[94] David Felsenthal & Jesse Overall, *Bad News: SAFTs May Not Be 'Compliant' after All*, CROWDFUND INSIDER (Mar. 16, 2018, 8:55 AM), https://www.crowdfundinsider.com/2018/03/130229-bad-news-safts-may-not-compliant/ [https://perma.cc/WL9R-RJ6J].

[95] Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027, 1032 (2d Cir. 1974) ("Customers could expect a doubling of the value of their investments in three to four years . . . .").

[96] *Id.* ("Milbank's expertise would be utilized in selecting the type and quality of Scotch whisky in casks to be purchased . . . .").

[97] *Id*. at 1034.

[98] *Id.* at 1035 (finding that where the investor relied upon the expertise of the manager, even where that expertise was used in the purchasing of commodities, an investment contract was still made).

[99] *Id.* at n. 7 ("As the court said, . . . the term 'investment contract' includes 'agreements where 'the purchasers (look) entirely to the efforts of the promoters to make their investment a profitable one . . . .'").

comparison is drawn between the efforts of the Scotch whisky purchaser and the efforts of the token issuer.[100] Just as the Scotch whisky scheme cannot succeed without the expertise of the purchaser, so too is the SAFT scheme dependent on the issuer. It is the expectation of the investor that the issuer possesses the necessary expertise to create the token and the underlying network.[101] Where the investor is dependent on the expertise of the issuer in creating profits, the commoditization of the underlying product is largely ineffectual in determining whether the SAFT is a security or not.[102]

Speaking at a panel titled "Structuring Legally Compliant Token Sales," Santori (of the SAFT Project) attempted to explain to a panel of seven people how a two-part SAFT token sale was closely analogous to mining for gold.[103] Despite his best efforts, he failed to convince the panel.[104] Aaron Wright, who served on the aforementioned panel and is cited throughout this paper, could not be won over, stating that law would simply not separate the transaction into two components the way Santori believed it would.[105] In an exchange with CoinDesk following the panel, Wright stated that he felt Santori was simply ignoring the law.[106] In pointing the reader to the natural resources cases, the Whitepaper is at best misunderstanding a line of case precedent, and at worst highlighting a way in which this line of legal precedent does not apply to the SAFT framework.[107] The White-

---

[100] Felsenthal & Overall, *supra* note 94 ("[T]he investor had 'entrust[ed] the promoters with both the work and the expertise to make the tangible profit pay off.' As discussed above, these are the sort of services that issuers of SAFTs are expected to render . . . .").

[101] *Id*.

[102] *Id.* ("Without the issuer's *indispensable* efforts to build a network on which the tokens can be used and defeating competition, the tokens would be completely worthless . . . .").

[103] Brady Dale, *Are Tokens Like Gold? Attorneys Ask Tough Questions on ICOs*, COINDESK (Nov. 25, 2017, 12:00 PM), https://www.coindesk.com/icos-saft-cftc-sec-cardozo/ [https://perma.cc/UK9K-WK9N].

[104] *Id.*

[105] *Id*.

[106] *Id.* ("In a conversation with CoinDesk afterwards, he said, 'That's the law.'").

[107] CARDOZO BLOCKCHAIN PROJECT, *supra* note 76, at 7 ("These cases simply do not support the broad statement found in the Whitepaper that it is 'unlikely' that post-functional utility tokens would be deemed a security.").

paper attempts to draw analogies between non-analogous products and ignores well established case law in the process.[108]

C. Timing and the Managerial Efforts of Others

The Whitepaper points to the timing of the ICO transaction in attempting to eschew securities regulations.[109] The Whitepaper states that while the creation of the functional token is in fact an essential effort, by the time that token is delivered to the investor, the essential component of that effort—the creation of the token and its supporting network—has come to an end.[110] If that essential portion has since come to a close, any ensuing profits therefore could not have been predominantly derived from the managerial efforts of others.[111] The problem with this argument is that it does not seem to have support in natural resource case law, as none of the decisions referenced by the Whitepaper speak to matters of timing, rather only to matters of managerial effort.[112] The natural resource cases relate to timing in the sense that they each deal with futures contracts, but the determining factor in each decision is how much effort was put in by management, to say nothing of when they put in that effort.[113]

The holding in *Life Partners* further cements the significance of matters of effort over timing.[114] While *Life Partners* discusses issuers' efforts in terms of pre- and post-purchase, the matter at hand is

---

[108] *Id.* at 7–8 (discussing case law by the Eleventh Circuit that rejects the distinction between the pre- and post-sale efforts of the seller).
[109] *See* SAFT Whitepaper, *supra* note 7, at 18 (describing how investors are exercising investment discretion as to the timing of the sale of their tokens).
[110] *Id.* at 9.
[111] *Id*.
[112] *See* CARDOZO BLOCKCHAIN PROJECT, *supra* note 76, at 7 ("At most, the Natural Resources Cases highlight the importance of seller's efforts, not their timing.").
[113] *See* SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. 1986) (finding that the ordinary efforts of a seller were not sufficient to create an investment contract); Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980) Noa v. Key Futures, Inc., 638 F.2d 77, 79 (9th Cir. 1980) (finding that where market fluctuations drove price on a secondary market it could not be held that managerial efforts were a predominant factor in the expectations of profits). Note that neither decision turned on matters of timing.
[114] *See* SEC v. Life Partners, 87 F.3d 536, 545 (D.C. Cir. 1996).

whether the post-purchase efforts were ministerial or material.[115] The case discusses the timing of issuer efforts primarily as a means of assessing the materiality of those efforts.[116] The case does not, however, establish a concrete timing distinction as is invented by the Whitepaper.[117] Attorneys Felsenthal and Overall are clear in stating that this timing distinction as it relates to the managerial efforts of others simply does not exist, as "[t]he overwhelming weight of authority holds that there is no such pre- and post-issuance distinction for *Howey* 'efforts of others' purposes."[118]

Further, it would be a bit ridiculous to suggest that the efforts of the issuer in bringing this token into existence are not fundamental to the expectation of profits. It is the managerial efforts of the issuer in bringing the token and its underlying platform to life that creates any token value in the first place.[119] While the Whitepaper suggests that all material issuer efforts are over once the token is created, the case law does not support this.[120] The Whitepaper states, "[i]t would be difficult to argue that any improvement on an already-functional token is an 'essential' managerial effort."[121] However, the court in *McCown v. Heidler* specifically stated that improvements promised by issuers speak to the value of an instrument and as such can satisfy the efforts-of-others prong.[122] The investor's initial decision to purchase the SAFT is entirely dependent on the issuer's representation as to its ability to create the token and the underlying network and to grow and

---

[115] *Id.* ("[W]e turn first to the distinction between those post-purchase functions that are entrepreneurial and those that are ministerial; thereafter, we consider the relevance of pre-purchase entrepreneurial services.").
[116] *Id.*
[117] SAFT Whitepaper, *supra* note 7, at 9.
[118] Felsenthal & Overall, *supra* note 94, at 7.
[119] *Id*. at 10 ("Without the issuer's indispensable efforts to build a network on which the tokens can be used and defeating competition, the tokens would be completely worthless. . . .").
[120] *Id.* (arguing that there is no support in securities jurisprudence for distinguishing between an issuer's pre-utility-token issuance and post-utility-token-issuance efforts).
[121] SAFT Whitepaper, *supra* note 7, at 9.
[122] 527 F.2d 204, 211 (1975) ("We note that without the substantial improvements pledged by Heidler Corporation and Timberlake the lots would not have a value consistent with the price which purchasers paid . . . . [A]n investor who purchased a Timberlake lot . . . could be relying upon the managerial efforts of Heidler Corporation and Timberlake for the management and appreciation of the investment.").

appreciate the value of that token.[123] As such, any expectation of profits surely follows from these managerial efforts.[124]

While the SAFT Whitepaper does posit several legally-grounded reasons that their four-step process eschews the *Howey* test, they present these reasons by misapplying and misrepresenting the legal precedent from which they are attempting to draw.[125] By pointing only to select portions of cases at the expense of the overall legal whole, the SAFT Project has managed to put forth a dangerously misleading legal analysis.[126] The Whitepaper, if followed, has the potential to induce an unknowing issuer to commit securities regulation violations, for which they will be held liable.

IV. Current SEC Perspective

Part of the danger of the misleading Whitepaper as detailed above is that there is currently a dearth of SEC guidance upon which issuers or investors could otherwise educate themselves on the legal perspectives as to what constitutes a properly conducted ICO.[127] SEC has yet to comment on the Whitepaper, despite it being widely read and discussed by legal critics and academics.[128] Without SEC commentary on the matter, investors and issuers are left to their own devices in determining what they think is the legal significance of the

---

[123] Felsenthal & Overall, *supra* note 94, at 10–11.

[124] *Id.* at 8 ("Any value that the utility tokens have, before a network on which they can be used exists, can only be value that is derived from speculative expectations investors have that the issuer will later be successful in building a network . . . . This is a purely speculative investment motive . . . [dependent] on an assessment of the issuer's management team.").

[125] CARDOZO BLOCKCHAIN PROJECT, *supra* note 76, at 9 ("[T]he Whitepaper has no meaningful legal support for its broad conclusion . . . [T]he Whitepaper's analytical approach faces significant legal hurdles.").

[126] *Id.* at 6 ("[T]he Whitepaper's rationale has sparse and controversial legal support.").

[127] Popper, *supra* note 19 (describing the current state of the ICO market as that of a gold rush in which an investor is encouraged to dive right in to investing because of the real and perceived lack of government regulatory control).

[128] Vinokourov, *supra* note 38 ("However there is one fundamental flaw, and that is the fact that the SEC is yet to officially confirm this approach avoids securities classification.").

Whitepaper—a job for which they are unlikely to be properly equipped.[129]

Part of the problem in failing to issue concrete guidance on the legality or proper structure of an ICO is that no two are alike.[130] If the SEC were to opine on the illegality of one ICO, it would simply be ruling out one specific variant of a SAFT offering.[131] Such a measure would allow issuers to amend and reshape the nature of their own offering to meet newly established views on legality, but would fail to provide a concrete framework by which the issuer would be able to determine with certainty that their ICO was in fact legally protected.[132]

While failing to keep regulatory pace on matters as related to ICOs, the SEC has begun taking steps to close the regulatory gap.[133]

A. SEC Probe

The Wall Street Journal reported in February 2018 that the SEC had issued "dozens of subpoenas and information requests" to companies involved in the burgeoning cryptocurrency market.[134] The probe was formulated as a response to the admitted lack of control in the cryptocurrency market in conjunction with a suggestion that securities regulators are aware that many ICOs are violating securities laws.[135] Specifically, the SEC is concerned with ICOs since they are not currently being governed with the same rigidity as their public

---

[129] *Id.* ("Now, we have self-proclaimed lawyers coming up with frameworks that have no legal basis and are at the very least subject to very dubious interpretations.").

[130] Brady Dale, *What If the SEC Is Going After SAFT?*, COINDESK (Mar. 6, 2018, 5:00 AM), https://www.coindesk.com/sec-going-saft/ [https://perma.cc/7F6V-NHN3] (quoting Jerry Brito of Coin Center: "'A SAFT isn't a thing. They're all going to be different,' because each one is going to be written a little differently by different attorneys.").

[131] *Id.* ("'A court looking at a particular offering would never say that the SAFT is broken,' Brito explained. It would only ever make a judgement about that particular instrument.'").

[132] *Id.*

[133] Jean Eaglesham and Paul Vigna, *Cryptocurrency Firms Targeted in SEC Probe*, WALL ST. J. (Feb. 28, 2018), https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266 (highlighting the SEC's inability to keep pace with ICOs and token sales despite the "handful" of enforcement actions it has brought).

[134] *Id.*

[135] *Id.*

offering counterparts.[136] Across the industry the results of these subpoenas have largely not yet been felt.[137] However, the SEC has seemingly put the SAFT framework under the microscope, as they fear the framework has led to several unchecked securities violations.[138] Discussing the effects of the SEC probe, an informed, though unnamed, source put it more bluntly, stating: "The SEC is targeting SAFTs."[139] With another unnamed attorney adding: "If I were consulting for token companies, I would be terrified."[140]

As 2018 progressed, the SEC instituted a second wave of subpoenas requesting further information from those issuers initially subpoenaed as well as adding several new issuers to the already expansive list of subpoenaed companies.[141] That wave of subpoenas concentrated on those issuers that failed to properly place their offerings within one of the SEC's espoused regulatory exemptions.[142] From the perspective of investors, it is important to remember the mission by which the SEC conducts itself.[143] The SEC is concerned first and foremost with investor protection.[144] That is, any remedial action that is to come as a result of the SEC probes will likely take great strides to insure a return of capital to investors.[145] These probes appear to be far more concerned with the potential misconduct of

---

[136] *Id.* ("The wave of subpoenas includes demands for information about the structure for sales and pre-sales of the ICOs, which aren't bound by the same rigorous rules that govern public offerings . . . .").
[137] *Id.* ("[The SEC's] warnings have failed to chill the booming market for digital tokens.").
[138] *Id*.
[139] Dale, *supra* note 130.
[140] *Id*.
[141] Daniel Roberts, *SEC Tightens the Noose on ICO-Funded Startups*, YAHOO! FIN. (Oct. 10, 2018), https://finance.yahoo.com/news/sec-tightens-noose-ico-funded-startups-145827742.html [https://perma.cc/778V-E6JJ] ("The SEC sent out a slew of initial information-seeking subpoenas at the start of 2018. Now the agency has returned to many of those companies, and subpoenaed many more . . .").
[142] *Id.* ("[F]ocusing on those that failed to properly ensure they sold their token exclusively to accredited investors.").
[143] *What We Do*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/Article/whatwedo.html [https://perma.cc/3KUG-57DD] (last visited Mar. 28, 2019).
[144] Dale, *supra* note 130.
[145] *Id.*

issuers in the wake of the Munchee order (detailed below).[146] It is possible that the subpoenas are aimed simply at establishing a deeper understanding of the ICO industry, but it is equally as likely that the SEC is attempting to determine which token issuers have been conducting securities violations as in the Munchee case.[147] In light of the probes, it is highly unlikely that the SEC will come out and invalidate the SAFT methodology in its entirety.[148] Rather, the results of these probes will at best provide guidance by which issuers and investors alike can measure the similarities of their intended ICO in order to take an educated guess at its legality.[149] As a result of the ambiguity as to the legal status of the SAFT framework, certain issuers have already begun to abandon the methodology in favor of investment options that offer more secure legal protections.[150] Where the bounds of the law are not clear, issuers are opting for avenues that are less likely to lead them to accidental violations of securities laws.

B. SEC Cyber Unit and Crypto Czar

Pursuant to a release issued on September 25, 2017, the SEC has put into force a new "Cyber Unit."[151] Among the tasks enumerated

---

[146] *Id.*

[147] *Id.* ("It's unknown if the SEC is simply trying to get a handle on the industry, or if it's interested in something more specific, like what kinds of token sales have launched since the agency halted the multi-million dollar Munchee ICO in December.").

[148] *Id*.

[149] *Id.* ("The best an existing project could do is look at the outcome of one case and ask themselves how much their own offering resembles it.").

[150] *See* Anthony Zeoli, *Initial Coin Offerings: Why the SAFT is DEAD…*, CROWDFUND INSIDER (Mar. 26, 2018, 2:33 PM), https://www.crowdfundinsider.com/2018/03/131044-initial-coin-offerings-why-the-saft-is-dead/ [https://perma.cc/3BWZ-WX2S] ("Moreover I know that StartEngine has abandoned the SAFT and is working on its own SEC compliant investment vehicle. Per Howard Marks of StartEngine, 'the SAFT was a promising idea but failed to offer protections for investors.'").

[151] Press Release, Sec. & Exch. Comm'n, SEC Announces Enforcement Initiative to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), https://www.sec.gov/news/press-release/2017-176) [https://perma.cc/H5WJ-3FTC] (announcing the creation of "a Cyber Unit that will focus on targeting cyber-related misconduct and the establishment of a retail strategy task force that will implement initiatives that directly affect retail investors reflect SEC Chairman Jay Clayton's priorities in these important areas").

in the release as falling under the purview of the new Cyber Unit is "targeting cyber related misconduct such as . . . violations involving distributed ledger technology and initial coin offerings."[152] It will be the responsibility of the Cyber Unit to protect inexperienced investors from what many skeptics view as a predatory ICO market.[153] In another move aimed at showing that the SEC is serious about taking regulatory control of the crypto-currency market, the Commission promoted Valerie Szczepniak to the role of senior advisor for digital assets, colloquially known as the Crypto Czar.[154] Specifically, Szczepniak's new role at the SEC will encapsulate ICOs and the way securities laws are applied to them.[155] Interestingly, she sees her role not as that of federal securities regulation enforcer, but rather as that of a regulatory guide to ICO issuers.[156] It is her goal to speak with ICO issuers in coming together to form solutions that work for both parties.[157] Her concern—as is the SEC's—is that ICO issuers are playing too fast and loose with billions of dollars of investor money without providing the proper protections for investor safety.[158] That said, she views the ICO market as a welcome new means of raising capital so long as the ICO issuers are willing to provide proper investor protections.[159] While most ICO investors and issuers have a negative view of

---

[152] *Id*.

[153] *See* Pete Rizzo, *New SEC Cyber Unit to Police ICOs and Other DLT Violations*, COINDESK (Sept. 26, 2017, 2:05 AM), https://www.coindesk.com/new-sec-cyber-unit-police-icos-dlt-violations/ [https://perma.cc/Z9N5-W659] ("Those words may come as welcome news to ICO skeptics who claim that many of these sales have preyed on unsophisticated consumers.").

[154] Stan Higgins, *The SEC Just Appointed Its First-Ever Crypto Czar,* COINDESK*,* (June 4, 2018), https://www.coindesk.com/sec-just-appointed-first-ever-crypto-czar/ [https://perma.cc/5GHL-YT6V].

[155] *Id.*

[156] Jeff John Roberts, *SEC's 'Crypto Czar' Says Smart Contracts Can Help Regulation*, FORTUNE (June 7, 2018), http://fortune.com/2018/06/07/valerie-szczepanik-sec/ [https://perma.cc/VN7S-86D7].

[157] *Id*. ("'We never turn down a request for a meeting. We've met dozens and dozens of entrepreneurs and lawyers,' she said. 'We're not going to do the innovating for people. But we want people to come in and propose solutions they want to accomplish.'").

[158] Benjamin Bain & Matt Robinson, *SEC's New Crypto Czar Wants Coin Industry to Step Out of Shadows*, BLOOMBERG (July 30, 2018, 8:15 AM), https://www.bloomberg.com/news/articles/2018-07-30/jiujitsu-is-easy-to-sec-crypto-czar-rapport-with-coinsters-hard ("[B]illions of dollars are pouring into largely unregulated tokens each month.").

[159] *Id*.

government regulation,[160] Szczepniak is aiming to work with issuers to create a forum in which ICOs can thrive.

As discussed in greater detail below, in perhaps the SEC's most informative showing to date, the Cyber Unit was responsible for issuing a cease and desist order to, and ultimately reaching a settlement with, ICO issuer Munchee.[161]

V. The Munchee ICO and the SEC's Response

While the SEC has not yet issued a blanket ruling on ICOs and the use of SAFT, the cease and desist order handed down by the Commission to Munchee works to provide the clearest articulation of the Commission's stance on ICOs to date.[162] As follows, a review of the facts of the Munchee offering, an analysis of the SEC's legal conclusions in its cease and desist order, and a legal examination drawing comparisons to the espoused SAFT framework will operate to give us the clearest possible picture on where the SEC stands on the use of SAFTs.

A. Facts

Released on to the iPhone app store in 2017, Munchee was an app that allowed users to take pictures of and review meals at restaurants.[163] In conjunction with a plan to make subsequent improvements to the app in the years following its initial release, Munchee developed a plan to raise capital through an ICO of their own

---

[160] *Id.*

[161] Stan Higgins, *SEC Halts Multimillion-Dollar 'Munchee' ICO for Securities Violations*, COINDESK (Dec. 11, 2017, 4:40 PM), https://www.coindesk.com/sec-halts-multimillion-dollar-munchee-ico-securities-violations/ [https://perma.cc/KV6Q-A2D6] ("The development represents the latest high-profile move by the agency to regulate initial coin offerings, ... [T]oday's order resulted from an investigation by the SEC's Cyber Unit.").

[162] Katherine Cooper, *SEC Munchee Order a Recipe for Securities Violations*, COINDESK (Dec. 22, 2017, 1:10 PM), https://www.coindesk.com/secs-munchee-order-recipe-securities-law-violations/ [https://perma.cc/VK2Z-GUSR].

[163] Munchee, Inc., Exchange Act Release No. 33-10445 (Dec. 11, 2017) (stating that Munchee is a California business that created an app (the "Munchee App") for use with iPhones and launched the app in the second quarter of 217).

issuance.[164] This plan involved raising $15 million dollars through the creation of 500 million "Mun Tokens" to be issued on the Ethereum blockchain and ultimately to be redeemable for certain products and services within the app itself.[165]

The ICO was announced via whitepaper on October 1, 2017.[166] The whitepaper included several key details about the offering process, including the way the raised capital was to be employed, the proposed means for growing the value of the Mun Token, the creation, maintenance, and ability to trade upon secondary markets, and the intended purchasing audience for the Mun Token.[167] The raised capital was to be used primarily, but not entirely, in order to hire employees capable of running the Mun Token platform.[168] The plan to grow the value of the Mun Token took up an outsized amount of the whitepaper and listed several means by which the Mun Token could be expected to grow in value.[169] One of these was the ultimate reduction of supply.[170] The creation of the secondary market was essential for the plan of continued Mun Token growth.[171] Finally, Munchee's intended investor audience were those with a penchant for investing in digital tokens and those who were likely to invest with an eye toward future profits and not with an eye toward eventual utilization of the Mun Tokens.[172]

Interestingly, the whitepaper claimed to have conducted a *Howey* analysis after which they determined that no securities laws would be implicated; however, they did not include any of this analysis in the whitepaper itself.[173] Also important to our understanding and ultimate SAFT analysis was Munchee's goal of creating a Mun Token redeemable for goods and services (a utility token), but during the offering period no purchaser was able to utilize the Mun Token in such

---

[164] *Id*. at 2.
[165] *Id*.
[166] *Id*.
[167] *Id*.
[168] *Id*.
[169] *Id*. ("In the MUN White Paper, on the Munchee Website and elsewhere, Munchee and its agents further emphasized that the company would run its business in ways that would cause MUN tokens to rise in value.").
[170] *Id*.
[171] *Id*. at 2–4 (explaining the different ways MUN will be used on secondary markets).
[172] *Id*. at 6.
[173] *Id*. at 8.

a way.[174] On October 31, 2017, Munchee began selling Mun Tokens to investors and on November 1, 2017, after being contacted by the SEC, Munchee stopped selling Mun Tokens and promptly returned all proceeds to investors, about $60,000 to forty investors.[175]

B. SEC Legal Conclusions; "The Mun Tokens Were Securities"[176]

The SEC utilized the *Howey* test understanding of Section 2(a)(1) in concluding that the Mun Tokens were investment contracts and, ergo, they were securities.[177] The cease and desist order quoted from the *Howey, Tcherepnin*, and *Forman* cases to make the point that the *Howey* analysis is intended to be conducted as a fluid and ever changing test with the sole aim of getting to the truth of a transaction, rather than abiding blindly by the details of name and form in allowing schemes to deceive investors.[178]

In concocting its own *Howey* analysis, the SEC reasoned that investors paid Ether or Bitcoin, which was sufficient monetary contribution to satisfy the first prong of the test, the investment of money.[179] Further, this was clearly a common enterprise (prong two),[180] and the SEC did not delve into that matter.[181] Mun Tokens were designed to appreciate in value through growth of the Mun Token ecosystem, and for that reason, among others, the SEC stated that investors could reasonably expect to have collected profits from

---

[174] *Id*. at 4 (explaining that the tokens were meant to be used in this manner but no token holders were ever able to).
[175] *Id*. at 7–8 (stating the SEC halted trading and Munchee had to return $60,000).
[176] *Id*. at 8.
[177] *Id*. at 2 ("MUN tokens were securities pursuant to Section 2(a)(1) of the Securities Act.").
[178] *Id*. at 8.
[179] *Id*. ("Investors paid Ether or Bitcoin to purchase their MUN tokens. Such investment is the type of contribution of value that can create an investment contract.").
[180] SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) ("In other words, an investment contract for purposes of the Securities Act means a contract, transaction *299 or scheme whereby a person invests his money in a common enterprise and is led to expect profits.").
[181] Press Release, *supra* note 151 (failing to discuss the analysis on whether or not Munchee was a common enterprise).

their Mun Token investment.[182] The last prong of the *Howey* test, and the one upon which the SAFT framework is primarily based, is whether the profits are created based on the significant efforts of the managers (issuers here).[183] The SEC answered this question with a resounding yes in the Munchee matter.[184] The commission reasoned that Munchee's efforts in creating and managing the app upon which the Mun Token was premised, in creating and maintaining the secondary market and in taking precautions to make sure the value of the Mun token appreciates were all sufficient to find that Munchee's managerial efforts predominated in influence over the expectation of profits.[185]

As a result of the SEC's finding that the Mun Token was a security, the SEC also inevitably found that Munchee violated Sections 5(a) and 5(c) of the Securities Act in offering to sell and ultimately selling a security without properly filed registration statements.[186] No civil penalty was assessed because of the near immediate remedial action taken by Munchee.[187]

C. What Does the Munchee Cease and Desist Order Mean for SAFTs?

As an attorney writing for CoinDesk, Katherine Cooper considers the Munchee order to be the clearest picture of how the SEC plans on handling ICOs including SAFTs that we've seen to date.[188] Similarly, David Felsenthal and Jessee Overall—also attorneys—writing for *Crowdfund Insider* state that the Munchee order likely points to the conclusion that SAFTs are for multiple reasons not securities laws compliant.[189] Both attorney-written articles aim to take the exact language of the order and extrapolate as to what said language would mean for the SAFT framework.

---

[182] Munchee, Inc., *supra* note 163, at 8. ("The investors reasonably expected they would profit from any rise in the value of MUN tokens created by the revised Munchee app and by Munchee's ability to create an 'ecosystem.'").
[183] *Id*.
[184] *Id*. at 9.
[185] *Id*. at 9.
[186] *Id*. at 10 (explaining that Munchee also violated 5(a) and 5(c)).
[187] *Id*. (observing that no civil penalty was assessed against Munchee).
[188] Cooper, *supra* note 162.
[189] *See* Felsenthal & Overall, *supra* note 94 (finding that in light of the SEC's Munchee enforcement action that SAFT's efforts of other argument falls short and does not preclude utility tokens from existing as securities).

1. Immediate Usability

The first of Cooper's six points regarding the Munchee order's influence on ICOs directly undermines the crux of the SAFT framework's argument stating that immediate usability does not ensure a utility token will not be a security.[190] The SAFT framework rests heavily on the assumption that the immediate usability of a utility token leans strongly in the direction of preventing that token from being a security.[191] Simply put, the assumption is that if a token has immediate usefulness, it is a utility token and not a security. In the order, the SEC explicitly denied this assumption, stating: "Even if MUN Tokens had a practical use at the time of offering, it would not preclude the token from being a security."[192] Even though the Munchee Tokens had no immediate usefulness, the SEC went out of its way in the Munchee order to state that even if they had been useful (like utility tokens) that would have little to no bearing on their status as securities.[193] Rather, their status as securities would depend on the circumstance of the offering.[194] The Munchee order serves to undermine one of the primary assumptions underlying the entirety of the SAFT framework—the assumption that the usefulness of a utility tokens places it firmly outside regulation as a security, a huge blow to SAFTs goal of circumventing federal securities laws.

2. Investment Intent

Felsensthal and Overall argue that one of the SEC's main points in the Munchee order was that where tokens are advertised to investors outside of the industry in which the token will be useful (in this case, the restaurant industry), the token cannot be said to be a utility token.[195] Cooper echoes this thought, stating that where the

---

[190] Cooper, *supra* note 162 ("The SEC cautioned against reasoning that if a token is immediately usable that is a strong factor for it not to be a security.").
[191] SAFT Whitepaper, *supra* note 7, at 2.
[192] Munchee, Inc., *supra* note 163, at 9.
[193] *Id*. at 9.
[194] Cooper, *supra* note 162. ("Even immediately usable tokens can be securities, depending on all the facts and circumstances of the ICO.").
[195] Felsenthal & Overall, *supra* note 94 ("First, the SEC argued they effectively were not bona fide utility tokens, because they were not marketed to person in the restaurant industry.").

Munchee whitepaper advised investors that they stood to profit from the passive holding of the Mun Token, rather than active use within the app of the token, said token could not be a utility token.[196] Passive possession with an eye toward token appreciation is akin to the intent of an investor rather than a user.[197] Seeing as the SEC stated that they are concerned with the underlying economic reality of a transaction,[198] the investment intent of the issuer and purchaser are sure to weigh most heavily.[199]

3. Managerial Efforts

Here, SAFT's reliance on the timing of the managerial efforts starts to pull apart. As previously stated, the SAFT framework relies on a timing technicality in separating the expectation of profits from the managerial efforts of the issuers as espoused by the third and fourth prongs of the *Howey* test.[200] The SAFT framework assumes that if the token is delivered after the issuer has fully completed the creation of the underlying network, then the issuer has ceased the application of their efforts and the expectation of profits is no longer predominated by such managerial effort.[201] As stated above, the legal support for the assertion is weak. Further, however, Felsenthal and Overall argue that the Munchee cease and desist enforcement order actually serves as an explicit statement by the SEC denying the validity of that assumption.[202]

Felsenthal and Overall argue that it is not the timing of the managerial effort—as the SAFT framework argues—that determines whether these efforts predominate over the expectation of profits, but

---

[196] Cooper, *supra* note 162.
[197] *Id*.
[198] Munchee, Inc., *supra* note 163, at 8 (stating that the underlying purpose of the transaction is more important than the label when determining whether a utility-token is a security).
[199] Felsenthal & Overall, *supra* note 94 (arguing that where an issuer advertises expected profits to come from passive possession of the token, rather than an active use, the investment intent inherent in the token predominates).
[200] SAFT Whitepaper, *supra* note 7 (stating the SAFT project's view that timing of delivery may minimize the "efforts of others" prong of *Howey*).
[201] *Id*.
[202] *See generally* Felsenthal & Overall, *supra* note 94.

rather the significance of the effort to the overall network.[203] Their article explains:

> [T]he key factor in creating the conditions necessary for demand to rise in the first place… was due to the issuer's managerial and entrepreneurial efforts. In the SEC's view, the issuer's role setting up the ecosystem could possibly be enough by itself, notwithstanding the tokens' marketing, to satisfy the 'efforts of other' prong of the *Howey* test and thus independently cause the tokens to be securities.[204]

The point here is simple. While it may be true that the issuer is delivering tokens after the efforts needed to create the network have since ceased, the efforts needed to create the token and the network in the first place are quite clearly the efforts predominating over the expectation of profits.[205] While SAFT exalts details of timing as a shield from the *Howey* test, the SEC—via the Munchee order—is far more likely to look at the big picture holding that the managerial effort needed to create the token and the network is the managerial effort which predominated over the expectation of profits.[206]

There is also an argument that the confidence of the investor is based upon the experience and ability of the issuer in both creating the token and the businesses and networks upon which it is premised.[207] Where the investor is choosing to make the investment relying upon the issuer's ability to create the token and platform, it would be hard to argue that the investor's expectation of profits is primarily reliant upon anything other than the managerial efforts of the issuer.[208]

---

[203] *Id.*
[204] *Id*.
[205] *Id*. ([“E]ven if they had been bona fide utility tokens, the expectation of profits likely would have stemmed from the issuer's managerial and entrepreneurial efforts in hiring persons to design and write the network's code . . . .”).
[206] *Id*.
[207] *Id*. (“Any value that the utility tokens have, before a network on which they can be used exists, can only be value that is derived from speculative expectations investors have that the issuer will later be successful in building a network that doesn't currently exist and *won't* and *can't* exist except through the issuer's entrepreneurial activity.”).
[208] *See id*.

Overall, while the Munchee order does not specifically outlaw the use of the SAFT framework to evade securities law, it does weigh heavily against its legal use.[209] Felsenthal and Overall said it best, stating "existing law does not appear to allow SAFTs, or their later-issued utility tokens, to escape regulation as securities or compliance with securities laws."[210]

VI. Conclusion

Starting first by introducing the sheer magnitude of the current ICO market, this note aimed to introduce the Simple Agreement for Future Tokens, to explain the legal machinations by which that methodology sought to avoid federal securities regulation, to critique the legal reasoning of that methodology and to provide insight into the response from the SEC as currently formulated.[211]

The SAFT methodology as espoused purports to create a fully usable utility token capable of issuance outside the purview of SEC regulation.[212] The key to this four-step process involved detailed matters of timing and the status of the utility token as fully usable upon delivery.[213] It is the belief of the SAFT Project that by delivering this fully usable digital token after the managers have dispensed with their key efforts in creating it that said token will escape status as a security by failing the *Howey* test.[214] As this note has laid out in detail, these arguments of timing as pertaining to managerial efforts simply do not have a solid backing in established case law. On the contrary, established case law points to a flexible system in which a financial instrument will be taken and adjudicated based upon the economic reality of the situation rather than details such as labeling and timing.[215]

While Congress has not passed pertinent legislation, nor has the SEC created explicit regulation indicating how issuers are to conduct ICOs, certain actions by the SEC have made relatively clear

---

[209] Felsenthal & Overall, *supra* note 94.
[210] *Id*.
[211] *See* Popper, *supra* note 1.
[212] SAFT Whitepaper, *supra* note 7.
[213] *Id*.
[214] *Id*.
[215] *See generally* Felsenthal & Overall, *supra* note 94; Munchee, *supra* note 163.

where it stands on the matter.[216] The creation of a Crypto Czar as well as a Cyber Unit tasked with monitoring ICOs makes clear that the SEC is aware that ICOs have created a regulatory problem and are actively seeking to fix it.[217] Further, the Munchee cease and desist order produced by the SEC Cyber Unit includes strong language indicating that the SAFT methodology is unlikely to skirt securities laws the way the SAFT Project had anticipated.[218] Specifically, the statement that a fully usable token will not preclude said token from being a security weighs fairly heavily against the SAFT methodology.[219] Further, the Munchee order implies that the creation of the network upon which the utility token is based may be a sufficient managerial effort to predominate over the expectations of investor profits thus establishing a security pursuant to the *Howey* test.[220]

Taking together the strength of the Munchee order with the comparative legal weakness of the Whitepaper, this note arguees that the SAFT framework is not SEC regulation-compliant. Any issuers and/or investors who follows the SAFT methodology are likely to find themselves on the wrong side of a Section 5 securities violation. As attorney Anthony Zeoli put astutely, "the SAFT is simply not an SEC compliant method for privately selling interest in cryptocurrency assets."[221]

However, there may be change on the horizon. In late September 2018, Congressman Warren Davidson hosted an event entitled "Legislating Certainty for Cryptocurrencies."[222] The goal of the event was to bring industry representatives to Washington, D.C. to discuss legislation that can be enacted to best help the ICO industry.[223] Industry representatives shared their concerns as to the currently ambiguous state of the ICO marketplace.[224] Among these industry

---

[216] *See, e.g.*, Roberts, *supra* note 141.
[217] *See, e.g.*, Higgins, *supra* note 154.
[218] *Id*.
[219] *Id.*
[220] Cooper, *supra* note 162.
[221] Zeoli, *supra* note 150.
[222] Nikhilesh De, *A Major Regulatory Effort is Brewing to Revive the US ICO Market*, COINDESK (Sept. 25, 2018, 8:30 PM), https://www.coindesk.com/a-major-regulatory-effort-is-brewing-to-revive-the-us-ico-market [https://perma.cc/G5NS-SN4T].
[223] *Id.* ("[D]iscussion to solicit input from the industry on these very points. A spokesperson for the lawmaker told CoinDesk that Warren intends to introduce 'light touch' legislation sometime within the next three weeks.").
[224] *Id*.

representatives was SAFT Project leader Marco Santori.[225] Santori himself conceded that the SAFT framework was not a workable long term solution, stating "for those of us who were involved in the early project, I think we all realized it was not an ideal solution. As Coin Center put it, it was the symptom of regulatory uncertainty. It was not the best we can do. It was the best we could do."[226] If Congressman Davidson's event and the legislation he aims to enact are successful in establishing steadfast guidance for the ICO industry, the legal ambiguity and regulatory pitfalls inherent in the SAFT framework may soon be a thing of the past, standing to greatly benefit investors and issuers alike. Until legislation can provide safe guidance, users of the SAFT framework run the risk of committing serious securities regulation violations.

[225] *Id.* (describing the SAFT project as a "symptom of regulatory uncertainty").
[226] *Id.*