

TOKEN WARS: HOW THE SEC CAN LEARN TO EMBRACE UTILITY TOKENS

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ABSTRACT

Tired of the power that mega platforms wield over the web, a growing chorus of internet users has hailed the arrival of blockchain technology, believing it can be used to build a new internet. Called “Web 3.0” by some, the new internet would allow users to exchange goods and services—digital currencies, cloud computing power, data storage—without needing a central intermediary to validate transactions. Instead, users would transact through decentralized platforms that use consensus-based mechanisms to verify users’ exchanges. And rather than rely on fiat money, users would use the platforms’ native currencies, called “utility tokens,” as the media of exchange.

Utility tokens also serve another purpose. Because rebuilding the internet is a costly endeavor, the groups developing decentralized platforms have turned toward selling utility tokens to fundraise their efforts. However, the issuance of utility tokens has caught the eye of the Securities and Exchange Commission (“SEC”)—the federal agency in charge of enforcing the nation’s securities laws—which has asserted its authority over utility token issuances. Unfortunately, the SEC’s oversight lacks transparency, and the agency’s rules do not protect investors against the risks they face in the digital economy. This Note calls for a bright-line test that would entitle issuers of utility tokens to a rebuttable presumption that the securities laws do not apply to sales of the issuers’ utility tokens if their tokens meet each of the test’s factors. This Note also advocates for modernizing the Regulation D private placement exemption so that it can address the realities implicit in token

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purchases. The changes pushed by this Note aim to quell developers' uncertainty and foster the ingenuity behind Web 3.0.

INTRODUCTION

In November 2008, as the global economy fell into tumult,¹ an account under the name “Satoshi Nakamoto” sent an email to a cryptography mailing list about a project involving a peer-to-peer electronic cash system.² At the end of the email, Satoshi attached a white paper describing the technology in more detail.³ In the paper, Satoshi revealed a novel technology that would allow users to send digital currency to one another without needing a trusted third party to intermediate the transaction.⁴ Satoshi named the digital currency “Bitcoin.”⁵

Satoshi released the technology in January 2009,⁶ and, since then, Bitcoin has ballooned in popularity.⁷ Notably, as Bitcoin has gone mainstream, it has done so without a leader. Satoshi last posted on a

1. See, e.g., Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Announces It Will Initiate a Program To Purchase the Direct Obligations of Housing-Related Government-Sponsored Enterprises and Mortgage-Backed Securities Backed by Fannie Mae, Freddie Mac, and Ginnie Mae (Nov. 25, 2008), <https://www.federalreserve.gov/newsevents/pressreleases/monetary20081125b.htm> [<https://perma.cc/JA9Y-DKP3>] (announcing a large-scale asset purchase program for mortgage-backed securities held by certain housing agencies); Deborah Solomon, Damian Paletta, Jon Hilsenrath & Aaron Lucchetti, *U.S. To Buy Stakes in Nation's Largest Banks*, WALL ST. J. (Oct. 14, 2008, 12:01 AM), <https://www.wsj.com/articles/SB122390023840728367> [<https://perma.cc/5FVU-94DC>] (announcing a \$250 billion injection of capital into the nation's largest banks by the United States government).

2. Posting of Satoshi Nakamoto, satoshi@vistomail.com, to cryptography@metzdowd.com (Nov. 1, 2008, 6:16 PM), <https://www.mail-archive.com/cryptography@metzdowd.com/msg09959.html> [<https://perma.cc/AR29-YDCM>].

3. *Id.*

4. See Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System 1 (2008) (unpublished manuscript), <https://bitcoin.org/bitcoin.pdf> [<https://perma.cc/WBC5-ZW2M>] (calling for “an electronic payment system based on cryptographic proof instead of trust, allowing any two . . . parties to transact directly . . . without the need for a trusted third party”).

5. Posting of Satoshi Nakamoto, satoshi@vistomail.com, to cryptography@metzdowd.com (Nov. 3, 2008, 2:45 PM), <https://www.mail-archive.com/cryptography@metzdowd.com/msg09967.html> [<https://perma.cc/6BV9-YLTL>].

6. Posting of Satoshi Nakamoto, satoshi@vistomail.com, to cryptography@metzdowd.com (Jan. 9, 2009, 8:05 PM), <https://www.mail-archive.com/cryptography@metzdowd.com/msg10142.html> [<https://perma.cc/D8AL-4DLH>].

7. As of August 4, 2022, a single Bitcoin was worth over \$22,000, the total supply of Bitcoin had reached nineteen million, and nearly \$10 billion worth of Bitcoin was traded every day. *Bitcoin*, COINDESK, <https://www.coindesk.com/price/bitcoin> [<https://perma.cc/Y7WB-DKSV>], (last updated Aug. 4, 2022, 3:33 PM).

forum created by the Bitcoin founder⁸ in December 2010.⁹ Satoshi then emailed early Bitcoin collaborators in 2011 and indicated that they were no longer working on Bitcoin.¹⁰ To this day, Satoshi's identity remains a mystery.¹¹

The Bitcoin network is an example of a decentralized platform using blockchain technology. No one has the power to unilaterally modify the code or alter the transaction log.¹² Instead, a community of

8. Bitcointalk is a forum founded by Satoshi and has historically been used by Bitcoin's founder and its users to share ideas about the currency. *Bitcoin Forums: A Beginners Guide on Where To Discuss BTC*, COINTELEGRAPH (2022), <https://cointelegraph.com/bitcoin-for-beginners/bitcoin-forums-a-beginners-guide-on-where-to-discuss-btc> [<https://perma.cc/Y5B8-J9CR>].

9. *Summary - Satoshi*, BITCOINTALK (2022), <https://bitcointalk.org/index.php?action=profile;u=3> [<https://perma.cc/T9Y5-MJY7>]. Satoshi's account on the P2P Foundation forum, one of the internet forums where Satoshi released the Bitcoin white paper, has been active three times since 2010. See Benedict George, *How Can Satoshi Nakamoto Have a Birthday? The Significance of April 5*, COINDESK (Aug. 5, 2022, 1:20 PM), <https://www.coindesk.com/learn/how-can-satoshi-nakamoto-have-a-birthday-the-significance-of-april-5> [<https://perma.cc/43S8-UVZT>]; Satoshi Nakamoto, Reply to *Bitcoin Open Source Implementation of P2P Currency*, P2P FOUND. (Mar. 7, 2014, 1:17 AM), <https://p2pfoundation.ning.com/forum/topics/bitcoin-open-source?commentId=2003008%3AComment%3A52186> [<https://perma.cc/3HY2-C8NM>] (“I am not Dorian Nakamoto.”); Marie Huillet, *‘Nour’ and a New Friend: Satoshi Nakamoto’s P2P Profile Makes New Post, Befriends User*, COINTELEGRAPH (Nov. 30, 2018), <https://cointelegraph.com/news/nour-and-a-new-friend-satoshi-nakamotos-p2p-profile-makes-new-post-befriends-user> [<https://perma.cc/74AE-QAPC>] (discussing a one-word status update by Satoshi's account); Satoshi Nakamoto, Reply to *Bitcoin Open Source Implementation of P2P Currency*, P2P FOUND. (Dec. 24, 2021, 12:28 PM), <https://p2pfoundation.ning.com/forum/topics/bitcoin-open-source?commentId=2003008%3AComment%3A169634> [<https://perma.cc/AFV8-LX8E>] (advertising a non-fungible token (“NFT”) purportedly minted by Satoshi). However, many doubt the authenticity of posts from Satoshi's account after 2014 because the email tied to the Satoshi account was hacked in November 2014. See Huillet, *supra* (“While the account is tied to Nakamoto's old email address . . . the same email was allegedly hacked in November 2014 . . .”).

10. Pete Rizzo, *10 Years Ago Today, Bitcoin Creator Satoshi Nakamoto Sent His Final Message*, FORBES (Apr. 26, 2021, 12:30 PM), <https://www.forbes.com/sites/peterizzo/2021/04/26/10-years-ago-today-bitcoin-creator-satoshi-nakamoto-sent-his-final-message> [<https://perma.cc/MBM4-QBFV>].

11. See Paul Vigna, *Who Is Bitcoin Creator Satoshi Nakamoto? What We Know—and Don't Know*, WALL ST. J. (Dec. 7, 2021, 2:27 PM) [hereinafter Vigna, *Who Is Bitcoin Creator*], <https://www.wsj.com/articles/who-is-bitcoin-creator-satoshi-nakamoto-what-we-know-and-dont-know-11638020231> [<https://perma.cc/ZL9T-5RQP>] (“Nakamoto remains a ghost.”).

12. See *Proof-of-Stake Vs. Proof-of-Work: Differences Explained*, COINTELEGRAPH (2022), <https://cointelegraph.com/blockchain-for-beginners/proof-of-stake-vs-proof-of-work:-differences-explained> [<https://perma.cc/5MMZ-9947>] (noting that “[b]ecause the machinery and power necessary to execute the hash functions [in a proof-of-work protocol] are expensive,” it is nearly “impossible for users to monopolize the network's processing capacity”).

users works together to improve the platform¹³ and validate transactions.¹⁴ For instance, whenever two users exchange Bitcoin, they submit their exchange to the network.¹⁵ Bitcoin “miners” (through a complex process called “proof of work”) then confirm that the user selling his or her Bitcoin has not already spent the Bitcoin elsewhere.¹⁶ Other decentralized platforms work similarly—they host a native currency that can be traded from one user to the next using blockchain technology. Where most decentralized platforms differ from Bitcoin is the value they assign to their currency. A Bitcoin does not grant its holder any special privileges or rights.¹⁷ In contrast, most decentralized platforms assign a value to their native currency.¹⁸ Often, they issue their native currency as a “utility token,” which is redeemable for a certain good or service hosted by the platform.¹⁹

Utility tokens also serve another purpose—decentralized platforms can use them to finance their projects.²⁰ Many developers raise money for their projects through Initial Coin Offerings

13. See, e.g., *Bitcoin Improvement Proposals*, GITHUB (2022), <https://github.com/bitcoin/bips> [<https://perma.cc/43KW-AP4Y>] (listing various Bitcoin Improvement Proposals made by Bitcoin users that have been put up to a vote).

14. See Alyssa Hertig, *What Is Proof-of-Work?*, COINDESK (Mar. 9, 2022, 3:25 PM), <https://www.coindesk.com/learn/2020/12/16/what-is-proof-of-work> [<https://perma.cc/93Z6-AUPY>] (describing the proof-of-work algorithm used to maintain distributed ledgers).

15. See *What Is Proof of Work?*, COIN RIVET, <https://coinrivet.com/guides/altcoins/what-is-proof-of-work> [<https://perma.cc/QWA2-RU23>] (describing how users submit their transactions to a decentralized network for approval).

16. See *Proof-of-Stake Vs. Proof-of-Work: Differences Explained*, *supra* note 12 (discussing how proof of work prevents the double-spending of digital currencies).

17. See Ryan Haar, *Why Do Bitcoins Have Value?*, NEXTADVISOR (Apr. 19, 2022), <https://time.com/nextadvisor/investing/cryptocurrency/why-do-bitcoins-have-value> [<https://perma.cc/7H5N-CBCZ>] (contrasting Bitcoin with Ether, another cryptocurrency, and noting that Bitcoin acts as a “store of value”).

18. See, e.g., Hugo Benedetti, Christian Caceres & Luis Álvaro Abarzúa, *Utility Tokens 13–16* (Dec. 15, 2021) (unpublished manuscript), <https://ssrn.com/abstract=4088568> [<https://perma.cc/UR7D-ZTBB>] (listing platforms which have issued utility tokens that grant holders access to goods and services hosted by the platform).

19. See Samuel Häfner, *Blockchain Platform Design 2* (June 6, 2022) (unpublished manuscript), <https://ssrn.com/abstract=3954773> [<https://perma.cc/5W89-97GQ>] (“Blockchain platforms that issue so-called utility tokens have become significant drivers of innovation in the blockchain industry. Utility tokens are a form of cryptographic tokens whose primary purpose is to allow users to consume the platform’s services.”).

20. See *id.* (“[T]he platforms . . . use their tokens to . . . raise funds for maintenance and service development.”).

(“ICOs”).²¹ In an ICO, investors can purchase utility tokens before the decentralized platform has become operational.²² The investors bet that once the platform comes online, the token will increase in value.²³ Once extremely popular,²⁴ ICOs are now rare.²⁵ A major reason for the decline? The Securities and Exchange Commission (“SEC”).²⁶ The SEC considers most utility tokens to be securities and therefore views ICOs as a public offering of securities.²⁷ As a result, unless a

21. See Nate Crosser, Note, *Initial Coin Offerings as Investment Contracts: Are Blockchain Utility Tokens Securities?*, 67 KAN. L. REV. 379, 379 (2018) (“Initial Coin Offerings (ICOs) are the online sale of cryptographic assets used to launch a cryptocurrency, finance a blockchain application development project, or sell access to features of a blockchain application.”).

22. See Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and the Dilemmas of Securities Regulation*, 68 AM. U. L. REV. 69, 87 (2018) (noting that an “ICO is carried out” oftentimes before the creation of a decentralized platform has “been undertaken or even initiated”). Many take issue with using “ICO” to describe sales of tokens. See, e.g., Gideon Lichfield, *The Problem with ICOs Is that They’re Called ICOs*, MIT TECH. REV. (Apr. 23, 2018), <https://www.technologyreview.com/2018/04/23/143440/the-problem-with-icos-is-that-theyre-called-icos> [<https://perma.cc/67PV-ZRZU>] (critiquing how many platforms use “ICO”). As a result, many have abandoned use of the “ICO” moniker and instead use other phrases. See, e.g., David L. Concannon, Yvette D. Valdez & Stephen P. Wink, *The Yellow Brick Road for Consumer Tokens: The Path to SEC and CFTC Compliance: An Update*, in BLOCKCHAIN & CRYPTOCURRENCY REGULATION 64, 66–67 (Josias N. Dewey ed., 2d ed. 2020) (using “pre-functional consumer token sales” and “token presale instruments” to describe the ways that blockchain developers issue tokens to investors prior to completing the development of a platform). Despite the issues associated with using “ICO,” the term is the most succinct way to describe “pre-functional consumer token sales.” Therefore, while many no longer use the term, this Note will use “ICO” generally to describe “pre-functional consumer token sales” that are conducted through a variety of “token presale instruments.”

23. Cf. Azgad-Tromer, *supra* note 22, at 88 (comparing utility tokens to derivatives contracts).

24. See David Floyd, *\$6.3 Billion: 2018 ICO Funding Has Passed 2017’s Total*, COINDESK (Sept. 13, 2021, 3:50 AM), <https://www.coindesk.com/markets/2018/04/19/63-billion-2018-ico-funding-has-passed-2017s-total> [<https://perma.cc/GLH2-TTKQ>] (showing the exponential growth of ICOs from 2014 to 2018).

25. See Osato Avan-Nomayo, *Crypto Startups Still Raising Millions in Capital Despite ICO Decline*, COINTELEGRAPH (Aug. 7, 2019), <https://cointelegraph.com/news/crypto-startups-still-raising-millions-in-capital-despite-ico-decline> [<https://perma.cc/V54Q-DDQJ>] (noting the decline in sales from ICOs).

26. See *id.* (quoting the Chief Executive Officer of one crypto hedge fund who stated, “[T]he decline in interest in . . . ICO[s] is primarily associated with the strengthening positions of regulators in the market . . .”).

27. See Jay Clayton, Chairman, SEC, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11> [<https://perma.cc/54E7-84JX>] (noting that most ICOs should be registered with the SEC); Gary Gensler, Chair, SEC, Remarks Before the Aspen Security Forum (Aug. 3, 2021), <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03> [<https://perma.cc/YH4E-FAKG>] (claiming that “many tokens may be unregistered securities”). A bipartisan

decentralized platform registers its ICO with the SEC (or acts under a safe harbor that exempts the platform from having to register²⁸), the SEC can, and likely will, prosecute the platform for conducting an unregistered securities offering.²⁹ Part I of this Note further explains how the SEC determined that utility tokens are securities and has cracked down on ICOs.

This Note argues that the SEC's current approach to ICOs is flawed. The SEC primarily focuses on whether the ICO in question has passed the traditional hurdle of adequate disclosure and examines whether the ICO's issuer has given potential investors the information necessary to make an informed decision.³⁰ However, the SEC measures the adequacy of disclosure largely through regulations it adopted in 1982.³¹ The SEC has not adjusted its disclosure requirements for the

framework is emerging in Congress to give the Commodities Futures Trading Commission ("CFTC") jurisdiction over spot transactions involving cryptocurrencies. *See* Tory Newmyer, *A Senate Proposal Would Give CFTC Responsibility for Policing Bitcoin, Ethereum*, WASH. POST (Aug. 3, 2022, 6:00 AM), <https://www.washingtonpost.com/business/2022/08/03/stabenow-boozman-bitcoin-cftc-bill> [<https://perma.cc/CZV2-66PA>] (noting how two different bipartisan bills in the Senate would give the CFTC the power to regulate spot transactions of cryptocurrencies). However, the only two bipartisan bills introduced in the Senate recognize that the initial sale of a utility token can be a securities offering subject to regulation by the SEC. *See* Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. § 301 (2022) (acknowledging that some digital assets may be sold "through an arrangement or scheme that constitutes an investment contract, as that term is used in section 2(a)(1) of the Securities Act of 1933"); Digital Commodities Consumer Protection Act of 2022, S. 4760, 117th Cong. §§ 2(a)(7), 3(2) (granting the CFTC jurisdiction over trades involving a "digital commodity" but excluding "a security" from the definition of "digital commodity"); *see also infra* note 44 and accompanying text.

28. *See infra* note 38.

29. *See, e.g.*, Press Release, SEC, SEC Orders Blockchain Company To Pay \$24 Million Penalty for Unregistered ICO (Sept. 30, 2019), <https://www.sec.gov/news/press-release/2019-202> [<https://perma.cc/KX7Y-G4LF>] (reporting a \$24 million settlement with a "blockchain technology company . . . for conducting an unregistered initial coin offering"); Press Release, SEC, SEC Charges Issuer with Conducting \$100 Million Unregistered ICO (June 4, 2019) [hereinafter Kik Press Release], <https://www.sec.gov/news/press-release/2019-87> [<https://perma.cc/YX7G-NXLY>] (announcing charges against Kik Interactive Inc. for not registering its ICO).

30. *See* Azgad-Tromer, *supra* note 22, at 104–05 ("[A]n offer or sale of securities to the public must be accompanied by a full and fair disclosure, enabling potential purchasers to make an informed investment decision."). *See generally* Usha R. Rodrigues, *Embrace the SEC*, 61 WASH. U. J.L. & POL'Y 133, 137 (2020) (noting that "U.S. securities laws are disclosure-based").

31. *See* Adoption of Integrated Disclosure System, 47 Fed. Reg. 11380, 11387–93 (Mar. 16, 1982) (codified at 17 C.F.R. § 229 (2022)) (reorganizing and setting forth the provisions of Regulation S-K, which guide issuers on the information they must include in any registration statements). The SEC streamlined some of Regulation S-K's requirements in 2021, but it did not adopt any provisions that specifically addressed utility tokens or decentralized platforms. *See* Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial

realities faced by utility token purchasers, who, unlike typical financial investors, are not purchasing a financial stake in the platform.³² Moreover, the SEC has been far from a beacon of clarity. At least one official in the SEC has acknowledged in passing that securities laws may not apply to utility tokens issued by fully decentralized platforms.³³ But the SEC has not clarified when utility tokens may be exempt from securities regulations.³⁴ Instead, the SEC has relied on ex post enforcement actions³⁵ and issuer-specific no-action letters.³⁶ And the SEC has stuck by its case-by-case approach to utility tokens even

Information, 86 Fed. Reg. 2080, 2087 (Jan. 11, 2021) (codified at 17 C.F.R. § 229.303 (2022)) (announcing changes designed to “modernize, simplify, and enhance” the Management’s Discussion and Analysis section).

32. See Carol R. Goforth, *Cinderella’s Slipper: A Better Approach To Regulating Cryptoassets as Securities*, 17 HASTINGS BUS. L.J. 271, 302 (2021) [hereinafter Goforth, *Cinderella’s Slipper*] (explaining how current disclosure requirements may “have nothing to do with the primary risks for investors in tokens”).

33. See William Hinman, Dir., Div. of Corp. Fin., SEC, Digital Assets Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018) [hereinafter Hinman Speech], <https://www.sec.gov/news/speech/speech-hinman-061418> [<https://perma.cc/9NQS-R5U6>] (“[T]here may be . . . sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required.”).

34. See Public Statement, Hester M. Peirce & Elad L. Roisman, Comm’rs, SEC, In the Matter of Coinschedule (July 14, 2021), <https://www.sec.gov/news/public-statement/peirce-roisman-coinschedule> [<https://perma.cc/WB6C-CK3T>] (noting the “lack of clarity for market participants around the application of the securities laws to digital assets”).

35. See, e.g., Press Release, SEC, SEC Charges Ripple and Two Executives with Conducting \$1.3 Billion Unregistered Securities Offering (Dec. 20, 2020) [hereinafter Ripple Suit Press Release], <https://www.sec.gov/news/press-release/2020-338> [<https://perma.cc/8JEM-XC23>] (announcing charges against Ripple Labs Inc. for using an unregistered digital asset securities offering to fundraise over \$1.3 billion since 2013); Uulala, Inc., Litigation Release No. 25157, 2021 WL 3423778 (Aug. 4, 2021) (disclosing a settlement between the SEC and Uulala, Inc. for, in part, Uulala’s unregistered sale of digital assets); Kik Press Release, *supra* note 29 (charging Kik Interactive for selling prefunctional tokens).

36. See, e.g., TurnKey Jet, Inc., SEC Staff No-Action Letter, 2019 WL 1471132 (Apr. 3, 2019) [hereinafter TurnKey No-Action Letter] (allowing TurnKey to issue digital tokens without registering them with the SEC). No-action letters are a way for regulated entities to gain clarity from the SEC. See SEC, *No Action Letters*, INVESTOR.GOV, <https://www.investor.gov/introduction-investing/investing-basics/glossary/no-action-letters> [<https://perma.cc/4F3C-FJ2G>] (“An individual or entity who is not certain whether a particular product, service, or action would constitute a violation of the federal securities law may request a ‘no-action’ letter from the SEC staff.”). The process involves the regulated entity sending a letter to the SEC, describing the actions the entity is about to take, and allowing the SEC to opine on whether the SEC believes the action conforms with U.S. securities laws. *Id.* If the SEC believes that no securities laws will be violated, it can inform the entity that it will take no action against the entity. *Id.*

as a few Commissioners disagree with the piecemeal approach.³⁷ Part II of this Note further explains the issues with how the SEC enforces securities laws against decentralized platforms.

Numerous academics and researchers have proposed changes to the SEC's guidance. Some argue that the SEC should modify existing registration exemptions³⁸ to accommodate ICOs so that the large majority of ICOs do not have to be registered with the SEC.³⁹ Others prefer a regulatory overhaul that modifies the steps decentralized platforms and token holders take before selling utility tokens.⁴⁰ Still others think the SEC should back off entirely and either give platforms

37. Compare Caroline A. Crenshaw, Comm'r, SEC, Remarks at SEC Speaks (Oct. 12, 2021), <https://www.sec.gov/news/speech/crenshaw-sec-speaks-20211012> [<https://perma.cc/U5DG-AWDE>] (telling utility token issuers to “work with” the SEC and come to the SEC proactively with “detailed plans,” while acknowledging that doing so is not easy or costless), with Peirce & Roisman, *supra* note 34 (arguing that “[p]roviding guidance piecemeal through enforcement actions is not the best way to move forward”), and Hester M. Peirce, Comm'r, SEC, Statement on Settlement with BlockFi Lending LLC (Feb. 14, 2022) [hereinafter Peirce BlockFi Statement], <https://www.sec.gov/news/statement/peirce-blockfi-20220214> [<https://perma.cc/QB33-G424>] (“[W]e need to commit to working with these companies to craft sensible, timely, and achievable regulatory paths.”).

38. The SEC has implemented different regulations that allow issuers to sell their securities without filing a registration statement. See, e.g., 17 C.F.R. pt. 227 (2022) (describing a registration exemption for securities-based crowdfunding); §§ 230.147–230.147A (providing registration exemptions for intrastate offers and sales); §§ 230.251–230.263 (exempting certain public offerings and sales of securities from registration requirements); §§ 230.500–230.508 (exempting securities offerings made to accredited and sophisticated investors from registration requirements).

39. See, e.g., Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, 70 HASTINGS L.J. 463, 522 (2019) (arguing for a modified Regulation A for ICOs); Michael R. Meadows, Note, *The Evolution of Crowdfunding: Reconciling Crowdfunding with Initial Coin Offerings*, 30 LOY. CONSUMER L. REV. 272, 292 (2018) (advocating for the SEC to incorporate cryptocurrencies into the Regulation Crowdfunding regulations).

40. See, e.g., Goforth, *Cinderella's Slipper*, *supra* note 32, at 318–19 (proposing that Congress recognize cryptoassets as securities but also impose lower requirements on offerings involving cryptoassets); Brian MacNiven, Note, *Initial Coin Offerings: Striking a Balance Between Protecting Investors and Fostering Growth*, 14 RUTGERS BUS. L. REV. 1, 28 (2019) (describing a “modified securities” exemption for utility tokens).

time to sufficiently decentralize before subjecting them to securities regulations⁴¹ or let platforms self-regulate.⁴²

This Note proposes a different approach. First, this Note argues utility tokens hosted by insufficiently decentralized platforms should be subject to a modified Regulation D exemption,⁴³ which changes the existing Regulation D disclosure requirements and alters the definition of “accredited investor” to account for technological expertise. Second, this Note contends that tokens hosted by sufficiently decentralized platforms should not be regulated as securities. Third, this Note sets forth a list of technical requirements that, if met, would provide a utility token issuer with a rebuttable presumption that it is sufficiently decentralized.⁴⁴ Part III discusses this Note’s proposal in more detail.

41. See, e.g., Public Statement, Hester M. Peirce, Comm’r, SEC, Token Safe Harbor Proposal 2.0 (Apr. 13, 2021), <https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0> [<https://perma.cc/6E45-MDM8>] (proposing a new rule that would allow platforms to issue utility tokens for up to three years after their inception without having to comply with securities laws); Tessa E. Shurr, Note, *A False Sense of Security: How Congress and the SEC Are Dropping the Ball on Cryptocurrency*, 125 DICK. L. REV. 253, 281 (2020) (asserting that the SEC should be allowed to regulate a utility token as a security only after a grace period following the token’s creation has elapsed).

42. See, e.g., Crosser, *supra* note 21, at 419–20 (critiquing some SEC regulation of utility tokens).

43. Regulation D permits unregistered securities offerings as long as the issuer limits the sale of securities to a subset of financially sophisticated investors. Investor Bulletin: Private Placements Under Regulation D, OFF. OF INV. EDUC. & ADVOC., SEC (Aug. 17, 2022), <https://www.sec.gov/oiea/investor-alerts-and-bulletins/private-placements-under-regulation-d-investor-bulletin> [<https://perma.cc/HU9M-ZEJM>]. For a more detailed explanation of Regulation D, see *infra* Part III.A.1.

44. Even though several bipartisan proposals aim to give the CFTC jurisdiction over spot transactions involving cryptocurrencies, the list of technical requirements presented in this Note would still play an important role in the regulatory regimes created by those bills. For instance, the Lummis-Gillibrand Responsible Financial Innovation Act requires the platform developers to submit periodic disclosures to the SEC until their platform is sufficiently decentralized. See Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. § 302 (2022) (requiring a token issuer to attest that “neither the applicable issuer, nor any entity controlled by the applicable issuer, engaged in entrepreneurial or managerial efforts that primarily determined the value of the ancillary asset” in order to terminate the issuer’s disclosure requirements). The list of technical requirements would aid the SEC in determining when a platform can terminate its periodic disclosures. Moreover, the bill only places a presumption that a utility token is a commodity, rather than a security, and allows the SEC to petition a court to find “that there is not a substantial basis for” such a presumption. *Id.* § 301. The list of technical requirements presented in this Note would aid a court in determining whether a utility token is a security and would provide clarity to platforms on how a court is likely to rule on the matter. Meanwhile, under the Digital Commodities Consumer Protection Act of 2022, the CFTC would only have jurisdiction over digital commodities that are not securities. Digital Commodities Consumer Protection Act of 2022, S. 4760, 117th Cong. §§ 2(a)(7), 3(2). Because the bill offers no definition

I. A NEW SECURITY: THE RISE AND FALL OF THE ICO

This Part details how the SEC halted ICOs in their tracks by bringing numerous enforcement actions against decentralized platforms conducting ICOs. To do so, this Part first explains how decentralized platforms operate, contrasting them with intermediated platforms. It then describes how platform developers, to finance the platform's development, conduct ICOs and offer early investors the opportunity to purchase utility tokens that can be used once the platform becomes fully functional. Finally, this Part reveals how the SEC views most ICOs as unregistered securities offerings, leaving platform developers with fewer financing options.

A. *Decentralized Platforms: A User-Run Alternative to Intermediated Services*

Some foresee a future where users exchange content,⁴⁵ rights,⁴⁶ and services⁴⁷ through decentralized platforms and one where these exchanges are approved by consensus, rather than by intermediaries.⁴⁸ To fully explain what “decentralization” means, and how some

of “security,” *see id.* § 2(a)(7) (excluding “a security” from the definition of “digital commodity”), the bill presumably relies on the definition of “security” in § 2(a)(1) in the Securities Act of 1933, *see* S. 4760, § 2(a) (amending the Commodity Exchange Act); Commodity Exchange Act § 1a(41), 7 U.S.C. § 1a(41) (defining “security” in the Commodity Exchange Act to mean “security as defined in § 2(a)(1) of the Securities Act of 1933”); Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77(b)(a)(1) (defining “security” for the purposes of the Securities Act of 1933). As a result, the bill would continue to give the SEC power to determine whether a particular utility token meets the § 2(a)(1) definition of a “security.” The list of technical requirements would play a similar role, therefore, under the bill as it would in the current state of affairs.

45. *See, e.g., Introduction to Web3*, ETHEREUM (Aug. 29, 2022), <https://ethereum.org/en/web3> [<https://perma.cc/976S-2MMP>] (explaining how “Web3 allows for direct ownership through non-fungible tokens (NFTs),” which users can later sell “on open markets”).

46. *See, e.g., Emilia La Capra, What Is the Role of a Decentralized Autonomous Organization in Web3?*, COINTELEGRAPH (Feb. 26, 2022), <https://cointelegraph.com/explained/what-is-the-role-of-a-decentralized-autonomous-organization-in-web3> [<https://perma.cc/EWQ4-3VX5>] (describing how decentralized autonomous organizations (“DAOs”) grant voting and equity rights through smart contracts and tokens).

47. *See, e.g., Dan Patterson, Explaining Web3: From the Blockchain and Crypto to NFTs and the Metaverse*, CBS NEWS (Jan. 3, 2022, 7:45 AM), <https://www.cbsnews.com/news/web3-blockchain-crypto-nft-metaverse-explainer> [<https://perma.cc/L2HV-FTQN>] (discussing “a new economy built around blockchain where individuals can provide services directly to each other”).

48. *See* Randolph A. Robinson II, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings*, 85 TENN. L. REV. 897, 907 (2018) (“The peer-to-peer architecture of the [blockchain] . . . allows for the direct exchange of value between parties without interference from banks, governments, or other intermediaries.”).

platforms may be more “decentralized” than others, a discussion of the underlying technology is needed.

1. *The Blockchain: How To Assign Ownership Rights Without an Intermediary*. Decentralized platforms use blockchain technology to document transactions and determine ownership rights.⁴⁹ To track exchanges between users, most decentralized platforms rely on distributed ledger technology, which disperses a log of transactions to any user connected to the network⁵⁰ and allows users to approve transactions.⁵¹ Moreover, most decentralized platforms use permissionless ledgers, which means users do not need the platform’s permission to contribute to the consensus process.⁵² And once a majority of users agree that an exchange is valid, it is added to the ledger.⁵³

Without blockchain technology, users would need an intermediary to transfer digital assets between one another.⁵⁴ For instance, say Tom agreed to send Jerry a ten dollar digital coupon for a cheese shop in exchange for a bottle of wine. Without an intermediary, Tom has no way to deliver the digital coupon to Jerry. Tom could send Jerry a PDF of the coupon, but Tom could also send many other purchasers the same PDF. Jerry has no way to ensure that Tom has not already spent the digital coupon. Before Jerry ships Tom the bottle of wine, Jerry will want to know that he is the only owner of the digital coupon. As a result, Jerry and Tom would have to use a trusted third party—like eBay—to facilitate the exchange. But if Jerry and Tom transacted

49. Azgad-Tromer, *supra* note 22, at 76.

50. See Rohr & Wright, *supra* note 39, at 470 (“Large public blockchains are redundantly stored on computers scattered throughout the globe . . .”). For a discussion of how users connect to the network through open-source software, see Azgad-Tromer, *supra* note 22, at 78, and Robinson II, *supra* note 48, at 913.

51. See Azgad-Tromer, *supra* note 22, at 78 (“Numerous nodes communicate by a designated ‘consensus protocol’ to vote on which updates to embed into the ledger . . .”). Unlike decentralized ledgers, centralized ledgers give platforms the exclusive right to host and modify the ledger. See *id.* at 77 (“In a centralized ledger, one party or organization, [sic] runs the software on the blockchain and exclusively controls the database embedded in its ledger.”).

52. See *id.* (describing how permissionless ledgers allow any user to authenticate network transactions). Permissioned ledgers grant approval rights to specified users. *Id.*

53. Cf. Robinson II, *supra* note 48, at 918 (stating that on numerous networks, the consensus process for a particular transaction does not end, and a reward is not given out, until “at least 51% of all nodes . . . agree that the block is valid”).

54. See *id.* at 915 (describing how, traditionally, users who exchanged assets over the internet required a trusted third party to facilitate the transaction).

through the blockchain, they would not require a trusted third party. Instead, Jerry would rely on the blockchain's other users to validate that Tom has not otherwise spent the coupon.

Having intermediaries be “the sole arbiters of the validity of any given transaction”⁵⁵ is dangerous. For one, intermediaries do not provide equal access to all users. Financial institutions, which often facilitate transactions between people, underserve low-income individuals and racial minorities.⁵⁶ Intermediaries also have ulterior motives. Robinhood, an intermediary for stock transactions, inexplicably halted trading when its users were seeking to enact a short squeeze on hedge funds that had shorted the Gamestop stock.⁵⁷ The platform cited margin requirements, which had risen due to the increased trading in the highly volatile Gamestop stock.⁵⁸ But some believe that Robinhood had a more sinister reason for halting trading—Robinhood wanted to please Citadel Securities, a firm that substantially contributes to Robinhood's bottom line, as Citadel had an outstanding loan to Melvin Capital, a target of the short squeeze.⁵⁹

Blockchain technology prevents one entity from unilaterally changing its rules at any moment. Instead, it allows any user to access the decentralized platform and participate in its governance.⁶⁰ Even further, the technology gives users the opportunity to suggest and approve improvements to the platform through the same consensus

55. *Id.*

56. Kristen Broady, Mac McComas & Amine Ouazad, *An Analysis of Financial Institutions in Black-Majority Communities*, BROOKINGS (Nov. 2, 2021), <https://www.brookings.edu/research/an-analysis-of-financial-institutions-in-black-majority-communities-black-borrowers-and-depositors-face-considerable-challenges-in-accessing-banking-services> [https://perma.cc/9HEL-VCUK] (describing data showing that low-income individuals and racial minorities are not afforded equal access to banking services).

57. Maggie Fitzgerald, *Robinhood Restricts Trading in Gamestop, Other Names Involved in Frenzy*, CNBC (Jan. 28, 2021, 9:19 AM), <https://www.cnbc.com/2021/01/28/robinhood-interactive-brokers-restrict-trading-in-gamestop-s.html> [https://perma.cc/8G7L-SHH3].

58. *Id.*

59. See Jeff Kearns & Hema Parmar, *Robinhood, Citadel Reject Conspiracy Claims that They Halted ‘Meme’ Trades*, L.A. TIMES (Feb. 17, 2021, 5:08 PM), <https://www.latimes.com/business/technology/story/2021-02-17/robinhood-citadel-reject-conspiracy-claims-they-halted-meme-trades> [https://perma.cc/29Q8-VDCX] (describing a conspiracy theory alleging that Robinhood halted GameStop trades to aid Citadel Securities).

60. See Robinson II, *supra* note 48, at 913 (stating that the use of open-source software leads to “increased participation . . . , which leads to the democratization . . . of business, social, and governance systems that run on the blockchain”).

mechanisms used to approve transactions.⁶¹ For example, Bitcoin uses an “Improvement Proposal” system where users “can propose changes to the blockchain, coordinate a discussion of their merits, and attempt to build a consensus in the community in favor of implementing the proposal.”⁶² And if a group of users are dissatisfied with the direction of the platform, they can choose to create a “fork” in the chain that branches off the original ledger.⁶³

2. *Utility Tokens: The Native Currencies of Decentralized Platforms.* Decentralized platforms often use the blockchain to track the transfer of utility tokens, a type of cryptocurrency used to purchase goods or services on the platform.⁶⁴ Utility token holders can either redeem the tokens on the platform, or they can resell the tokens.⁶⁵ Utility tokens appreciate as “perceived functional utility of the token and expectations of its future value” rise.⁶⁶

Utility tokens are like a voucher to watch a movie of the holder’s choosing at the local movie theater. The voucher’s holder can either choose to redeem the voucher for a movie, or they can choose to trade it to the highest bidder. The value of the voucher will rise and fall depending on numerous factors, including what movies are currently playing, the quality of the theater, and the ease of getting to the theater. If the theater improves its layout by adding reclining chairs, or if a series of Oscar-contending movies are released, the value of the voucher will rise. Similarly, a utility token’s value largely depends on the development of the platform on which it will be used and on the demand for the services a utility token can obtain.

61. Azgad-Tromer, *supra* note 22, at 81 (explaining how the consensus protocols can be used to modify the platform’s underlying software).

62. *Id.* at 91; see *Bitcoin Improvement Proposals*, *supra* note 13 (listing various Bitcoin Improvement Proposals made by Bitcoin users that have been put up to a vote).

63. Azgad-Tromer, *supra* note 22, at 81.

64. See Robinson II, *supra* note 48, at 926 (“Utility tokens are entity-specific crypto-assets that have some utility within the software application or platform being developed.”).

65. See Crosser, *supra* note 21, at 392–93 (“Utility tokens can be tradeable on secondary markets and appreciate like tokenized securities, but primarily exist to integrate into the blockchain application they are issued for.”).

66. *Id.* at 391.

B. ICOs: How Decentralized Platforms Use Utility Tokens To Finance Their Development

Decentralized platform developers can fundraise their efforts by selling utility tokens to investors through ICOs. Choosing to sell utility tokens, rather than equity, provides unique benefits to platform developers. However, the SEC, applying existing case law, has determined that most ICOs implicate federal securities laws and requires developers to register the issuances.

1. *An Overview of ICOs.* Developing a platform requires capital. As a result, platform creators must find a way to raise money to finance their efforts. They could raise money from venture capital firms by selling equity stakes in the platform.⁶⁷ But venture capital firms are unlikely to invest in the open-ended, white-space endeavor of building a decentralized network.⁶⁸ Therefore, decentralized platform developers often fundraise by selling utility tokens through an ICO.⁶⁹ The process often begins with the developer publishing a white paper that outlines the project, describes the platform, and reveals how the utility tokens will integrate with the platform.⁷⁰ Afterward, the developer typically releases the code⁷¹ so that it can undergo a public audit for bugs and security flaws.⁷² Then the developer markets the project, oftentimes “relying on popular technology-leaning social media sites such as Reddit and Twitter to generate interest.”⁷³ The

67. See generally Adam Hayes, *Venture Capital*, INVESTOPEDIA (May 31, 2022), <https://www.investopedia.com/terms/v/venturecapital.asp> [<https://perma.cc/K32E-QUFX>] (explaining how venture capital firms “pledge an investment of capital in exchange for equity in [a start-up] company”).

68. Cf. Robinson II, *supra* note 48, at 920 (noting how venture capital firms “search for profits”).

69. See Crosser, *supra* note 21 (“[ICOs] are the online sale of cryptographic assets used to launch a cryptocurrency [and] finance a blockchain application development project . . .”).

70. Rohr & Wright, *supra* note 39, at 477–78; see also Azgad-Tromer, *supra* note 22, at 84 (“Many ICOs are accompanied by a white paper or a ‘plan,’ describing the merits of the proposed investment offer . . .”).

71. Decentralized platforms are usually developed through open-source software, which means that the code underlying any blockchain technology is copyrighted and can only be used, modified, or copied by users who agree to a license governing the software. For more information on copyright protection for the open-source software used to run the blockchain, see Peter Van Valkenburg, *What is “Open Source” and Why Is It Important?*, COIN CENTER (Oct. 17, 2017), <https://www.coincenter.org/education/advanced-topics/open-source> [<https://perma.cc/SQ5V-LC6V>].

72. Rohr & Wright, *supra* note 39, at 478.

73. *Id.*

developers might even communicate updates to the public about the project's development.⁷⁴ Lastly, the developers sell the tokens, often by letting investors buy the tokens off the project's website.⁷⁵ After purchasing utility tokens through an ICO, investors can resell their utility tokens at any moment,⁷⁶ often through a cryptocurrency exchange like Coinbase.⁷⁷

At some point, the decentralized platform's users will take over governance of the platform.⁷⁸ The developers will often retain a significant share of tokens as a reward for their efforts,⁷⁹ but they will no longer have the power to unilaterally update, modify, and develop the platform. Instead, they will rely on user consensus for future changes. For example, Vitalik Buterin, who designed the Ethereum network,⁸⁰ no longer runs the platform.⁸¹ Instead, numerous individuals and groups, like the nonprofit Ethereum Foundation,⁸² support the network.

2. *SEC Regulation of ICOs.* Beginning in 2013, the SEC started to focus on utility tokens and ICOs. The SEC first released an Investor

74. *Id.*

75. *See id.* at 478–79 (explaining that “parties interested in buying a token simply go to an online portal and purchase tokens”).

76. *See* MacNiven, *supra* note 40, at 6–7 (“Distinct from a typical venture capital investment . . . ICO investors can instantly trade tokens on the secondary market. Token investors have the ability to realize profits immediately, as opposed to potentially waiting years.”).

77. *See* Azgad-Tromer, *supra* note 22, at 85 (listing different “web-based exchange platforms” that cryptocurrency holders can use to sell their tokens). *See generally* COINBASE (2022), <https://www.coinbase.com> [<https://perma.cc/88QJ-MYUE>] (providing a platform for individuals to purchase and sell cryptocurrencies).

78. *See, e.g.,* Azgad-Tromer, *supra* note 22, at 93 (noting how Bitcoin “relies on a broad community of miners to expand and prosper”).

79. *See, e.g.,* Vigna, *Who Is Bitcoin Creator*, *supra* note 11 (discussing how many assume that Satoshi Nakamoto owns “about one million bitcoins that were ‘mined’ in bitcoin’s first year”).

80. The Ethereum platform allows users to initiate, develop, and run smart contracts. Rohr & Wright, *supra* note 39, at 472. Users use its native utility token, Ether, to pay for the computing power necessary to execute their smart contracts. *Id.* at 473.

81. *See* Andrew R. Chow, *The Man Behind Ethereum Is Worried About Crypto’s Future*, TIME (Mar. 18, 2022, 6:00 AM), <https://time.com/6158182/vitalik-buterin-ethereum-profile> [<https://perma.cc/4BH9-52QH>] (“[Buterin] may not have the ability to prevent Ethereum from veering off course. . . . Buterin is not the formal leader of Ethereum. And he fundamentally rejects the idea that anyone should hold unilateral power over its future.”).

82. *See About the Ethereum Foundation*, ETHEREUM (Sept. 1, 2022), <https://ethereum.org/en/foundation> [<https://perma.cc/4PEW-ACTP>] (“The Ethereum Foundation (EF) is a non-profit organization dedicated to supporting Ethereum [The EF’s] role is not to control or lead Ethereum”).

Alert warning investors of Ponzi schemes involving virtual currencies.⁸³ Then, in 2014, the SEC again warned investors about cryptocurrencies, though this time specifically naming Bitcoin as a vehicle for fraud.⁸⁴ Finally, in 2017, the SEC made its biggest statement yet through a release known as the DAO Report—declaring that tokens might be securities.⁸⁵ Through its report, the SEC signaled a shift in its approach toward ICOs and indicated that it was putting utility token issuers on notice.⁸⁶

The SEC's power to regulate utility tokens and ICOs comes from the Securities Act of 1933 ("the Securities Act").⁸⁷ The Securities Act requires that before any person or entity offer to sell a security, the offering must be registered with the SEC.⁸⁸ The Securities Act defines "security" to include "any note, stock, . . . bond, debenture, . . . any put, call, straddle, option, [or] certificate of deposit."⁸⁹ Most importantly, the Securities Act declares that "investment contract[s]" are securities.⁹⁰ The Supreme Court later defined "investment contract" in *SEC v. W.J. Howey Co.*,⁹¹ giving rise to the *Howey* test. In *Howey*, the SEC charged the owners of an orange grove with conducting an unregistered securities offering.⁹² The grove's operators had offered prospective customers the opportunity to purchase a strip of land within an orange grove, telling each customer that to buy the

83. Investor Alert: Ponzi Schemes Using Virtual Currencies No. 153, OFF. OF INV. EDUC. & ADVOC., SEC (July 1, 2013), https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf [<https://perma.cc/5BEM-2EDT>].

84. Investor Alert: Bitcoin and Other Virtual Currency-Related Investments, OFF. OF INV. EDUC. & ADVOC., SEC (July 29, 2014), <https://www.sec.gov/oiea/investor-alerts-bulletins/investor-alerts-bitcoin.html> [<https://perma.cc/FM6D-V9YE>].

85. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207, 117 SEC Docket 10 (July 25, 2017) [hereinafter DAO Report] ("In this Report, the Commission considers the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new paradigm.").

86. *See id.* (warning that "securities law may apply" to ICOs). The SEC has subsequently relied on the DAO Report to take action against utility token issuers that have not registered their ICOs. *See, e.g.*, Munchee Inc., Securities Act. Release No. 10,455, 2017 WL 10605969 (Dec. 11, 2017) (citing the DAO Report to support a cease-and-desist order against an iPhone app that had sold utility tokens without registering its offering with the SEC).

87. Securities Act of 1933, 15 U.S.C. ch. 2A.

88. § 5(c).

89. § 2(a)(1).

90. *Id.*

91. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

92. *Id.* at 294–95.

land, the customer would also have to buy a servicing contract.⁹³ Conveniently, the orange grove operators also offered servicing contracts.⁹⁴ The grove operator, leveraging its existing operation and expertise, charged a fee plus the cost of equipment to cultivate, harvest, and market the oranges grown on the grove owner's strip of land.⁹⁵ After the fruit was sold, the grove operator would then send a portion of the net profits to each land strip owner.⁹⁶ The Supreme Court held that the servicing arrangement was an "investment contract" and therefore a "security" under the Securities Act.⁹⁷ More importantly, the Court developed its test for whether something was an "investment contract." The Court ruled that an investment contract includes any arrangement "whereby a person [(1)] invests his money [(2)] in a common enterprise and [(3)] is led to expect profits [(4)] solely from the efforts of the promoter or a third party."⁹⁸ Ever since *Howey*, the courts and the SEC have used the test to determine whether something is an investment contract, subjecting it to the provisions of the Securities Act.⁹⁹

In the DAO Report, the SEC applied *Howey* to conclude that a token called the DAO Token was an "investment contract" covered by the Securities Act.¹⁰⁰ First, the SEC held that DAO Token purchasers had invested money when they bought their tokens with Ether.¹⁰¹ Second, the SEC found that DAO Token purchasers expected to earn profits from investments funded by proceeds raised through the sale of DAO Tokens.¹⁰² Last, the SEC found that DAO Token purchasers relied on the efforts of others to "monitor[] the operation of The DAO, safeguard[] investor funds, and determin[e] whether proposed

93. *Id.* at 295.

94. *Id.*

95. *Id.* at 296.

96. *Id.*

97. *Id.* at 300.

98. *Id.* at 298–99.

99. *See, e.g.*, DAO Report, *supra* note 85, at 11 (applying the *Howey* test to DAO tokens).

100. *See id.* (concluding that DAO tokens are investment contracts under *Howey*).

101. *Id.* The SEC relied on a federal district court decision, which held that the investment of Bitcoin satisfies the "investment of money" prong of the *Howey* test. *See SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182, at *2 (Aug. 6, 2013) (holding that "Bitcoin is a currency or form of money" and that investors who used Bitcoin to invest "provided an investment of money").

102. DAO Report, *supra* note 85, at 12.

contracts should be put for a vote.”¹⁰³ DAO Token holders could vote on investment proposals.¹⁰⁴ But any proposal had to be reviewed and approved by a group of individuals who had been selected by the DAO’s creators before it could be put to a vote.

Since the release of the DAO Report, the SEC has aggressively targeted ICOs as unregistered offerings of securities. For example, in 2019, the SEC sued Kik Interactive, a chat app, for selling \$98 million in utility tokens during a 2017 offering.¹⁰⁵ Kik had designed the “Kin” tokens as a form of digital currency for the Kik platform.¹⁰⁶ The SEC ultimately won the case, securing a \$5 million judgment against Kik.¹⁰⁷ More recently, the SEC has taken on Ripple for its role in distributing the XRP token,¹⁰⁸ which was, at the time of the suit, the “third most valuable cryptocurrency” behind Bitcoin and Ether.¹⁰⁹ The SEC alleges that by selling XRP to the public, Ripple conducted an unregistered securities offering.¹¹⁰

103. *Id.* at 12–13. Notably, the SEC did not address separately whether DAO Token purchasers had invested in a “common enterprise.” The SEC refuses to recognize the “common enterprise” prong as a separate element of the *Howey* test despite acknowledging that federal courts generally do recognize investment in a “common enterprise” as a separate prong. *See, e.g., SEC, FRAMEWORK FOR “INVESTMENT CONTRACT” ANALYSIS OF DIGITAL ASSETS* 13 n.10 (2019) [hereinafter *DIGITAL ASSET FRAMEWORK*] (“The Commission . . . does [not] view a ‘common enterprise’ as a distinct element of the term ‘investment contract.’”).

104. DAO Report, *supra* note 85, at 4.

105. *See* Press Release, SEC, SEC Obtains Final Judgment Against Kik Interactive for Unregistered Offering (Oct. 21, 2020) [hereinafter *Kik Final Judgment Press Release*], <https://www.sec.gov/news/press-release/2020-262> [<https://perma.cc/S6NR-K7SF>] (describing the initial complaint by the SEC against Kik); *see also* Khari Johnson, *Kik Raises \$98 Million in Kik Cryptocurrency Token Sale*, VENTUREBEAT (Sept. 26, 2017, 8:07 AM), <https://venturebeat.com/2017/09/26/kik-raises-98-million-in-kin-cryptocurrency-token-sale> [<https://perma.cc/YEW6-XJNY>] (“Chat app Kik announced today that it has raised nearly \$100 million from more than 10,000 people in its token distribution event.”).

106. *See generally* *Introducing Kin*, KIK (2022), <https://www.kik.com/kin> [<https://perma.cc/P6GR-QLPM>] (explaining how users can use Kin on the Kik platform).

107. Kik Final Judgment Press Release, *supra* note 105.

108. *See* Ripple Suit Press Release, *supra* note 35.

109. Jeff John Roberts, *Ripple Says It Will Be Sued by the SEC, in What the Company Calls a Parting Shot at the Crypto Industry*, FORTUNE (Dec. 21, 2020, 8:01 PM), <https://fortune.com/2020/12/21/ripple-to-be-sued-by-sec-cryptocurrency-xrp> [<https://perma.cc/Q6AW-8WR2>].

110. Ripple Suit Press Release, *supra* note 35. Neither the SEC nor Ripple has signaled any intention to back down from the fight, and the case may drastically impact the regulatory landscape for utility tokens. *See* Dave Michaels, *Ripple’s Legal Brawl with SEC Could Help Settle When Cryptocurrencies Are Securities*, WALL ST. J. (Feb. 2, 2022, 7:23 AM), <https://www.wsj.com/articles/crypto-industry-hopes-looming-legal-brawl-will-thwart-secs-regulation-push-11643724002> [<https://perma.cc/8547-2YDT>] (noting that “Ripple . . . has litigated aggressively” and explaining that “[a]n SEC win would boost its case to impose investor protections on . . . the . . . crypto

The SEC expects that most, if not all, offerings of utility tokens will need to conform to securities laws.¹¹¹ In particular, ICO issuers will either need to register their securities with the SEC or rely on an exemption from registration.¹¹² Either option is a difficult one for a new platform. Registration provides the greatest clarity because, after an issuer registers an ICO with the SEC, the utility tokens sold through the ICO can be freely sold and resold.¹¹³ However, “[t]he registration process is incredibly expensive and time consuming.”¹¹⁴ Alternatively, ICO issuers could rely on an exemption to registration, but exemptions limit who could purchase the utility token offered through the ICO,¹¹⁵ often prohibiting purchasers from reselling the utility token,¹¹⁶ and are complex enough that ICO issuers would likely need to hire securities counsel to guide the issuer through the process.¹¹⁷ Due to their increased complexity, ICOs have gone nearly extinct.¹¹⁸

market, while a loss would reinforce the industry’s call for Congress to write clearer and more suitable laws”).

111. See *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs.*, 115th Cong. 40, 40 (2018) (statement of Jay Clayton, Chairman, SEC) (“[B]y and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate . . . our Federal securities laws.”).

112. See *id.* at 41 (“The registration process itself, or exemptions from registration, are available for [ICO] offerings . . .”).

113. See Securities Act of 1933 § 5(a)(2), 15 U.S.C. § 77e(a)(2) (prohibiting the sale of securities “[u]nless a registration statement is in effect as to such security”).

114. Goforth, *Cinderella’s Slipper*, *supra* note 32, at 294.

115. See, e.g., 17 C.F.R. § 230.147A(b) (2022) (limiting the exemption to residents of the state where the issuer’s principal place of business is located); § 230.506(b) (limiting the Regulation D exemption to accredited or sophisticated investors).

116. See, e.g., § 230.502(d) (specifying that securities purchased through a 17 C.F.R. § 230.506(b) exemption cannot be resold unless the issuer subsequently registers the securities or the purchaser relies on another exemption to resell the securities).

117. See Goforth, *Cinderella’s Slipper*, *supra* note 32, at 294 (“[Exemptions] are . . . often complex enough to require the assistance of experienced securities counsel.”).

118. See Paul Vigna, *Raising Money in the Crypto World Has Gotten a Lot Harder*, WALL ST. J. (Mar. 31, 2019, 9:00 AM), <https://www.wsj.com/articles/raising-money-in-the-crypto-world-has-gotten-a-lot-harder-11554037201> [<https://perma.cc/86SM-LD77>] (noting that as a result of the SEC’s enforcement actions, ICO fundraising has nearly dried up).

II. THE SEC STRIKES BACK: ISSUES WITH THE SEC'S REGULATION OF ICOs AND UTILITY TOKENS

ICOs hold enormous potential.¹¹⁹ They provide platform developers with cash early in the endeavor,¹²⁰ efficiently raise capital,¹²¹ and attract investors whose motives are not entirely aligned with generating profits (a necessary attribute because most decentralized platforms are not designed to earn profits).¹²² But ICOs are not without their risks. For instance, ICO issuers may sell purchasers on the idea of a *decentralized* platform but may set up the platform so that they can control it behind the scenes.¹²³ Developers may mislead vulnerable investors about the nature of the endeavor,¹²⁴ or the platform may have a security flaw that hackers can exploit.¹²⁵ And some ICOs are outright

119. See *supra* notes 67–68 and accompanying text (discussing how most venture capital firms refuse to invest in decentralized platforms before they have a viable product).

120. Venture capitalists want to finance “finished, easily monetized products,” while ICO purchasers are more willing to throw money behind “early stage ideas and concepts.” Robinson II, *supra* note 48, at 920.

121. See Rohr & Wright, *supra* note 39, at 485 (noting how the structuring, monitoring, and enforcement costs for ICOs are lower than those of traditional equity issuances and commenting on how “the distributive power of the Internet . . . combined with the raw power of a blockchain to manage and transfer assets globally . . . has extraordinary potential for capital formation”).

122. See M. Todd Henderson & Max Raskin, *A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets*, 2019 COLUM. BUS. L. REV. 443, 446–47 (describing how previous ICOs have “showed that individuals are willing to participate in equity raises with mixed motives that include not only profit seeking, but also consumptive utility and charitable satisfaction”); *supra* note 48 and accompanying text (discussing how decentralized platforms are designed to allow the exchange of goods and services without an intermediary there to extract rent from the transactions).

123. See Azgad-Tromer, *supra* note 22, at 92 (discussing how “[c]ontrolling costs[, which] are the costs the investor incurs from the behavior of a party that is positioned with sufficient influence to exert control on the blockchain[,] . . . are an important source of blockchain agency costs, and include potential self-dealing, which diverts value from the blockchain”).

124. See *id.* at 90 (“[A] recent empirical survey of ICOs finds that there is constant gap between contract and code, with significant differences documented between the blockchain’s code and its accompanying white paper . . .”).

125. See *id.* at 98 (“[E]ncoding the investment contract on the blockchain poses risk for costly mistakes and hidden bugs . . .”). The results of a hack can be catastrophic—transactions that take place on the blockchain are immutable, so users are left with little defense if a hack takes place. See Crosser, *supra* note 21, at 386 (“No individual can typically control or own a public blockchain once it is activated . . . This is a double-edged sword: hacking and internal fraud are difficult to carry out, but when a problem does arise, it can be difficult to solve.”). Moreover, cryptocurrency-related hacks are on the rise. Goforth, *Cinderella’s Slipper*, *supra* note 32, at 386.

scams.¹²⁶ The issues associated with ICOs demonstrate a need for some oversight, but the SEC's current regulatory approach misses the mark.

A. *Unnecessary Disclosure: Why the Current Securities Disclosure Requirements Are Inappropriate for ICOs*

The laws governing securities offerings focus on ensuring that potential purchasers have enough information to make an informed decision.¹²⁷ For instance, if an ICO issuer decides to file a registration statement with the SEC, Regulation S-K requires the issuer include specific information about the issuer and its offering in its filing.¹²⁸ The SEC then reviews the filing to ensure that the information provided by the issuer is complete and accurate.¹²⁹ If the SEC allows the statement to become effective, then the issuer may conduct the ICO.¹³⁰ Similarly, issuers who choose to rely on an exemption to registration must provide disclosure around their offering. For example, if an ICO issuer wishes to sell utility tokens in a Regulation D offering, it may have to provide purchasers with detailed information regarding its business and operations.¹³¹

126. See MacNiven, *supra* note 40, at 8 (describing pump-and-dump schemes where bad actors drive up a token's value by advocating for it on numerous chat boards and social media platforms and then sell the token to reap a handsome profit); Carol R. Goforth, *Using Cybersecurity Failures To Critique the SEC's Approach to Crypto Regulation*, 65 S.D. L. REV. 433, 440 (2020) [hereinafter Goforth, *Using Cybersecurity Failures*] (detailing a "rug pull" scam where a group will tout an ICO for a platform that does not exist). And token holders may have little legal recourse as there is often no issuer or entity that the authorities can prosecute when an ICO scam takes place. See MacNiven, *supra* note 40, at 8 ("Without a central authority, it is difficult to track the flow of money.").

127. See Azgad-Tromer, *supra* note 22, at 104–05 ("[A]n offer or sale of securities to the public must be accompanied by a full and fair disclosure, enabling potential purchasers to make an informed investment decision."); Goforth, *Cinderella's Slipper*, *supra* note 32, at 301 ("[F]ederal law relies primarily on mandatory disclosures from persons seeking to sell securities to U.S. citizens.").

128. 17 C.F.R. § 229.10(a)(1) (2022). See generally *id.* pt. 229 (containing Regulation S-K's requirements).

129. See Securities Act of 1933 § 8(b), 15 U.S.C. § 77h(b) (allowing the SEC to stop a registration statement from going into effect if it is "incomplete or inaccurate in any material respect").

130. See § 5(a)(1) (prohibiting the sale of securities only if a registration statement is not in effect).

131. See 17 C.F.R. § 230.502(b) (2022) (specifying the information that issuers must provide to purchasers in a Regulation D offering). Notably, issuers do not have to provide information to accredited investors, § 230.502(b)(1), which includes financial institutions, investment groups, and any person whose net worth exceeds \$1 million dollars, § 230.501(a).

The disclosure requirements aim to resolve information asymmetries between issuers and purchasers.¹³² By requiring issuers to disclose details about their business, the securities laws ensure investors have a “reasonable basis on which to make informed investment decisions.”¹³³ An issuer who does not provide accurate information may face civil or criminal liability.¹³⁴

The current disclosure requirements, however, are not well suited for ICOs where utility tokens are offered. Currently, regulations in large part require an ICO issuer to speak to “the overall financial health of the issuer’s business, its management, sources of competition, and risks related to its operations and projections.”¹³⁵ However, utility token holders care less about the decentralized platform’s financials because a utility token does not convey an equity interest in the decentralized platform. Instead, holders concern themselves more with issues that will impact the value of the utility token, such as its functionality, secondary market volatility, and cybersecurity issues.¹³⁶ As a result, current disclosure requirements do little to provide utility token purchasers with the information needed to make an informed purchase,¹³⁷ but they do cost ICO issuers a pretty penny to pull together.¹³⁸

132. Azgad-Tromer, *supra* note 22, at 105.

133. Goforth, *Cinderella’s Slipper*, *supra* note 32, at 301.

134. See Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (providing a cause of action to purchasers of a security if the registration statement covering the security contains materially misleading information or omits material information); § 12(a)(2) (allowing purchasers of securities who relied on a misleading prospectus or oral statement to rescind their purchase); § 17(a)(2) (making it unlawful to sell a security through misleading statements or omissions).

135. Goforth, *Cinderella’s Slipper*, *supra* note 32, at 302.

136. See *id.* at 305–08 (discussing the information that utility token purchasers care about).

137. See Crosser, *supra* note 21, at 418 (“It is not apparent that the creation of a prospectus would help the average person better understand the token sale than would the white paper.”).

138. See *Considering an IPO? First, Understand the Costs*, PwC, <https://www.pwc.com/us/en/services/consulting/deals/library/cost-of-an-ipo.html> [<https://perma.cc/A2C8-ZFEA>] (estimating “going public costs” to be between \$8.2 million and \$25 million for a company making less than \$100 million in revenue and seeking to raise between \$100 million and \$249 million); Elizabeth A. Whitman, *Rule 506(b) Offerings Continue To Dominate Small Business and Real Estate Equity Offerings*, WHITMAN LEGAL SOLS. (Jan. 12, 2020), <https://whitmanlegalsolutions.com/blog/2020-506-capital-formation> [<https://perma.cc/83WC-KX96>] (noting that a private placement conducted under Regulation D could cost between \$25,000 and \$50,000); see also Goforth, *Cinderella’s Slipper*, *supra* note 32, at 302 (“One of the most common complaints is the sheer expense of complying with these reporting obligations.”).

B. Uncertain Guidance: How the SEC's Mixed Statements Have Confused the Market on What Makes a Utility Token a Security

Issuers only need to provide disclosure during an ICO if the utility tokens being offered through the ICO are securities.¹³⁹ And resale restrictions placed on utility tokens purchased in an unregistered ICO—one conducted through a registration exemption—only apply if the utility tokens are considered securities.¹⁴⁰ The SEC has recognized that some utility tokens, under *Howey*, are not investment contracts (and therefore not securities).¹⁴¹ But the SEC has provided limited guidance on what is necessary for it to not consider a utility token a security.

1. *Issues with Howey: Why Howey's "Investment Contract" Test Does Not Cleanly Apply to Utility Tokens.* For a utility token to be considered an investment contract under *Howey*, the token's purchasers must (1) purchase the token (2) along with other purchasers (3) with the expectation that the purchasers will profit off the token (4) due to the managerial efforts of platform's owners and developers.¹⁴²

139. See Securities Act of 1933 § 5, 15 U.S.C. § 77e (regulating the offer and sale of "securities").

140. The resale restrictions applying to the tokens under Regulation D no longer apply if the tokens are not considered securities. See 17 C.F.R. § 230.502(d) (2022) (restricting the resale of "securities").

141. See, e.g., TurnKey No-Action Letter, *supra* note 36 (recognizing that tokens issued by TurnKey Jet, which can be used to purchase air charter services with TurnKey Jet, are not securities); Pocketful of Quarters, Inc., SEC Staff No-Action Letter, 2019 SEC No-Act. LEXIS 319 (July 25, 2019) [hereinafter PoQ No-Action Letter] (stating that Quarters tokens issued by Pocketful of Quarters that serve as the platform's native currency are not securities); see also Hinman Speech, *supra* note 33 (recognizing that investors who purchase utility tokens to use on decentralized platforms likely do not rely on the managerial efforts of a third-party—the fourth prong of the *Howey* test). The SEC has sought to distance itself from Former Director William H. Hinman's speech, claiming that it is "not binding SEC policy." Objection to Orders Compelling the SEC To Produce Privileged Internal Communications at 1, SEC v. Ripple Labs., Inc., 540 F. Supp. 3d 409 (S.D.N.Y. July 27, 2022) (No. 20-cv-10832), 2022 U.S. Dist. Ct. Motions LEXIS 206295. But at least one court has criticized the SEC for arguing "on the one hand, that the [Hinman] Speech is not relevant to the market's understanding of how or whether the SEC will regulate cryptocurrency, and on the other hand, that Hinman sought and obtained legal advice from SEC counsel in drafting his Speech." SEC v. Ripple Labs., Inc., No. 20-cv-10832, 2022 WL 2705396, at *3 (S.D.N.Y. July 12, 2022).

142. See SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) (listing the requirements for a security to be considered an investment contract).

The sale of utility tokens clearly satisfies the first two prongs. Investors purchase utility tokens with money¹⁴³ alongside other purchasers.¹⁴⁴

The “expectation of profits” prong poses the first real issue in applying the *Howey* test to utility tokens. In *United Housing Foundation, Inc. v. Forman*,¹⁴⁵ the Court held that purchasers “motivated by a desire to use or consume the item purchased” do not satisfy the “expectation of profits” prong of the *Howey* test.¹⁴⁶ In *Forman*, the Court dealt with the purchase of shares from a co-op building.¹⁴⁷ To rent an apartment in the co-op, renters had to purchase eighteen shares of the corporation, which owned and operated the co-op.¹⁴⁸ The shares had no other purpose—their holders could not transfer, pledge, or encumber them; they did not grant their holders any voting rights; and anyone who left the building had to offer the shares back to the corporation at the original purchase price.¹⁴⁹ Despite the fact that renters purchased “shares,” the Court held that its analysis would be driven by the “economic realities underlying the transaction, and not [by] the name appended thereto.”¹⁵⁰ Then, the Court held that the shares were not investment contracts as their purchasers “were attracted *solely* by the prospect of acquiring a place to live, and not by financial returns on their investments.”¹⁵¹

Whether the “expectation of profits” prong is satisfied by utility token purchases is unclear. On the one hand, utility token purchasers are like the tenants in *Forman*. At least some purchasers acquire a utility token to redeem on the token’s associated platform.¹⁵² On the

143. Even if purchasers buy utility tokens using other cryptocurrencies, they have still purchased the tokens with money. See DAO Report, *supra* note 85, at 14 (showing how DAO Token purchasers who used Ether to purchase DAO Tokens had met the first prong of the *Howey* test).

144. See Rohr & Wright, *supra* note 39, at 490 (stating that it is likely utility tokens meet the horizontal commonality test because they are “typically sold to more than one purchaser”).

145. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

146. *Id.* at 852–53.

147. *Id.* at 842.

148. *Id.*

149. *Id.*

150. *Id.* at 849.

151. *Id.* at 837, 853 (emphasis added).

152. See Rohr & Wright, *supra* note 39, at 486 (“Because [utility tokens] entitle the holder to use a service or software, they have a practical use and derive value from the rights they confer on their holders.”); see also Crosser, *supra* note 21, at 412 (“[A] reasonable participant, one who at least marginally understands the technology and model before investing, will be motivated by the usefulness of the tokens for commercial or personal use.”).

other hand, some purchase utility tokens with the desire to resell them for a higher price later.¹⁵³ Every purchaser of a utility token stands to gain from any increase in the token's value,¹⁵⁴ but so do the purchasers of many goods.¹⁵⁵ Therefore, the fact that some token holders may have purchased their tokens in order to profit on their resale is not definitive. Instead, what should matter is how a token's issuer has marketed the asset.¹⁵⁶

A second issue arises with the “managerial efforts of others” prong. In the early days of a decentralized platform, the efforts of the platform's founders to improve the platform likely have the largest impact on the value of the utility token.¹⁵⁷ As a result, sales of a utility token during an ICO, which often occurs before the platform is functional,¹⁵⁸ will likely satisfy the “managerial efforts” prong. However, as the decentralized platform comes online, its original founders come to have less influence over it.¹⁵⁹ Instead, the platform's token holders begin to exert their control over the platform, meaning that the token holders' efforts have the largest impact on the value of the platform and its tokens.¹⁶⁰ As a result, the utility token holders' no

153. See Rodrigues, *supra* note 30, at 143 (noting that “in general the public is buying tokens or coins not to use them, but as an investment”).

154. See Rohr & Wright, *supra* note 39, at 486 (“The existence of highly liquid exchanges that facilitate an active secondary market . . . [is an] important way[] that *utility tokens* differ from these more traditional, non-securities that combine consumption with the potential for profit.”).

155. See, e.g., Curtis Bunn, *Sneakers Are So Hot, Resellers Are Making a Living off of Coveted Models*, NBC NEWS: NBCBLK (Oct. 23, 2021, 6:02 AM), <https://www.nbcnews.com/news/nbcblk/sneakers-are-hot-resellers-are-making-living-coveted-models-rcna3619> [<https://perma.cc/8ZC5-M8QS>] (discussing the sneaker resale market that “generated \$2 billion in 2019” and is set to “generate up to \$30 billion by 2030”).

156. See *Forman*, 421 U.S. at 854 (focusing the “expectation of profit” analysis, in part, on whether the co-op “[sought] to attract investors by the prospect of profits”).

157. See Rohr & Wright, *supra* note 39, at 499 (stating that initial purchasers of utility tokens have little control over how the platform is updated, modified, and completed). A variety of factors may influence the value of utility token. But an information asymmetry exists if the token's developers have the unilateral power to develop the platform. Investors can only speculate on the direction that the developers will take the platform and, therefore, are dependent on the developers' “managerial efforts.”

158. Cf. Crosser, *supra* note 21 (noting that ICOs are used to finance the initial development of a decentralized platform).

159. See *supra* notes 78–82 and accompanying text (discussing how developers relinquish their control over decentralized platforms).

160. See Rohr & Wright, *supra* note 39, at 499 (“[S]ome *utility tokens* allow their holders to participate in certain decisions related to the enterprise, and it is conceivable that such participation, if sufficiently extensive, could call into question the security status of the token.”).

longer depend on the managerial efforts of *others* to increase the value of their asset—they depend on their own managerial efforts.¹⁶¹

2. *A Lack of Clarity from the SEC.* In 2018, William Hinman, the then-SEC Director of the Division of Corporate Finance, revealed his doubts that utility tokens issued by sufficiently decentralized platforms were investment contracts.¹⁶² Hinman indicated that the SEC does not view Bitcoin and Ether as securities because the platforms that host them are sufficiently decentralized.¹⁶³ The SEC then officially recognized that some utility tokens are not securities through a series of no-action letters.¹⁶⁴ In both letters, the SEC remarked that the platforms had fully developed their platforms, allowed purchasers to redeem their tokens immediately upon purchase, and restricted the transfer of the tokens to users on the platform.¹⁶⁵ Although the no-action letters signaled a softening of the SEC's stance, they also did not create relief for most ICOs because most utility tokens issued through ICOs are not immediately redeemable.¹⁶⁶

Since the no-action letters, the SEC has done little to clarify its stance on utility tokens. Rather, the SEC has continued to maintain its flexibility to address the ever-changing cryptocurrency market by refusing to make determinative statements or issue any regulations. In 2019, the SEC did release a “Framework” explaining its process for

161. See Crosser, *supra* note 21, at 414 (“The fact that issuers make the market and add some value should not make an instrument a security if the majority of the value of the enterprise (or at least a necessary amount) comes from the active participation of the instrument holders.”).

162. See Hinman Speech, *supra* note 33 (“If the network on which the token or coin is to function is sufficiently decentralized . . . the assets may not represent an investment contract.”).

163. *Id.*

164. See TurnKey No-Action Letter, *supra* note 36 (informing TurnKey that it may offer digital tokens that can be used to purchase air charter services without registering the offer with the SEC); PoQ No-Action Letter, *supra* note 141 (allowing Pocketful of Quarters to issue tokens that can be used for gaming on the platform without needing to register the issuance with the SEC).

165. See TurnKey No-Action Letter, *supra* note 36 (noting that TurnKey “will not use any funds from Token sales to develop the [TurnKey] Platform, Network, or App, and each of these will be fully developed and operational at the time any Tokens are sold”); PoQ No-Action Letter, *supra* note 141 (noting that Pocketful of Quarters “will not use any funds from [tokens] sales to build the Quarters Platform, which has been fully developed and will be fully functional and operational immediately upon its launch and before any of the [tokens] are sold”).

166. See Goforth, *Cinderella's Slipper*, *supra* note 32, at 288 (“Unfortunately, factors that the SEC mentions as being important to its decision in the TurnKey Jet case also reveal that the no-action letter is unlikely to be relevant to most cryptoassets.”).

analyzing whether a digital asset is an investment contract.¹⁶⁷ However, the “Framework” lists over forty open-ended questions that guide the SEC’s analysis.¹⁶⁸ It does little to guide a prospective ICO issuer on how to avoid conducting an unregistered public offering of securities.¹⁶⁹

The SEC’s ad hoc approach leaves decentralized platforms uncertain of how to move forward.¹⁷⁰ A platform that wants to sell its utility tokens to the public could approach the SEC and ask for guidance, but the platform risks being drawn through a “difficult, lengthy, unproductive, and labyrinthine regulatory process.”¹⁷¹ The platform may choose to issue its utility tokens in a different country to avoid the reach of U.S. securities laws.¹⁷² Or the platform might try to test its luck and sell its utility tokens without complying with the registration and disclosure requirements. At best, the SEC does not notice and only realizes what the platform has done when the platform has become sufficiently decentralized and its utility tokens no longer qualify as securities in the eyes of the SEC.¹⁷³ The platform’s success would likely encourage others to try the “ask for forgiveness rather than permission” approach. Although the platforms would benefit,

167. See DIGITAL ASSET FRAMEWORK, *supra* note 103, at 1 (“[W]e provide a framework for analyzing whether a digital asset has the characteristics of . . . an ‘investment contract.’”).

168. See *id.* at 3–10 (listing considerations that will impact whether a utility token qualifies under *Howey* as an investment contract).

169. See Hester M. Peirce, Comm’r, SEC, *How We Howey*, Address Before the Securities Enforcement Forum (May 9, 2019), <https://www.sec.gov/news/speech/peirce-how-we-howey-050919> [<https://perma.cc/2XJD-7GVA>] (“[N]on-lawyers and lawyers not steeped in securities law . . . will not know what to make of the guidance. Pages worth of factors, many of which seemingly apply to all decentralized networks, might contribute to the feeling that navigating the securities laws in this area is perilous business.”).

170. See Peirce & Roisman, *supra* note 34 (noting that the best that platforms can do is study the SEC’s pattern of enforcement actions against utility token issuers while acknowledging that doing so will “not necessarily produce clear answers”).

171. Peirce BlockFi Statement, *supra* note 37.

172. See Crosser, *supra* note 21, at 417 (“[I]f the United States stringently imposes securities regulations, issuers will just sell their tokens in foreign markets . . .”).

173. See Henderson & Raskin, *supra* note 122, at 482–83 (noting that at one point Ether was a security, but the SEC failed to take action against the Ethereum network for its unregistered sales of Ether, and it chooses not to do so now because it no longer views Ether as a security). The remedy for an unregistered sale of securities is to require that the issuer give each purchaser the opportunity to rescind their purchase, exchanging the security for her original purchase price. See Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l(a)(1) (stating that any issuer who violates § 5 of the Securities Act by selling an unregistered security is liable for the “consideration paid for such security . . . upon the tender of such security”). However, the statutory language requires the tender of “such security,” *id.*, making it ambiguous as to whether the SEC could command a token issuer to issue a rescission offer for tokens that are no longer securities.

such an approach would place investors—who are being offered securities outside the protection of the SEC—at risk. At worst, the SEC does notice and sues the platform for selling a security without an effective registration statement or exemption. Because no two utility tokens are the same, the SEC will have to make its case each time it prosecutes a platform for conducting an unregistered offering.¹⁷⁴ The resulting litigation will likely be a “time-and-resource-consuming task for the court, regulators, and issuers alike.”¹⁷⁵

Academics have proposed different ways that the SEC could provide clarity to platforms that sell utility tokens.¹⁷⁶ The next Part details this Note’s proposal for how the SEC should oversee utility token issuances.

III. RETURN OF THE ICO: A SAFE HARBOR FOR UTILITY TOKENS

This Note proposes two sets of regulatory approaches—one that applies if a utility token’s platform is sufficiently decentralized and one that governs if the platform is not. First, this Note contends that tokens issued by nondecentralized platforms are securities. For tokens that are securities, this Note acknowledges that Regulation D offers the easiest route for platform developers to sell utility tokens to investors before the platform has become sufficiently decentralized. This Note introduces modifications to Regulation D that would align its information disclosure and investor accreditation requirements with the risks that investors face when investing in tokens. Second, this Note argues that tokens issued by decentralized platforms are not securities and can be freely resold by the platform and any initial investors.

Moreover, this Note argues the SEC should specify what criteria would make a platform, in the SEC’s eyes, sufficiently decentralized. Providing *ex ante* clarity would allow ICO investors to know how their utility tokens would escape the purview of U.S. securities laws and allow the investors to freely resell their tokens. The result would be increased investor demand for ICOs¹⁷⁷—which would mean that

174. See Crosser, *supra* note 21, at 410–11 (discussing the features of structurally similar yet varied tokens and how they are evaluated to determine whether an individual token is a security).

175. *Id.* at 410.

176. See *supra* notes 38–42 and accompanying text (discussing the proposals by academics and researchers to reform the SEC guidance).

177. See Christian Fisch & Paul P. Momtaz, *Institutional Investors and Post-ICO Performance: An Empirical Analysis of Investor Returns in Initial Coin Offerings (ICOs)*, 64 J. CORP. FIN. 1, 2 (2020) (“Since institutional investors often dislike regulatory uncertainty, reducing regulatory voids may be vital to stimulating institutional investments.”).

platforms could once again rely on ICOs as a viable fundraising avenue. This Note attempts to provide clarity by describing a set of factors that, if met, would entitle a platform to a rebuttable presumption that it is sufficiently decentralized.

A. Before the Platform Is Sufficiently Decentralized

Utility tokens offered by insufficiently decentralized platforms should be regulated as securities. First, these utility tokens are investment contracts under *Howey*. The question of whether investors “expect profits” from their purchase of securities—the third prong under *Howey*¹⁷⁸—depends on whether the tokens are functional. *Forman* casts doubt on the idea that something is an investment contract when its primary purpose is to provide its owner with a good or service.¹⁷⁹ When a utility token is not immediately usable, its purchasers are likely not “motivated by a desire to use or consume the” utility token.¹⁸⁰ Some may actually want to hold onto the token until they can actually use it; however, it is far more likely, especially given the highly liquid secondary markets for tokens, that purchasers of prefunctional utility tokens intend to resell their token for a profit.¹⁸¹ But even if the tokens are immediately functional, tokens issued by an insufficiently decentralized platform fail the fourth prong of *Howey* as the purchasers of these utility tokens are mostly dependent on the efforts of the platform’s founders to improve the value of the token.¹⁸²

Second, disclosure, albeit different disclosure than what is currently required,¹⁸³ serves an important purpose when a platform has not fully decentralized: it protects investors. Before a platform has

178. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (noting that an investment contract is a transaction where 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”).

179. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852–53 (1975) (“[W]hen a purchaser is motivated by a desire to use or consume the item purchased . . . securities laws do not apply.”).

180. *Id.*

181. See *Robinson II*, *supra* note 48, at 951 (stating that when a utility token is prefunctional, “the value of many crypto-tokens is being driven by speculative trading”).

182. See *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973) (holding that the fourth prong of *Howey* depends on “whether the efforts made by those other than the investor are . . . those essential managerial efforts which affect the failure or success of the enterprise”); *Azgard-Tromer*, *supra* note 22, at 121 (“Investors of blockchain-based assets . . . must rely on the efforts of others on the blockchain’s ecosystem to bring their investment to fruition.”).

183. See *supra* Part II.A (discussing the SEC’s current unnecessary disclosure requirements).

decentralized, its founders hold all the power. They understand where the project is headed, the capital and resources needed to get there, and how well the technology is performing. Investors may receive a white paper describing the project, but there is no guarantee that the project will follow the path outlined in the white paper.¹⁸⁴ And investors do not have adequate incentives to collect information from the platform's founders on their own—they would rather rely on other investors to do so, creating a “free rider” problem.¹⁸⁵

1. *Regulation D: The Best Path To Conduct an ICO.* The SEC recognizes two ways to provide adequate disclosure. The SEC either requires issuers of securities to disclose significant amounts of information, in which case the issuer can then sell its security to nearly anyone,¹⁸⁶ or it allows issuers to disclose fewer details about their business, in which case the issuer can only sell securities to a limited subset of purchasers.¹⁸⁷

Regulation D fits within the latter camp—it allows an issuer to sell securities without filing a registration statement so long as the issuer (a) only sells its securities to investors who understand and have experience in finance and investing¹⁸⁸ and (b) prevents purchasers from reselling the securities.¹⁸⁹ The SEC recognizes purchasers who have verifiable proof of their financial know-how as “accredited”¹⁹⁰ and purchasers who can demonstrate their financial know-how as

184. Cf. Azgad-Tromer, *supra* note 22, at 90 (“[A] recent empirical survey of ICOs finds that there is constant gap between contract and code, with significant differences documented between the blockchain’s code and its accompanying white paper . . .”).

185. See *id.* at 109 (“[I]ncentives to collect information by each investor are suboptimal. . .”).

186. See, e.g., *supra* notes 132–134 and accompanying text (discussing the detailed disclosure that issuers must make in a registration statement before they can conduct a public offering); 17 C.F.R. §§ 230.251–230.252 (2022) (allowing issuers to sell their securities to the public as long as they file an offering statement and allow the SEC to review it for accuracy and adequacy).

187. See, e.g., § 230.147A(d) (allowing issuers to sell their securities without disclosing any information but only allowing purchases from residents of the same state as the issuer); §§ 230.502(b), 230.506(b)–(c) (allowing issuers to provide limited disclosures before they sell securities but only allowing purchases from accredited or sophisticated investors).

188. § 230.506(b)(2)(ii).

189. § 230.502(d).

190. See § 230.501(a) (recognizing investors or entities with specific qualifications, net worth, or incomes as “accredited investors”).

sophisticated.¹⁹¹ Nonaccredited investors can purchase securities in a Regulation D offering if they are sophisticated.¹⁹² However, the issuer is limited on how many nonaccredited purchasers can participate in a Regulation D offering—the issuer cannot sell securities to more than thirty-five nonaccredited investors in any “90-calendar-day period.”¹⁹³ The issuer must also provide certain nonfinancial and financial information to nonaccredited investors,¹⁹⁴ and the issuer cannot advertise its offering if it sells its security to nonaccredited investors.¹⁹⁵

Issuers primarily rely on Regulation D if they wish to sell their securities without registering them with the SEC.¹⁹⁶ Regulation D makes sense for issuers wishing to sell large amounts of securities—such as platforms performing an ICO¹⁹⁷—because it does not place a cap on how much an issuer can raise through the offering. In comparison, other exemptions, including Regulation A and Regulation Crowdfunding, cap how much an issuer can raise if the issuer relies on those exemptions.¹⁹⁸ Exemptions that place a dollar cap on securities offerings, which some have advocated for,¹⁹⁹ artificially limit how much

191. See § 230.506(b)(2)(ii) (“Each purchaser who is not an accredited investor . . . has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment . . .”).

192. *Id.*

193. § 230.506(b)(2)(i).

194. § 230.502(b).

195. § 230.502(c). In determining whether an issuer has generally advertised its offering or generally solicited purchases, the SEC examines whether the issuer had a pre-existing relationship with the purchasers of its security before the issuer contacted the purchasers about the offering. See Kenman Corp., Exchange Act Release No. 21,962, 1985 WL 548507, at *3 n.6 (Apr. 19, 1985) (“In determining what constitutes a general solicitation, the Commission’s Division of Corporation Finance has underscored the existence and substance of pre-existing relationships between the issuer and those being solicited.”).

196. In 2017 alone, more than \$1.8 trillion worth of securities were sold through Regulation D offerings. SCOTT BAUGUESS, RACHITA GULLAPALLI & VLADIMIR IVANOV, SEC, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009-2017, at 7–8 (2018). Comparably, less than \$100 billion worth of securities were sold under all other registration exemptions combined. *Id.* at 8.

197. Cf. Kate Rooney, *Blockchain Start-Up Just Raised \$4 Billion Without a Live Product*, CNBC (May 31, 2018, 12:26 PM), <https://www.cnbc.com/2018/05/31/a-blockchain-start-up-just-raised-4-billion-without-a-live-product.html> [<https://perma.cc/RT25-XPDX>] (listing eleven ICOs, which each raised over \$140 million).

198. See, e.g., 17 C.F.R. § 230.251(a)(2) (2022) (capping Regulation A offerings at \$75 million); § 227.100(a)(1) (limiting the amount that can be raised in an offering conducted through Regulation Crowdfunding to \$5 million).

199. See *supra* note 39.

capital the issuer can raise and do not allow issuers to fundraise for their actual needs.

Notably, Regulation D is not the only registration exemption that allows issuers to sell unregistered securities without capping how much the issuer can raise in its offering. But the other two exemptions—Rule 147 and Rule 147A—limit offerings to purchasers who reside in the same state as the issuer.²⁰⁰ Regulation D allows issuers to sell their securities nationwide. However, by only allowing issuers to sell securities to accredited or sophisticated investors through Regulation D, the SEC ensures that those who purchase securities in a Regulation D offering are capable of assessing the risks involved with investing. While Regulation D only imposes affirmative disclosure requirements on issuers selling their securities to nonaccredited investors,²⁰¹ it is reasonable to expect accredited investors—financial institutions, venture capital firms, high net worth individuals—to perform due diligence on their investment.

Some, including Commissioner Hester M. Peirce, have proposed allowing platforms to sell utility tokens through an ICO to anyone, regardless of the purchaser's qualifications.²⁰² While the proposals generally call for ICO issuers to provide limited disclosure about their platforms and tokens,²⁰³ they do not ensure that the tokens' purchasers will fully appreciate the risks involved with their investment. Instead, they allow ICO issuers to freely target unsophisticated purchasers. Allowing platforms to swindle individuals who cannot properly fend for themselves in the investment arena is not a recipe for success. And any resulting backlash would likely lead to general distrust of platforms selling utility tokens.²⁰⁴

200. 17 C.F.R. §§ 230.147(b), 230.147A(c)(1) (2022).

201. § 230.502(b).

202. See *supra* note 41 and accompanying text (proposing a new rule that would allow platforms to issue utility tokens for up to three years after their inception without having to comply with securities laws).

203. See Peirce, *supra* note 41 (noting that platforms will have to provide initial disclosures about their source code, token economics, plan of development, and development team if they want to rely on Commissioner Peirce's safe harbor proposal); Shurr, *supra* note 41 (arguing that platforms wishing to rely on Shurr's proposed safe harbor must "publish key information to consumers").

204. See Henderson & Raskin, *supra* note 122, at 448 ("[I]f fraudsters can make promises as easily as upstanding issuers, then good firms will leave the market because investors will confuse them with bad actors.").

2. *A Modified Regulation D for ICOs.* Although Regulation D provides the smoothest path to platforms wishing to conduct an ICO, the SEC should modify several of the Regulation's provisions for offerings involving utility tokens.²⁰⁵ A modified Regulation D could significantly expand the investor base for ICOs while ensuring that each investor can make an informed judgment concerning the offering.

First, the SEC can change the types of disclosures that it mandates platforms provide to sophisticated investors. Instead of requiring a platform to offer details on its business, operations, and financials, the SEC can instead amend its disclosure requirements to focus on the platform, its underlying code, how far along the platform is on its development timeline, and the ways in which purchasers will be able to use its tokens. By focusing on the matters germane to the risks involved with the utility tokens,²⁰⁶ the SEC will ensure that potential purchasers are equipped with the right information to assess their investment.²⁰⁷ And by eliminating the need to disclose information not relevant to the risks involved with utility tokens, the SEC will prevent purchasers from being inundated with unnecessary information.²⁰⁸

Second, the SEC should incorporate investors who are certified as technological experts into its "accredited investor" definition. Currently, the SEC recognizes that a person who holds certain professional certifications or credentials issued by accredited educational institutions can be an accredited investor.²⁰⁹ However, the SEC limits accredited investor status to those purchasers whose credentials measure their "comprehension and sophistication in the areas of securities and investing."²¹⁰ The SEC justified relying on professional credentials because the credentials demonstrate that an

205. For a workable definition of "utility token," which can be used to limit the reach of the changes to Regulation D, see the definition of "token" in Peirce, *supra* note 41.

206. See *supra* Part II.A (explaining that the laws governing securities offerings focus on ensuring that potential purchasers have enough information to make an informed decision).

207. See Goforth, *Cinderella's Slipper*, *supra* note 32, at 305 (discussing the issues relevant to assessing the risks involved with purchasing a utility token).

208. See Goforth, *Using Cybersecurity Failures*, *supra* note 126, at 462 ("[E]ven if the crypto-specific information is disclosed in addition to all the other required data, under current rules it would be buried in a mountain of information that is not particularly relevant.>").

209. See 17 C.F.R. § 230.501(a)(10) (2022) (defining "accredited investor" to include "[a]ny natural person holding in good standing one or more professional certifications or designations or credentials from an accredited educational institution that the Commission has designated as qualifying an individual for accredited investor status").

210. § 230.501(a)(10)(ii).

investor holding them can properly assess the risks involved with their investments.²¹¹ Because many of the issues related to the risks involved with purchasing a utility token involve complicated technological matters,²¹² the SEC would be wise to similarly recognize certified technological experts as accredited investors.

By incorporating technological expertise into the “accredited investor” definition, the SEC would be widening the possible investor base for utility token offerings. Platforms would not have to limit how many credentialed technological experts they include in their offering.²¹³ By recognizing credentialed technological experts as accredited investors, the SEC would allow a platform to include these experts in an offering even if the platform promoted the offering over the internet.²¹⁴ As a result, platforms could accomplish two goals: they could conduct the offering over the internet—expanding the reach of the offering—while also including the technologically-savvy individuals who may be more inclined to invest in utility tokens.

B. After the Platform Is Sufficiently Decentralized

Once a platform is sufficiently decentralized, the application of the securities laws to any sales or resales of its utility tokens makes less sense. First, utility tokens hosted by decentralized platforms do not fit within the *Howey* framework.²¹⁵ Second, the platform no longer has anyone qualified to make the required disclosures about its business, its development, or its financials. Proposals by some to continue requiring mandatory disclosure after a platform is sufficiently decentralized ignore this reality.²¹⁶ Last, mandatory disclosure is

211. Accredited Investor Definition, 85 Fed. Reg. 64234, 64241 (Oct. 9, 2020) (codified at 17 C.F.R. § 230.501(a)(10) (2022)).

212. See Goforth, *Cinderella’s Slipper*, *supra* note 32, at 305 (listing the open-source protocol, details on the platform’s policy for situations when users disagree on a transaction’s validity, and privacy protections among the relevant considerations for utility token purchasers).

213. See 17 C.F.R. § 230.506(b)(2)(i) (2022) (placing a limit only on the number of nonaccredited investors).

214. See § 203.502(c) (allowing general advertisement and solicitation for offerings conducted under § 230.506(c), which in turn requires that all purchasers be accredited investors).

215. See *supra* Part II.B.1 (explaining why utility tokens hosted by decentralized platforms usually fail the “managerial efforts” prong of the *Howey* framework).

216. See Goforth, *Cinderella’s Slipper*, *supra* note 32, at 318–19 (proposing to exempt utility token sales from registration requirements if they “disclose meaningful information about the token project”); MacNiven, *supra* note 40, at 30 (advocating for a modified exemption that would allow the unregistered sale of tokens if the tokens’ issuer filled out a standard form).

unnecessary. The value of a utility token hosted by decentralized platforms will most likely come from how the market values the token and the services to which it entitles its owners.²¹⁷ Potential purchasers possess the same amount of information as the token's creators when it comes to the market's assessment of the token—meaning that there are no information asymmetries to be addressed.

Recognizing that utility tokens issued by sufficiently decentralized platforms are not securities will have two effects. First, members of decentralized platforms, through specified governance rules, can vote to sell additional tokens to the public.²¹⁸ Second, utility token holders who purchased their tokens through a Regulation D offering can freely resell their tokens on the open market once the platform becomes sufficiently decentralized.²¹⁹ Enhancing the liquidity of utility tokens will allow platforms and token holders to capitalize on their token assets.

C. A Rebuttable Presumption of Decentralization

The SEC should create *ex ante* guidance so investors and platform developers can assess what efforts are needed for the SEC to consider a platform sufficiently decentralized. Right now, utility token issuers have nothing to guide them but two no-action letters, several enforcement proceedings, and a list of forty-seven open-ended questions.²²⁰ The state of uncertainty surrounding utility tokens and their security status has essentially put a halt to ICOs.²²¹ To move forward, the SEC should clarify how platforms can become “sufficiently decentralized” so that their utility tokens are no longer considered securities. Platform developers would then know the steps necessary to escape the reach of securities laws. Guidance would also allow investors to credibly assess whether the SEC will one day consider a platform conducting an ICO to be sufficiently decentralized.

217. See Goforth, *Cinderella's Slipper*, *supra* note 32, at 307 (discussing how market volatility, which is outside of the platform's control, significantly influences the value of a utility token).

218. An offering by a decentralized platform would not be considered an offering of a security, and therefore the SEC would not require the platform to register the utility tokens nor seek an exemption from registration. See *supra* note 139 and accompanying text (describing the regulations associated with the offer and sale of securities).

219. See *supra* note 140 and accompanying text (explaining that the resale restrictions applied to the tokens under Regulation D no longer apply if the tokens are not considered securities).

220. See *supra* notes 164–169 and accompanying text (describing the no-action letters, enforcement proceedings, and questions currently available to guide utility token users).

221. See *supra* notes 25–26 and accompanying text (noting the decline in interest in ICOs).

This Note takes the first step in this approach by listing factors that, if met, would entitle a platform to a rebuttable presumption that it is sufficiently decentralized.

A rebuttable presumption does not prevent the SEC from targeting platforms that, while meeting all the factors, are clearly controlled by a third party. It creates a higher pleading standard for the SEC—disincentivizing the agency from taking actions against platforms who rely on the presumption in good faith. But if the SEC believes strongly enough that a platform is attempting to evade the securities laws, it can bring an action and prove its case.

1. *Uses a Distributed Ledger.* A platform that uses a distributed ledger, rather than a centralized ledger, relies on the consensus of its users—particularly its validators—to approve of exchanges between purchasers and sellers of utility tokens.²²² The platform would have no say over what transactions are approved, and it cannot reverse any exchanges. If a platform had the unilateral ability to approve of transactions, it could indirectly dictate the platform’s policy by reversing transactions with which it did not agree, or, in general, freezing transactions if it believed the users were acting contrary to the platform owners’ wishes.²²³ The use of a distributed ledger prevents the platform’s founders from formulating and directly enforcing policies that are not inscribed into the open-source protocol that runs the platform.

2. *Uses a Permissionless Ledger.* When a platform uses a permissionless ledger, its founders do not have a say in who has the power to approve of transactions.²²⁴ If a platform’s founders could select which individuals can participate in the consensus process, they could indirectly control the platform. The founders could instruct their appointees to only approve of certain transactions or reverse others.

222. See *supra* notes 50–51 and accompanying text (discussing the differences between centralized and distributed ledgers).

223. For example, the platform could seek to prevent certain users from using its services. It could write its prohibitions into its open-source protocol, but the platform would have to ensure that its code only targeted the people it wanted to exclude, and its decision to do so would be viewable to the world. Therefore, a platform is more likely to enforce an opaque exclusionary policy *ex post* by reversing transactions to persons it does not believe should participate on the platform.

224. See *supra* note 52 and accompanying text (describing how permissionless ledgers allow any user to authenticate network transactions).

Even if the founders did not instruct their selected approvers on how to approve of exchanges, the approvers would serve as de facto controllers of the ledger. They could uniformly impose their will on the platform and direct its policies.

3. *Prevents 51 Percent Control over the Consensus Mechanism.*

Platforms make their decisions based on majority consensus. For instance, the proof-of-work model generally requires that a majority of the computing power provided to the platform, not a majority of the users participating in the consensus process, approve transactions.²²⁵ On a network that relies on proof of work, any person or entity who directly or indirectly controls a majority of the computing power used to approve of transactions would have de facto control of the platform.²²⁶ Platforms that use alternative consensus mechanisms will need to ensure that no individual person or group has majority control over the platform's particular consensus mechanism.

4. *Puts All Governance Issues to a Vote.* When a platform wants to make improvements, update its code, or issue new tokens, it could either give certain individuals the power to unilaterally do so or it could mandate that any decision be put up to a vote.²²⁷ If a platform gives certain people unilateral control over any of its matters, it runs the risk that its utility tokens will be considered investment contracts. Purchasers of the utility tokens would be dependent on the leaders' "managerial efforts" to guide the development of the platform, which in turn would affect the value of the token.²²⁸ Platforms instead would need to give each individual token holder the right to vote on all decisions that affect the platform's operations and affairs.²²⁹

225. See Azgad-Tromer, *supra* note 22, at 79 (“[C]onsensus protocols use weighted voting, where the weight of a miner’s vote, relative to other miners, depends on some measure of resource investment. [C]urrently, most blockchains rely on ‘proof-of-work,’ where votes are effectively weighed according to the amount of computational effort spent solving mathematical puzzles.”).

226. See *supra* note 53 and accompanying text; see also *supra* note 223 and accompanying text.

227. See Azgad-Tromer, *supra* note 22, at 90–91 (describing the different governance regimes used by platforms running on blockchain technology).

228. See *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 477 (9th Cir. 1973) (focusing on whose “essential managerial efforts . . . affect the failure or success of the enterprise”).

229. See generally Benedict George, *What Is a Governance Token?*, COINDESK (Jan. 12, 2022, 11:23 AM), <https://www.coindesk.com/learn/what-is-a-governance-token> [<https://perma.cc/82A6-VJCU>] (describing how platforms can grant token holders a say in the management of the platform through the use of “governance tokens”).

5. *Provides Equal Voting Rights for Token Holders.* Platform founders could grant specific token holders a weighted vote so that they have an outsized say in how the platform is managed. However, in doing so, the founders would effectively be giving outsized control rights to specific voters. The founders would be incentivized to give voting power to individuals who align with the founders' preferences. Platforms that solely allocate voting rights based on how many tokens one holds would meet the requirements of this factor.

6. *Offers Newly Issued Utility Tokens on Exchanges.* Because voting power is tied to tokens, a platform's founders could privately offer certain individuals tokens either for free or at a discount, granting those token holders outsized control in the affairs of the platform. The best way to check the founders' ability to offer tokens at below-market prices is to require that platforms offer any newly issued utility tokens on an exchange so that they cannot control who purchases the tokens, nor could they control the price at which individuals purchase the tokens.

7. *Limits Any Individual or Group from Holding a Majority of the Tokens.* Platform founders could retain a majority of the platform's utility tokens to ensure they have voting power over the platform—giving them control over the platform and the ability to dictate its management. A platform should therefore code restrictions into its open-source protocol that prohibit any individual or group from exerting control over a majority of the platform's tokens.

8. *Maintains a Fully Functional Token.* If a utility token is not fully functional, then it is more difficult for the platform to establish that the token's purchasers are guided by a desire to use the token.²³⁰ Moreover, the utility holders would depend upon the future development of the platform to increase the value of their token.²³¹ Therefore, whether utility token holders can immediately redeem their token impacts the availability of the presumption.

Under the status quo, developers and investors lack certainty on how a platform can be designed such that the SEC no longer considers the platform's utility tokens securities. But armed with the

230. See *supra* note 181 and accompanying text.

231. If a platform is not developed, then the token will not have any use and would not hold any value.

presumption, developers can offer investors, who initially purchase tokens through a Regulation D offering, clarity on when the tokens can be freely resold. The enhanced promise of future liquidity would encourage investment and breathe life back into the ICO.

CONCLUSION

Many believe that decentralized platforms will democratize the internet. While some of the wide-eyed claims around the future of decentralized platforms are lofty, these platforms do have the ability to create a future without rent-seeking intermediaries. However, decentralized platforms will never take off if they cannot adequately fundraise. And the best vehicle to raise capital—the ICO—is surrounded by a shroud of uncertainty. The SEC, which currently possesses regulatory authority over ICOs, can and should provide regulatory clarity on how decentralized platforms can sell their utility tokens in compliance with securities laws. As well, the SEC should amend its regulations to reflect the differences between utility tokens and traditional financial investments vehicles. The SEC can empower ICOs *and* protect investors, or it can choose to do nothing and leave everyone—platforms, investors, courts—in regulatory limbo.