Published on *The National Law Review* https://natlawreview.com

Bridging the Week by Gary DeWaal: April 1 – 5 and April 8, 2019 (You Say Security, I Say Utility; Midtrial Acquittal)

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The Securities and Exchange Commission's FinHub group issued guidance last week, providing a checklist of characteristics to help determine whether a cryptoasset may constitute a security or not. It's helpful, but the introduction of a concept called "Active Participant" may be problematic. Contemporaneously, the SEC's Division of Corporation Finance published a no-action letter to an air charter service company that intends to issue a stablecoin-type cryptoasset to serve as a means of payment for booking flights through its permissioned blockchain relying on smart contract technology. Staff said the token did not need to be registered as a security; however, this conclusion may also be less helpful as precedent than apparent. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- SEC Staff Outlines Characteristics of Cryptoassets That Could Cause Them to Be Regarded as Securities (includes **My View** and **Legal Weeds**);
- Alleged Programmer for Flash Crash Spoofer Acquitted of Criminal Conspiracy Charges; Aiding and Abetting Allegations Pending (includes **My View**); and more.

Article Version:

Briefly:

- **SEC Staff Outlines Characteristics of Cryptoassets That Could Cause Them to Be Regarded as Securities**: The Securities and Exchange Commission's Strategic Hub for Innovation and Financial Technology issued guidance on what characteristics a cryptoasset might have that could make it more likely to be deemed an investment contract, and thus a security, under US securities laws. FinHub noted that these characteristics pertain not solely to the "form and terms" of the digital asset itself, but also "the means in which it is offered, sold or resold (which includes secondary market sales)."

Cryptoassets that are securities must be registered under applicable securities law (unless qualified for an exemption) and require disclosure of certain information to investors.

In providing its analysis, FinHub utilized the three prongs of the *Howey* test to determine if an instrument was an investment contract (i.e., an (1) investment of money (2) in a common enterprise with the (3) reasonable expectation of profits through efforts of others), and keyed in on the last prong. (Click here to access the Supreme Court's 1946 decision in *SEC v. W.J. Howey*.)

Generally, FinHub wrote, purchasers would more likely be relying on the efforts of others if, in connection with a cryptoasset, a promoter, sponsor or other third party, or an affiliated group of third parties (each defined as an "Active Participant" or "AP") has a principal role in developing, operating or promoting the cryptoasset, or the network or project with which it is associated, or creates or supports a market or the price of the digital asset. This would be particularly relevant, said FinHub, where a network is still in development and not fully functional, and an AP "promises further developmental efforts in order for the digital asset to attain or grow in value." Additionally, where cryptoasset purchasers would reasonably expect an AP for its own benefit to undertake efforts to enhance the value of a digital asset, or the network or project, the third prong of the *Howey* test is more likely satisfied, claimed FinHub.

FinHub indicated that investors' expectation of profits could arise from their right to share in income or profits generated by a network or project, or from capital appreciation of the cryptoasset. A reasonable expectation of profit would more likely exist where a digital asset is traded on a secondary market, the cryptoasset is offered broadly (as opposed to a limited group in connection with their use of goods and services), and a digital asset is promoted as an investment.

Contrariwise, FinHub noted that certain characteristics would suggest a reasonable expectation of profits is less likely. These would include, among other factors, that the relevant network and cryptoassets are fully developed and operational; there is a low likelihood of appreciation in value of the cryptoassets and that, for digital assets referenced as virtual currencies, payment can be made with the cryptocurrency without first converting it to another digital asset or fiat currency. Also relevant would be whether the cryptoasset is marketed in a manner that emphasizes its functionality as opposed to the potential for appreciation

FinHub observed that the characteristics that might render a cryptoasset an investment contract at one point in time should be reevaluated at later times, as changes in characteristics might alter the classification of the digital asset.

In other legal and regulatory developments involving cryptoassets:

- Cryptoassets for Air Charter Services Determined to Be Utility Tokens by SEC Corp Fin: The SEC's Division of Corporation Finance indicated it would not recommend an enforcement action against TurnKey Jet, Inc. for issuing a digital asset to facilitate sales of air charter services without registering the token as a security under applicable law.

According to a description written by TurnKey, the digital token, as proposed, would effectively be a stablecoin offered in increments of US $1 that would effectuate easier payment for air charter services by potential users to air charter providers (including potentially TurnKey) and intermediary brokers. All transactions would occur solely among subscribers to TurnKey's membership program utilizing the firm's fully developed permissioned blockchain and smart contract technology. Proceeds from token purchases would be deposited in escrow accounts maintained at FDIC-insured US banks. Users could only use the tokens on the TurnKey network. Tokens might be repurchased by TurnKey but ordinarily only at a discount to face value. As a result, tokens might also be bought and sold

among members, but there would be no “incentive to buy from other Token holders at a premium above one dollar per Token.” TurnKey would solely fund the development and operation of its network (and not use any proceeds from token purchases) and would charge membership fees to users, providers and brokers. TurnKey would market the tokens for their functionality and not as an investment.

In its request for no-action relief, TurnKey argued that its digital tokens were neither investment contracts nor evidence of indebtedness.

- NY Federal Court Denies Motion by ICO Orchestrator to Dismiss Securities Fraud Claim Because No Security Involved: A federal court in New York denied a motion to dismiss a proposed class action lawsuit against a cryptocurrency company and its two founders for violating applicable securities laws because it determined that the plaintiff’s complaint reasonably alleged that the company’s initial coin offered tokens were securities. Raymond Balestra, the plaintiff, alleged that ATBCoin LLC along with Edward Ng and Herbert Hoover, the company’s founders and executives, sold unregistered securities when the company conducted an ICO for ATB Coins without registering the offering with the Securities and Exchange Commission.

According to the court, ATBCoin raised over US $20 million from June through September 2017 as a result of the ATB Coins’ ICO which was to be used to fund the development of the ATB Coin blockchain. ATBCoin allegedly promoted its ICO as an “investment opportunity,” claiming that its distributed ledger network would be the fastest blockchain in the Milky Way galaxy with “near-zero cost payments to anyone in the world.” Plaintiff’s lawsuit followed the collapse in price of ATB Coins when the technology of the ATB Coin blockchain purportedly did not live up to the pre-ICO hype.

In their motion to dismiss, defendants claimed that the plaintiff failed to sufficiently allege there was a common enterprise and a reasonable expectation of profits derived solely from the efforts of others – elements necessary to evidence an investment contract under US securities laws. The court rejected defendants’ arguments, saying that the plaintiff adequately pleaded that all investors’ ICO funds were pooled together to launch the ATB Coin’s blockchain and that the potential value of ATB Coins was intricately tied to ATBCoin’s blockchain’s success. Moreover, investors could reasonably believe that ATB Coins would increase in value based on defendants’ management and entrepreneurial efforts.

- Cryptocurrency Developers Claim They Can’t Be Sued for Securities Fraud Because Virtual Currencies Are Not Investment Contracts: The developers of the cryptoasset Nano moved to dismiss a purported class action against them for issuing an unregistered security, claiming that the relevant cryptoasset (traded as “XRB”) is a virtual currency and not a security. According to defendants' to a motion to dismiss filed at the end of March 2019, unlike an initial coin offering, where a cryptoasset is sold for payment of fiat currency or another cryptoasset, XRB tokens were distributed for free and “their value is derived from their utility as a currency, rather than from the success of any business operated by their developers.”

James Fabian, the named plaintiff, had alleged in his complaint against Nano and its developers that XRB tokens are a security because XRB was marketed as a speculative investment, and investors relied “almost exclusively” on the efforts of defendants and their core team to develop and operate

the Nano network. Plaintiff acknowledged that XRB was initially offered free through a method of distribution known as a "faucet," but said that defendants retained a substantial quantity of XRB for themselves for their work in developing and promoting the Nano network. Mr. Fabian allegedly acquired his XRB tokens through secondary market purchases in September and December 2017.

My View and Legal Weeds: The FinHub guidance provides a cogent overview of SEC staff's view of characteristics of cryptoassets and their sales that could render the virtual currencies securities under applicable law. These characteristics tend, in the SEC's view, to evidence whether or not a purchaser of a cryptoasset has a reasonable expectation of profit through the efforts of others.

Most importantly, within this guidance FinHub articulated express characteristics that would likely render a cryptoasset not to be a security based on an expectation of profits analysis. These characteristics would include: (1) a distributed ledger network that is fully developed and operational, allowing holders of relevant cryptoassets to immediately use their tokens on the network (e.g., if a virtual currency, solely for payments); (2) the cryptoassets are designed for user needs as opposed to speculation; (3) the opportunity for appreciation in value of the cryptoassets is limited; and (4) if the Active Participants promoting the relevant cryptoasset facilitate a secondary market, "transfers of the digital asset may only be made by and among users of the platform." This last characteristic may be relevant in some circumstances, but certainly not for a utility or payment token that has a fixed or consistently pegged value whose constancy is supported by the Active Participants or otherwise.

Additionally, the SEC coupled its issuance of the FinHub guidance with release of a no-action letter to TurnKey Jet, Inc., which, although interesting, in and of itself does not significantly further insight into SEC staff's practical thinking on security versus utility tokens. This is because of the narrow scope of Turnkey's proposed digital token offering: the firm's relief solely extends to cryptoassets that function as stablecoins issued on a tightly controlled permissioned blockchain. As a result, the precedential value of this no-action letter is likely limited.

The SEC staff's view in the FinHub guidance expands on prior SEC positions articulated in their 2017 DAO Report of Investigation; settlement orders in *Munchee*, and most recently *Air Fox*, *Paragon* and *Glaudius*; and various public commentary by SEC Chairman Jay Clayton and William Hinman, Director of Corporation Finance. (Click here to access background on the DAO Report in the article "SEC Declines to Prosecute Issuer of Digital Tokens That It Deems Securities Not Issued in Accordance with US Securities Laws" in the July 26, 2017 edition of *Between Bridges*. Click here to access information on the Glaudius and certain predecessor SEC orders in the article "ICO Promoter Settles SEC Enforcement Action for No Fine After Self-Reporting Potential Securities Law Violations" in the February 24, 2019 edition of *Bridging the Week*. And click here to access insight on Mr. Hinman's views on the qualities of cryptoassets that might cause them to be securities in the article "Anything but Sleep Inducing: SEC Corporation Finance Director Says Ether Not a Security and Canada Issues Guidance on Utility Tokens" in the June 17, 2018 version of *Bridging the Week*.)

All in all, given that no two cryptoassets typically are precisely alike, and specific facts and circumstances dictate all ultimate analyses, the staff's guidance provides a meaningful checklist to help gauge in advance whether a specific proposed cryptoasset likely constitutes an investment contract, and thus a security (or not) but does not address all potential circumstances. As a result, some may wish the SEC had been more expansive in its analysis, but it's difficult to address all possible permutations of cryptoassets in a single guidance. Perhaps, at some point soon the SEC can formally adopt standards of other jurisdictions (e.g., Wyoming; click here to access the relevant law) in expressly defining a utility token and confirming it would take no action against entities issuing

such digital instruments.

Moreover, in its guidance, FinHub introduced the concept of an Active Participant or AP; these are promoters, sponsors or other third parties (or affiliated group of third parties) who may be responsible for the development improvement (or enhancement), operation or promotion of a network. According to FinHub, investors' expectation that an Active Participant will perform or oversee tasks "...that are necessary for the network or digital to asset to achieve its intended purpose or functionality" could make the digital token associated with the network more likely to be regarded as a security. However, the concept of an AP is a bit murky as it not only potentially includes a single person but an affiliated group of unspecified third parties; "affiliated" is not defined. FinHub tries to restrict problematic activities of an AP to those that constitute "essential managerial efforts that affect the success of the enterprise" and contrasts tasks performed by an AP with those of an "unaffiliated, dispersed community of network users (commonly known as a 'decentralized' network)." However further clarification would be helpful regarding staff's thinking on this term.

- **Alleged Programmer for Flash Crash Spoofer Acquitted of Criminal Conspiracy Charges; Aiding and Abetting Allegations Pending**: Jitesh Thakkar was acquitted of the criminal charge of conspiracy to commit spoofing during his criminal trial last week related to his role in the spoofing activities of Navinder Sarao, who pleaded guilty to criminal charges in November 2018. Two pending counts of aiding and abetting spoofing against Mr. Thakkar are scheduled to be considered by a jury this week, after the presiding judge, the Hon. Robert Gettleman of the US District Court for the Northern District of Illinois, referred to the government's overall action as resting on a "thin case," according to numerous reports. (Click here for a sample report by the *Chicago Tribune.*)

Mr. Thakkar was named in a criminal action by the Department of Justice and a civil action by the Commodity Futures Trading Commission for purportedly developing "back-of-the-book" software that was used by Mr. Sarao to effectuate his spoofing activities. In court papers, Mr. Thakkar has claimed that he never was told by Mr. Sarao the purpose of his software request, but in any case, he did not develop the actual software; he assigned the task to other programmers at his company – Edge Financial Technologies, Inc.

Two weeks ago, Mr. Thakkar prevailed in a motion to preclude the government from instructing the jury they could convict the defendant if they found he had a strong suspicion that the relevant software would be used for spoofing, but he purposely avoided confirming that fact. Instead, the government will have to show Mr. Thakkar possessed knowledge of Mr. Sarao's illicit purpose beyond a reasonable doubt. (Click here for background on the charges against Mr. Thakkar and Mr. Sarao in the article "Criminal Trial of Purported Programmer for Convicted Spoofer Begins This Week; Proposed Ostrich Instruction to Jury Rejected by Court" in the March 31, 2019 edition of *Bridging the Week*.)

My View: After the court's dismissal of the conspiracy count against Mr. Thakkar, it seems less likely that the jury evaluating Mr. Thakkar's remaining aiding and abetting charges will find beyond a reasonable doubt that Mr. Thakkar knew of the purpose of the software requested by Mr. Sarao used to effectuate his spoofing activities. Coming on the heels of the acquittal of Andre Flotron, the former UBS trader, who last April 2018 was found not guilty by a jury for conspiracy to defraud in connection with purported spoofing?type trading activity involving precious metals futures contracts listed on the Commodity Exchange, Inc., a total defeat by the Department of Justice against Mr. Thakkar would elevate questions regarding the type and quality of evidence required by the DoJ to gain a successful

spoofing conviction. We should know a lot more by next week. (Click here for background regarding Mr. Flotron's acquittal in the article "Former UBS Trader Found Not Guilty of Conspiracy to Defraud for Alleged Spoofing" in the April 29, 2018 edition of *Bridging the Week*.)

More Briefly:

- **UK-Based Branch of Non-US-Based Financial Institution Authorized by CFTC Staff Temporarily to Operate Without IB Registration in Light of Reorganization of Business in Light of Brexit**: The Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight granted a temporary exemption from introducing broker registration to an unnamed non-US, non-UK-based global financial firm, to enable its London branch temporarily to handle non-solicited order flow from US institutional customers for execution on US designated contract markets to be introduced on a fully disclosed basis to the London branch's US futures commission merchant affiliate.

Previously, such introductions were made by a so-called Part 30.10 subsidiary of the non-US-based global financial firm that was overseen in all material aspects by the UK Financial Conduct Authority. However, in light of Brexit, the financial firm dissolved the Part 30.10 firm. Although the London branch is overseen by the FCA for some aspects, the FCA cannot sponsor it for Part 30.10 relief because it is a branch office of a non-UK-based financial firm that is also regulated by a non-UK regulator.

Because the non-US-based financial firm is itself in the process of applying for Part 30.10 relief, DSIO consented to allow the firm's London branch to effectively act as an introducing broker through no later than May 4, 2020, subject to a number of conditions, including that it will not solicit or handle the customer funds of any US person for trading on a DCM.

Under CFTC Rule 30.10, a non-US firm subject to comparable regulations as a US FCM may be authorized to carry accounts for US persons to trade non-US futures and options without registering as an FCM. (Click here to access CFTC Rule 30.10.) Under another CFTC rule, a non-US firm that is qualified as a Rule 30.10 person may also introduce institutional accounts to a registered FCM on a fully disclosed basis for trading on US DCMs, if it is substantially affiliated with a US FCM, and certain other requirements are satisfied. (Click here to access CFTC Rule 3.10(c)(4).)

- **CFTC Staff Grants Further Brexit Relief**: Multiple divisions of the Commodity Futures Trading Commission granted temporary regulatory relief to effectuate the possibility of a hard and soft Brexit as early as April 12, 2019. Under one letter, staff extended existing relief currently available to certain European Union entities under multiple staff correspondence to UK entities following Brexit, until such dates as provided for in the applicable letters. In another letter, staff provided temporary relief to ensure the continued application of substituted compliance and regulatory relief under various existing determinations and exemption orders for EU entities to UK entities while the CFTC assesses UK law to make equivalent determinations as appropriate. In the case of a hard Brexit, such relief will not extend beyond the latest of six months after the date the United Kingdom withdraws from the European Union.

Video Version:

National Law Review, Volume IX, Number 98