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The Cardozo Blockchain Project

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CARDOZO BLOCKCHAIN PROJECT

Research Report #1

**NOT SO FAST—RISKS RELATED TO THE
USE OF A “SAFT” FOR TOKEN SALES**

November 21, 2017

About

The Cardozo Blockchain Project is an initiative from Cardozo Law School to explore the legal issues and challenges related to blockchain technology. The project is directed by Aaron Wright. To learn more, please visit our website: <https://cardozo.yu.edu/programs-centers/blockchain-project> or send an email to aaron.wright@yu.edu.

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The Cardozo Blockchain Project would like to thank the following individuals (acting solely in their personal capacity) for their substantial input and guidance on the below report.

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The following individuals express some or all of the reservations with regard to the SAFT Whitepaper, discussed herein.

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On October 2, 2017, Cooley LLP and Protocol Labs released a whitepaper entitled “The SAFT Project: Toward a Compliant Token Sale Framework” (the “Whitepaper”), purporting to develop “a new, compliant framework” for engaging in the sale of blockchain-based tokens.¹ The Whitepaper acknowledged that the framework has limitations, and invited a conversation within the blockchain and legal community. In that spirit, the below report analyzes the framework proposed in the Whitepaper and highlights a number of risks related to the use of a Simple Agreement for Future Tokens (a “SAFT”) for token sales.

As explained below, while the framework proposed in the Whitepaper is arguably attractive in its simplicity, it may create more problems than it solves for sellers that follow its prescriptions. In particular, the Whitepaper seemingly advances an approach that:

- Blurs the true test of how tokens will be analyzed under U.S. federal securities law, which is highly dependent on the relevant facts and circumstances;
- Increases the risk that a token will be treated as a security by emphasizing the token’s speculative, profit-generating potential and relying on vague notions of “functionality” as a panacea to guard against broad securities laws implications; and
- Creates a class of early investors that are incentivized to flip their holdings instead of supporting enterprise growth, which could fuel speculation and hurt consumers.

Although outside the scope of this report, the approach advanced in the Whitepaper also creates: (i) uncertainty as to the tax treatment of SAFT proceeds; and (ii) risk that the SAFT may constitute a non-exempt forward contract with potential implications under U.S. commodities laws.

This report aims to advance the conversation regarding this emerging space and to caution those who may seek to rely solely on the Whitepaper’s conclusions as a basis for analyzing potential U.S. securities law risks when engaging in a token sale.² The report does not take a position on whether other pre-sale or pre-order agreements for pre-functional tokens could comply with securities law.³ And, it is not intended to—and should not—be relied upon as legal advice; token sellers should consult their own counsel.

The report proceeds in three parts. The first two sections provide a brief overview of utility tokens and the SAFT proposed in the Whitepaper. The final section outlines four concerns that should serve as a warning for those considering buying or selling tokens through a SAFT.

¹ See Juan Batiz-Benet, Marco Santori, and Jesse Clayburgh, *The SAFT Project: Toward a Compliant Sale Framework*, (October 2, 2017), <http://www.saftproject.com/static/SAFT-Project-Whitepaper.pdf> [hereinafter the “Whitepaper”].

² The use of the term “SAFT” and the process of preparing pre-sale or pre-order agreements in advance of broader token sales has become relatively common in some form and that the term SAFT may be interpreted by some as a general category or type of agreement. For purposes of clarity, when this report refers to the “SAFT,” or to the express terms of a SAFT, we are referring specifically to the form of agreement attached as an exhibit to the Whitepaper, and not to any pre-order agreement, pre-sale agreement or other self-described “SAFT” that may exist that is not in that form.

³ Additionally, this report does not purport to analyze the applicability of securities laws to any particular transaction, including any transaction to-date that may have made use of the SAFT Approach.

Overview of Utility Tokens

Digital tokens are most commonly created using the “ERC20” standard on the Ethereum blockchain. They are, fundamentally, programmable instruments with a variety of uses and functionality, depending on how they are designed and implemented and what characteristics and rights are ascribed to them. Possibilities include everything from pre-paid access to an online service and debt instruments to a traditional share in a company. With seemingly endless possibilities for collaboration and innovation across decentralized networks, tokens are poised to power new models of online collaboration and spur entrepreneurship across the United States and around the globe.

Blockchain-based tokens generally fall within two separate categories: “investment” tokens, on the one hand, and “utility” tokens, on the other hand.⁴ According to a recent study of over 250 token sales by researchers at the Università Bocconi and the Polytechnic University of Milan, utility tokens represent the majority of tokens issued to date.⁵ Approximately 68% of token sales involve rights to access an online platform, and nearly 25% provide some sort of governance rights, like voting on decision polls. Only 26.1% of token sales offer an overt profit right.⁶

The contours between investment and utility tokens are not well-defined at this point, but utility tokens are generally designed to offer a consumptive or functional utility, as opposed to an inherent opportunity for profit. Many utility tokens are integral to the functioning of a blockchain-based platform that creates a decentralized network and can represent, for example, membership or licensing rights, staking mechanisms, or incentivization systems.

Utility tokens often are highly fungible and typically are traded on secondary exchanges. As a result, some purchasers acquire utility tokens for investment purposes in addition to or instead of a *bona fide* desire to make direct use of the relevant consumptive aspect of a token on a blockchain-based platform. These investment-minded purchasers can obtain their tokens directly from a token creator and resell those tokens on a secondary exchange for a profit. Of course, utility tokens are not the first or only consumptive goods resold for profit. Consumers routinely sell everyday assets, like gold and silver, artwork, wine, event tickets, and collectibles with the hopes of generating financial gains.

⁴ Jonathan Rohr and Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, Cardozo Legal Studies Research Paper No. 527, (October 4, 2017), <https://ssrn.com/abstract=3048104>; see also *How Tokenization is Putting Real-World Assets on the Blockchain*, Nasdaq, March 30, 2017, <http://m.nasdaq.com/article/how-tokenization-is-putting-real-world-assets-on-blockchains-cm767952>.

⁵ Saman Adhami et al., *Why Do Businesses Go Crypto? An Empirical Analysis of Initial Coin Offerings* (September 30, 2017), <https://ssrn.com/abstract=3046209>.

⁶ *Id.*

Overview of the SAFT Approach

The Whitepaper proposes an approach (the “SAFT Approach”) to facilitate investments in utility tokens by venture capital firms, hedge funds, and large holders of cryptocurrencies that supposedly is consistent with U.S. federal securities laws. The SAFT Approach is an investment scheme divided in two separate, though inextricably connected, events: (1) the raising of money from institutional or other large investors to fund the development of a token-based platform, and (2) the delivery of “genuinely functional” tokens to investors for later resale to the public. The scheme is based on the so-called “Simple Agreement for Future Equity,” or SAFE, a financing mechanism used as a conduit for some venture investments.⁷

The SAFT Approach begins with token creators selling a self-described “investment contract” (the SAFT) to accredited investors pursuant to which the token creators agree to deliver tokens to the parties to the SAFT at a future date when the tokens are deemed to be “functional.”⁸ Token creators use the SAFT proceeds “to develop [a] genuinely functional network, with genuinely functional utility tokens.”⁹ Once the network is functioning, token creators deliver these tokens to the SAFT purchasers, who then are expected to resell the tokens for profit.¹⁰

Under this approach, SAFT purchasers acquire utility tokens only to profit from the sale of these tokens, and not to consume or enjoy the use of the underlying blockchain-based technology. Indeed, each SAFT purchaser unambiguously represents that it “has *no intent to use or consume* any or all Tokens on the corresponding blockchain network for the Tokens after network launch” and enters into the SAFT “*purely to realize profits* that accrue from purchasing Tokens at [a] Discount Price.”¹¹

The Whitepaper contends that this approach “elegantly navigates” hurdles with federal securities laws.¹² The initial SAFT sale does not run afoul of these laws, because the sale involves the private placement of securities to accredited investors. Subsequent token sales, or re-sales, fall outside the scope of federal securities laws, because, once the tokens are “genuinely functional,” the tokens supposedly are not dependent upon “essential efforts” of the token creators and, therefore, according to the Whitepaper, are not securities.¹³

Concern #1: The SAFT Whitepaper Wrongly Suggests that Application of the U.S. Federal Securities Laws Will Turn on Bright-line Rules.

Many readers of the Whitepaper are left with the impression that U.S. federal securities laws recognize something akin to a bright-line test, namely, that the question of whether a utility token will be deemed a security will generally turn on whether the token is “functional.” However, courts and the SEC have repeatedly, and unambiguously, explained that the test for

⁷ The SAFE, itself, has recently been subject to scrutiny by the SEC. See SEC, *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding* (May 9, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes. In this Investor Bulletin, the SEC noted that “[d]espite its name, a SAFE may not be ‘simple’ or ‘safe.’”

⁸ Whitepaper, *supra* note 1, at 1.

⁹ *Id.*

¹⁰ *Id.*

¹¹ SAFT, ¶ 5(c) (emphasis added).

¹² Whitepaper, *supra* note 1, at 17.

¹³ *Id.*

whether a particular instrument will be deemed a security depends not on bright-line rules but rather on the relevant facts, circumstances, and economic realities.

The Whitepaper correctly cites *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) as the origin of the legal test for an “investment contract” security. In that case, the U.S. Supreme Court explained that an instrument is an investment contract if it involves “[1] a contract, transaction, or scheme [2] whereby a person invests money, [3] in a common enterprise, and [4] is led to expect profits solely from the efforts of the promoter” (the “*Howey test*”).¹⁴

Importantly, and sensibly, the *Howey test* is not applied in a vacuum. Instead, as repeatedly confirmed by the U.S. Supreme Court, the test is evaluated in light of “the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties.”¹⁵

The multi-factored and fact-dependent nature of this test was recently emphasized again by the SEC in the context of digital tokens. In its DAO Report, the SEC “deem[ed] it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale.”¹⁶ The SEC reiterated that “[w]hether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction.”¹⁷

The flexible, case-by-case nature of this analytical framework is particularly well-suited for utility tokens in light of their varied forms and potential uses.

Concern #2: Token Creators Following the SAFT Approach Could Face Greater Risk Under U.S. Federal Securities Laws.

The SAFT Approach runs the risk of increasing the scrutiny of sellers of utility tokens under the U.S. federal securities laws for two reasons. First, sellers using a SAFT naturally will emphasize the speculative, profit-generating aspects of the utility tokens they are developing in a way that could trigger federal securities law scrutiny well beyond the initial SAFT sale. Second, the legal analysis underpinning the SAFT’s attempt to “navigate” around federal securities laws is not well supported by current law.

¹⁴ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). As noted above, in its recent analysis the SEC confirmed the applicability of such test to the determination of whether a digital token may be considered a security. See SEC Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf> [hereinafter the “DAO Report”].

¹⁵ *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851-852 (1975); *Int’l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 558 (1979).

¹⁶ DAO Report, *supra* note 8, at 10.

¹⁷ *Id.* at 17-18.

A. Emphasizing Tokens as an Investment Scheme Makes Tokens More Likely to Be Characterized as Securities.

There is little room to dispute that sellers relying on a SAFT will emphasize the speculative, profit-making potential of the underlying utility token. On its face, the SAFT is designed as a security, and as noted above, SAFT purchasers expressly disclaim any desire to use or consume the tokens for any purpose other than selling the tokens to earn an investment profit. Because gaining the support of self-admitted profit-seeking accredited investors is the first step in finding purchasers to enter a SAFT, it is reasonable to assume that many token-creators using the SAFT Approach will design their token, platform, and message with an eye on the profit potential of their tokens. And many token-creators will, understandably, tout the quantity of SAFT investments raised and the involvement of high-profile SAFT “investors” as evidence of that profit potential.

Touting the investment and profit potential of tokens during a SAFT sale process may well impact a federal securities law analysis of a token developed pursuant to a SAFT. Indeed, it seems reasonable to assume that, in many cases, the SAFT sales process and related marketing efforts could impact the “economic realities” of purchasing or selling these tokens, thereby tipping the scales of any facts-and-circumstances approach towards the application of federal securities laws.

By implication, even though the SAFT purports to make the sale of proposed utility tokens more compliant with applicable law, in practice, it could increase the risk that a utility token will be subject to securities law regulation under U.S. federal law. As a result, a token seller’s reliance on a SAFT could transform an inherently consumptive digital good (the token itself), which otherwise would fall outside the scope of *Howey*, into an investment contract subject to federal securities laws.

Bifurcating the purchase of tokens through a SAFT from the delivery of underlying transaction is merely form over substance and likely will do little to cloud the transaction’s economic reality.¹⁸ The SAFT Approach, like the scheme in *Howey*, actively encourages speculation by emphasizing the gains to be reaped from being an “early stage investor” in a new token ecosystem. Artificially dividing the overall investment scheme into multiple events does not change the fact that accredited investors purchase tokens (albeit through SAFTs) for investment purposes, and likely will not prevent a court from considering these realities when assessing whether these tokens are securities.¹⁹

¹⁸ The United States Supreme Court has repeatedly indicated that when “searching for the meaning and scope of the word ‘security’ . . . form should be disregarded over substance and the emphasis should be on the economic reality.” *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); see also *Howey*, 328 U.S. at 298; *Forman*, 421 U.S. at 848.

¹⁹ *Reves v. Ernst & Young*, 494 U.S. 56, 61, 71 (1990) (“Congress’ purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called,” and explaining that the Court was “not bound by legal formalisms, but instead [must] take account of the economics of the transaction under investigation.”); *McCown v. Heidler*, 527 F.2d 204, 208 (10th Cir. 1975) (following a “flexible approach” that depends “not upon the form, but upon the substance and economic reality of the transaction in question”) (citing *Forman*, 421 U.S. 837 at 849).

B. Arguments Related to the Timing of a Seller’s Efforts Lacks Meaningful Support Under the Law.

Because the SAFT pushes the economic realities of SAFT-developed tokens towards a scheme that would qualify as an investment contract under *Howey*, the Whitepaper attempts to “navigate” around federal securities laws by broadly claiming that achieving token “functionality” will make it “unlikely” that these tokens would be deemed securities.²⁰

The Whitepaper’s rationale is that a “functional” token will not satisfy *Howey*’s requirement that purchasers expect profits “solely from the efforts of the promoter.” The Whitepaper contends that “for an already-functional utility token, a great variety of forces can predominate the effects of the ‘efforts of others’ on the purchaser’s ‘expectation of profit.’”²¹ The Whitepaper’s authors reason that “if the purchaser has an ‘expectation of profit’ from the purchase of a pre-functional token, that expectation is very likely to be predominantly from the ‘efforts of others.’”²² In other words, the Whitepaper largely concedes that the efforts of sellers are essential and significant in creating a “functional” token (as well as selling the SAFT), but contends that the federal securities laws are not implicated if those efforts are completed before delivering or selling the tokens.

To start, as noted above, it is not clear that a court or the SEC will agree with the distinction that is fundamental to—yet unaddressed in the Whitepaper’s analysis—that the SAFT investment is a purchase of the SAFT and *not* also a purchase of the underlying tokens. Even setting that issue aside, the Whitepaper’s rationale has sparse and controversial legal support.

The authors of the Whitepaper principally rely on three cases—*Noa v. Key Futures*,²³ *SEC v. Belmont Reid*,²⁴ and *Sinva v. Merrill Lynch*²⁵ (collectively, the “Natural Resources Cases”)—to buttress their position. These cases involved sales agreements for subsequent delivery of natural resource-based commodities such as gold, silver, and sugar. The courts in these cases concluded that the federal securities laws did not apply, even though the purchasers of these agreements had an expectation of profit, because that profit depended on the rise of global gold, silver, or sugar prices and not the efforts of any particular seller or promoter.

The Whitepaper does not provide much explanation as to how the Natural Resources Cases make it “unlikely” that a utility token, marketed as an investment opportunity, would not be deemed a security under *Howey*. The authors’ logic appears to be that the SAFT is like the sale agreements in the Natural Resources Cases. And, because those sale agreements did not convert gold, silver, or sugar into securities where profit potential was dictated by market prices that were not meaningfully impacted by sellers’ efforts, the SAFT should not convert its later-delivered utility tokens into securities where SAFT profits are dictated primarily by market prices of already functional tokens.

²⁰ Whitepaper, *supra* note 1, at 10.

²¹ *Id.* at 9-10, 17.

²² *Id.* at 11.

²³ 638 F.2d 77, 79 (9th Cir. 1980).

²⁴ 794 F.2d 1388, 1391 (9th Cir. 1986).

²⁵ 253 F. Supp. 359, 367 (S.D.N.Y. 1966).

However, the Natural Resources Cases are inapposite to the critical question that courts will need to grapple with when dealing with utility tokens: whether the utility tokens, in and of themselves, will be deemed investment contracts under *Howey*. Unlike physical commodities—such as gold, silver, or sugar—utility tokens are not homogenous and carry with them various rights, features, and obligations. Therefore, one cannot broadly conclude that just because a contract for the sale of gold, silver, or sugar was not deemed a security, the same must be categorically true for utility tokens.

Likewise, while a sale agreement for gold may not convert gold into a security, that says nothing about whether a SAFT may alter the facts, circumstances, and economic realities surrounding the SAFT’s underlying utility token in a way that implicates federal securities laws. At most, the Natural Resources Cases highlight the *importance* of seller’s efforts, not their *timing*.²⁶ These cases simply do not support the broad statement found in the Whitepaper that it is “unlikely” that post-functional utility tokens would be deemed a security.²⁷

Although not cited in the Whitepaper, the primary case that advances an approach similar to the Whitepaper’s attempt to distinguish between pre- and post-sale efforts of sellers is the highly controversial decision by the D.C. Circuit Court in *SEC v. Life Partners, Inc.*, 87 F.3d 536, 547 (D.C. Cir. 1996). There, the D.C. Circuit Court analyzed whether viatical settlements²⁸ fell within the purview of *Howey*. The court determined that these asset-backed instruments were not securities, because at the time of the sale: (1) “the value of the promoter’s efforts ha[d] already been impounded into the . . . purchase price of the investment”; and (2) “neither the promoter nor anyone else [was] expected to make further efforts that w[ould] affect the outcome of the investment.”²⁹

However, even *Life Partners* provides only limited support, if any, for the Whitepaper’s broad legal conclusions. First, the *Life Partners* decision has been the subject of significant criticism, with the SEC adopting a different position when analyzing viatical settlements and a number of Circuits and courts around the country refusing to recognize a distinction between a seller’s pre- and post-sale efforts.³⁰ Indeed, in *SEC v. Mutual Benefits*, the Eleventh Circuit

²⁶ Indeed, other cases involving commodities have, *inter alia*, focused on the efforts of the promoter and not the timing of the promoter’s efforts. See, e.g., *Smith v. Gross*, 604 F.2d 639, 643 (9th Cir. 1979) (investment scheme involving earthworms); *Miller v. Cent. Chinchilla Grp., Inc.*, 494 F.2d 414, 417 (8th Cir. 1974) (investment scheme involving chinchillas); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 485 (5th Cir. 1974) (investment scheme involving cosmetics).

²⁷ Whitepaper, *supra* note 1, at 9-10.

²⁸ A viatical settlement is the sale of a policy owner’s existing life insurance policy to a third party for more than its cash surrender value, but less than its net death benefit.

²⁹ *SEC v. Life Partners, Inc.*, 87 F.3d 536, 547 (D.C. Cir. 1996).

³⁰ Recent Innovations in Securitization: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs., 111th Cong. 46, 57 (2009) (statement of Paula Dubberly, then Associate Director, Division of Corporate Finance, United States Securities and Exchange Commission, where Dubberly stated “life settlements are securities, and, therefore, are subject to the requirements of the federal securities laws, including the anti-fraud rules.”). Other courts also have found viatical settlements securities, refusing to adopt the reasoning set forth by the D.C. Circuit in *Life Partners*. See *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005); *Wuliger v. Eberle*, 414 F. Supp. 2d 814, 819–21 (N.D. Ohio 2006); *Wuliger v. Mann*, 2005 WL 1566751, at *3-4 (N.D. Ohio July 1, 2005); *Wuliger v. Anstaett*, 363 F. Supp. 2d 917, 921–22 (N.D. Ohio 2005); *SEC v. Mutual Benefits Corp.*, 323 F. Supp. 2d 1337, 1343-44 (S.D. Fla. 2004), *aff’d* 408 F.3d 737 (11th Cir. 2005); *Wuliger v. Christie*, 310 F. Supp.2d 897, 903-07 (N.D. Ohio 2004); *SEC v. Tyler*, 2002 WL 32538418, at *4-6 (N.D. Tex. Feb.

expressly rejected the analysis in *Life Partners* deeming the D.C. Circuit’s approach as novel and not envisioned by the holding in *Howey*.³¹ In reaching its decision, the Eleventh Circuit observed that under *Howey* and the more recent Supreme Court decision of *SEC v. Edwards*, courts must construe the term “investment contract” broadly to “encompass virtually any instrument that might be sold as an investment.”³² The court refused to engage in artificial line drawing relating to the timing of a promoter’s efforts because investment schemes “often involve a combination of both pre- and post-purchase managerial activities, both of which should be taken into consideration in determining whether *Howey*’s test is satisfied.”³³

Second, applying *Life Partners* would likely lead to the opposite result intended by the Whitepaper—namely, many if not most token projects may be found to involve post-sale efforts of sellers that are sufficient to satisfy *Howey*’s “efforts of others” prong. As the *Life Partners* court clarified in denying rehearing, it held only “that [1] pre-purchase services cannot by themselves suffice to make the profits of an investment arise predominantly from the efforts of others, and that [2] ministerial functions should receive a good deal less weight than entrepreneurial activities.”³⁴

The Whitepaper does not dispute that utility token projects often include ongoing efforts by sellers after token delivery, such as “improv[ing] the network.”³⁵ To be sure, many token-based projects set forth multiple stages of development for the relevant platform. For example, an alpha version may be released within a specified period of days after the initial token sale; a beta version may become available once certain milestones are met; and, often, future versions of the platform, with additional features and functions, may be released as the platform matures and its user base expands.³⁶ This general approach is demonstrated in many existing token-sale whitepapers (including tokens sales that have used a SAFT), with token sellers describing plans to continue developing and building their platform after initial “functionality” has been achieved to provide additional marketing, business development, and engineering support.³⁷

21, 2002); *SEC v. Torchia*, 183 F. Supp. 3d 1291, 1309 (N.D. Ga. 2016); *Life Partners, Inc. v. Arnold*, 464 SW 3d 660 (Tex. Sup. Ct. 2015); *Siporin v. Carrington*, 23 P.3d 92, 97 (Ariz. Ct. App. 2001); *Joseph v. Viatica Mgmt., LLC*, 55 P.3d 264, 266-68 (Colo. Ct. App. 2002); *Allen v. Jones*, 604 S.E.2d at 645-47 (Ga. Ct. App. 2004); *Poyser v. Flora*, 780 N.E.2d 1191, 1195-97 (Ind. Ct. App. 2003); *Hill v. Dedicated Res., Inc.*, 2000 WL 34001915, at *2-3 (Kan. Dist. Ct. July 12, 2000); *Michelson v. Voison*, 254 Mich. App. 697 (Mich. Ct. App. 2003); *Rumbaugh v. Ohio Dep’t of Commerce*, 800 N.E.2d 780, 784 (Ohio Ct. App. 2003); see also *Kligfeld v. Fla. Office of Fin. Regulation*, 876 So.2d 36, 38 (Fla. Dist. Ct. App. 2004).

³¹ *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005); see also *SEC v. Edwards*, 540 U.S. 389 (2004).

³² *Id.* at 742.

³³ *Id.* at 743-44.

³⁴ 102 F.3d 587, 588 (D.C. Cir. 1996).

³⁵ Whitepaper, *supra* note 1, at 9.

³⁶ A similar approach of ongoing support is obviously also evidence with other more traditional, centralized platforms like Netflix or Facebook, where the enterprise carefully cultivates the network through added features and upgrades—often over a number of years—to enrich the network for its stakeholders and platform users, which in turn increases the network’s value for its shareholders. There is no reason to believe that decentralized, blockchain-based platforms will be different.

³⁷ See Protocol Labs, “Filecoin Token Sale Economics,” https://coinlist.co/assets/index/filecoin_index/Filecoin-Sale-Economics-e3f703f8cd5f644aec7ae3860ce932064ce014dd60de115d67ff1e9047ffa8e.pdf (noting that Protocol Labs was reserving funds for ongoing “research, engineering, deployment, business development, marketing, distribution, and more.”).

The Whitepaper argues that these post-delivery efforts are not sufficient to fall under the scope of *Howey* because they are not “essential” efforts. However, that is a markedly higher bar than *Life Partner’s* lenient requirement that post-sale efforts merely involve *some* entrepreneurial efforts to tip a *Howey* analysis towards a finding that an investment scheme involved the sale of a security.

In effect, the SAFT Approach advances an even more aggressive interpretation of *Howey* than *Life Partners*, narrowing the scope of what would qualify as an investment contract and thus likely making the approach a non-starter for the SEC or courts when analyzing post-sale efforts. Indeed, if adopted, the SAFT Approach could have the unintended consequence of moving a large portion of securitized products outside the reach of federal securities laws. After securitization products are sold, many of these products, such as mortgage-backed securities, often require comparatively less ongoing “efforts” by their promoters. The *Life Partners* court was able to limit fears that these less-significant efforts would not be sufficient “efforts of others” under their approach for applying *Howey*. The court explained that the “efforts of others” prong would be satisfied under their approach even by post-sale tasks such as collecting late payments and arranging for secondary trading.³⁸ But while these types of tasks satisfied *Life Partners’* requirement of some ongoing entrepreneurial and non-ministerial tasks, it is less clear whether they would satisfy the Whitepaper’s requirement that such ongoing efforts be “essential.”

When viewed as a whole, the Whitepaper has no meaningful legal support for its broad conclusion that utility tokens supporting “functional” blockchain-based platforms are “unlikely” to be deemed a security, and given the widespread concern leveled against *Life Partners*, the SAFT Approach does not rest on a “very strong argument that the tokens themselves are not securities.”³⁹ Instead, the SAFT Approach encourages profit-seeking investments in utility tokens and downplays the fact-and-circumstance nature of *Howey* by overemphasizing (1) whether tokens support a “functional” network and (2) the timing of a token seller’s efforts. To heed the SAFT Approach, the SEC and courts would need to shift how they currently evaluate a promoter’s “efforts” potentially causing viatical settlements and other similar financial products to fall outside the scope of federal securities laws. At a minimum, before deciding to rely upon the SAFT Approach to navigate federal securities laws, market participants should recognize the risk that the Whitepaper’s analytical approach faces significant legal hurdles to adoption.

Concern #3: Notwithstanding the Whitepaper’s Policy Concern, Pre-Selling Consumptive Goods Does Not by Itself Run Afoul of Securities Laws.

The Whitepaper advances a policy concern to justify its approach, by claiming that “direct token pre-sales” to “unaccredited investors” of “pre-functional tokens” needlessly forces consumers to shoulder “enterprise risk.”⁴⁰ This policy concern is a red-herring.

The mere presence of some level of “enterprise risk” does not, in and of itself, implicate U.S. federal securities laws. If it did, every fan who purchased a ticket in advance for an entertainment or sporting event that was subsequently canceled might have a U.S. federal

³⁸ *Life Partners*, 102 F.3d at 191.

³⁹ Whitepaper, *supra* note 1 at 9, 15.

⁴⁰ *Id.* at 14-15.

securities law claim against the promoters.⁴¹ Likewise, Kickstarter-style crowdfunding campaigns where the public purchases a good or product that may or may not ever be produced or meet expectations generally are not regarded as “securities,” even though a number of these projects have raised tens of millions of dollars, with one project—Star Citizen, a video game—raising over \$160 million in funding.⁴² Nor are the pre-ordered purchases of hundreds of millions of dollars of high-technology consumer goods, like Tesla cars, generally seen as implicating federal securities laws.⁴³ These goods regularly involve not only inherently complex and often lengthy build timelines before delivery and purchase, but may also require significant firmware upgrades and subject consumers to other enterprise risks after the purchase date for such goods.

Many token sales, regardless of the level of platform functionality at the time of sale, can be analogized to the types of transactions described above, with other federal agencies, like the Federal Trade Commission (“FTC”) or Commodity Futures Trading Commission (“CFTC”), policing for fraud or abusive trading practices. And, consistent with the treatment of such other transaction types, sales of tokens being developed for purposes of use and consumption on a functional blockchain-based platform should not be designated as sales of securities merely because some level of functionality still needs to be developed. Instead, the current “facts and circumstances”-based *Howey* test should be applied to each particular use case, with a emphasis on the consumptive aspects of the underlying utility token.⁴⁴

In fairness to the authors of the Whitepaper, a minority of U.S. states, such as California, apply a different securities law doctrine known as the “risk capital test,” which determines whether an instrument is a security for state law purposes in part based on whether the purchasers of the instrument incur similar risks to ordinary investors in an enterprise—*i.e.*, the purchasers could lose all of their purchase price or “capital” if the enterprise fails.⁴⁵ However, even in those states, the presence of “risk capital” is not sufficient to determine the existence of a

⁴¹ *The Ticket Reserve, Inc.*, SEC No-Action Letter, 2003 WL 22195093 (Sept. 11, 2003); *see also San Francisco Baseball Associates, LP*, SEC No-Action Letter, 2006 WL 488513 (Feb. 24, 2006) (no-action letter issued in relation to service operated by San Francisco Giants to assist in matching buyers and sellers of seat license that entitled the holder to purchase season tickets).

⁴² C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 31 (2012) (explaining that “[d]onation-model crowdfunding sites are not offering securities to investors.”); *see also* Regulation Crowdfunding codified as amended at 17 C.F.R. § 200, 227, 232, 240 and 249 (2015), available at <http://www.sec.gov/rules/final/2015/33-9974.pdf>; Roberts Space Industries, *The Stretch Goals*, <https://robertsspaceindustries.com/funding-goals> (noting that Star Citizen raised \$163 million from over 1,000,000 people online); Nina Kipzen, *The 10 Most Funded Kickstarter Campaigns Ever*, Entrepreneur, December 28, 2015, <https://www.entrepreneur.com/article/235313> (listing a number of Kickstarter projects that have raised over \$10 million dollars).

⁴³ For example, Tesla pre-sold access to its Model 3 electric car, receiving \$1,000 deposits for over 325,000 cars and raising over \$325 million in revenue. *See* Bill Vlasic, “Tesla’s Model 3 Already Has 325,000 Preorders,” N.Y. Times, Apr. 7, 2016, <https://www.nytimes.com/2016/04/08/business/teslas-model-3-already-has-325000-prospective-owners.html>. The Tesla Model 3 has yet to be delivered to consumers.

⁴⁴ Indeed, this was the approach recently adopted by the Monetary Authority of Singapore in its recently issued Guide to Digital Token Offerings, <http://www.mas.gov.sg/~media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/Regulations%20Guidance%20and%20Licensing/Guidelines/A%20Guide%20to%20Digital%20Token%20Offerings%20%202014%20Nov%202017.pdf>.

⁴⁵ *Silver Hills Country Club v. Sobieski*, 13 Cal. Rptr. 186, 187 (1961).

security. Other elements also must be satisfied, such as the investors being “substantially powerless to affect the success of the enterprise,” which may not be true of all blockchain token enterprises—particularly ones that are highly decentralized and depend on the efforts of volunteers to generate network effects and underlying value.⁴⁶

Moreover, U.S. federal securities laws implicitly recognize the commercial reality that nearly every private contract with a counterparty involves incurring some degree of “enterprise risk.” That is why the *Howey* test and other U.S. federal securities tests do not explicitly consider this factor.⁴⁷ Indeed, if the presence of “enterprise risk” were a factor in determining whether an instrument is a security, the securities laws would be extremely vague, as nearly every commercial transaction involves some degree of “enterprise risk.”⁴⁸

Concern #4: The SAFT Approach Could Harm Consumers.

The SAFT poses a risk of misaligned incentives among founders, SAFT holders, and other consumers who may own or purchase tokens for consumptive purposes. Of particular concern is the extent to which the SAFT provides opportunities for SAFT holders to engage in abusive trading practices.

As recently recognized by current SEC Chairman, Jay Clayton, token holders often “have access to immediate liquidity, as do larger investors, who may purchase tokens at favorable prices.” As a result, tokens are “susceptible to price manipulation and other fraudulent trading practices.”⁴⁹

While these risks are present in many token transactions, especially those involving pre-sales or lax token lockup requirements, the SAFT exacerbates these risks. With traditional equity investments, investors are generally aligned to support the long-term growth of a company and its valuation and are subject to robust transfer restrictions. Under the SAFT Approach, however, SAFT purchasers are incentivized to profit from a short-term token sale event. That single sale event may be all that a SAFT purchaser needs (depending on the discount rate they receive under the SAFT) to recoup their initial investment and make a substantial profit. Though these investors may retain tokens for future sales, SAFT purchasers are admittedly profit-seeking and may choose instead to do a “quick flip” and move on to their next SAFT opportunity.

By positioning tokens as merely a means for profit, the SAFT helps cultivate an environment that incentivizes investors to push for a successful token sale more than a successful token-based platform. Investors who receive tokens via a SAFT may, for example, exert their influence and power to achieve a profitable initial token sale, not a viable long-term token network. They could pressure token sellers to rush to market without sufficient technical development, business model ideation, or technical diligence.

⁴⁶ *Id.*

⁴⁷ *Howey*, 328 U.S. at 298-99.

⁴⁸ *Belmont Reid*, 794 F.2d at 1391 (finding “efforts of others” prong not met, even though the greatest risk was seller’s failure to deliver purchased goods, because such risk would apply “to any sale-of-goods contract in which the buyer pays in advance of delivery and the ability of the seller to perform is dependent, in part, on both his managerial skill and some good fortune”).

⁴⁹ Jay Clayton, “Governance and Transparency at the Commission and in Our Markets,” November 8, 2017, New York, NY, <https://www.sec.gov/news/speech/speech-clayton-2017-11-08>.

Worse, SAFT purchasers may hold a material number of the total tokens created and thus would be in a position to manipulate the price of tokens in order to recognize quick profits. These practices could result in extreme price volatility for a token. For example, when SAFT purchasers immediately sell their tokens in a secondary market and liquidate their positions, the sale could cause a rapid decline in the price of the token, generating large losses for other purchasers.⁵⁰

Alternatively, market manipulation could increase the cost of blockchain-based services for everyday consumers.⁵¹ Under such a scenario, economically privileged purchasers will receive exclusive access to purchase utility tokens—a fundamentally consumptive technology—at an early stage in the platform’s development and at substantial discounts, even though they have no intent to use these tokens or enjoy the underlying technology. If these investors speculate on the price of these tokens, their value could increase, potentially making it more expensive for consumers to purchase tokens and participate on these networks.

When stripped to its core, even though the SAFT Approach is couched in terms of consumer protection, the result very well could be the opposite. Everyday consumers could lose out if speculating investors inflate the pricing of next-generation digital consumer goods. By shoehorning inherently consumptive goods, such as utility tokens, into exemptions to U.S. federal securities laws and channeling the sale of these goods first to sophisticated investors in search of profits, the SAFT Approach could heighten the exuberance manifesting in markets for blockchain-based tokens and make it even more difficult to provide consumers access to potentially impactful new technology.

Conclusion.

All told, while the authors of this report sympathize with the instinct to impose a simple heuristic framework on a complex body of law, and while the SAFT Approach perhaps could be adaptable in an individual case, the SAFT Approach ultimately fails to deliver a simplified and binary compliant token sale framework as advertised. Tokens underlying a SAFT may be more likely to be deemed securities, thus potentially subjecting token sellers to significant legal or economic risks. The SAFT rests on a fundamentally flawed interpretation of U.S. securities laws, in contravention of underlying principles and established precedent. If widely used, the SAFT could result in wealthy institutional investors playing an unnecessarily prominent role in the development of the next generation of global technology platforms and potentially could exacerbate speculation.

Notwithstanding the views expressed above, it may be possible to structure or pre-sell access to tokens, without increasing the risk that a token would be deemed a security under *Howey*. The Cardozo Blockchain Project, along with the contributors to this report are working

⁵⁰ Note, this risk is not exclusive to the SAFT. The same risks manifest in any token sale where the holding are not widely distributed. Indeed, such risks are already beginning to surface. See Olga Kharif, *Hedge Funds Flip ICOs, Leaving Other Investors Holding the Bag*, Bloomberg, Oct. 3, 2017, <https://www.bloomberg.com/news/articles/2017-10-03/hedge-funds-flip-icos-leaving-other-investors-holding-the-bag>. However, by purporting to provide a simple, lawful means for venture capital funds and hedge funds to profit from utility tokens, the risks become heightened.

⁵¹ Others also have recognized this impact. See Michael Casey, *Where SAFT Falls Short*, CoinDesk, Oct. 4, 2017, <https://www.coindesk.com/saft-falls-short/>.

together to develop alternative frameworks or, at a minimum, guiding principles that can help guide projects seeking to sell or pre-sell utility tokens.

Whichever approach is taken in terms of a token sale, it is critical to work closely with well-informed legal counsel to navigate through the complex facts and circumstance analysis underpinning the U.S. federal securities laws.