A Securities Law Framework for Blockchain Tokens

A **blockchain token** is a digital token created on a blockchain as part of a decentralized software protocol.

There are many different types of blockchain tokens, each with varying characteristics and uses. Some blockchain tokens, like Bitcoin, function as a digital currency. Others can represent a right to tangible assets like gold or real estate.

Blockchain tokens can also be used in new protocols and networks to create distributed applications. These tokens are sometimes also referred to as App Coins or Protocol Tokens. These types of tokens represent the next phase of innovation in blockchain technology, and the potential for new types of business models that are decentralized - for example, cloud computing without Amazon, social networks without Facebook, or online marketplaces without eBay.

However, there are a number of difficult legal questions surrounding blockchain tokens. For example, some tokens, depending on their features, may be subject to US federal or state securities laws. This would mean, among other things, that it is illegal to offer them for sale to US residents except by registration or exemption. Similar rules apply in many other countries.

The Framework focuses on US federal securities law because these laws pose the biggest risk for crowdsales of blockchain tokens. In many jurisdictions, there may also be issues under anti-money laundering laws and general consumer protection laws, as well as specific laws depending on what the token actually does.

This document is a general guide for developers and users of tokens.

Part 1 is designed to estimate how likely a particular token is to be a security under US federal securities law.

Part 2 sets out some best practices for crowdsales.

Part 3 is a detailed securities law analysis by Debevoise & Plimpton LLP.

As more fully set forth in the component parts of this document, the document does not constitute legal advice and should not be relied on by any person. Developers and users should consult their own counsel in connection with their initiatives in this area.

You should not rely on this Framework as legal advice. It is designed for general informational purposes only, as a guide to certain of the conceptual considerations associated with the narrow issues it addresses. You should seek advice from your own counsel, who is familiar with the particular facts and circumstances of what you intend and can give you tailored advice. This Framework is provided "as is" with no representations, warranties or obligations to update, although we reserve the right to modify or change this Framework from time to time. No attorney-client relationship or privilege is created, nor is this intended to be attorney advertising in any jurisdiction.

December 7, 2016

An initiative of Coinbase, Coin Center, Union Square Ventures and Consensys

Part 1: How to determine if a token is a security

The Howey Test

The US Supreme Court case of *SEC v Howey* established the test for whether an arrangement involves an investment contract. An investment contract is a type of security.

In the context of blockchain tokens, the *Howey* test can be expressed as three independent elements (the third element encompasses both the third and fourth prongs of the traditional *Howey* test). All three elements must be met in order for a token to be a security.

1. An *investment of money*
2. in a *common enterprise*
3. with an *expectation of profits* predominantly from the *efforts of others*.

Using the Framework

Click here to access the framework (google sheet). Save a copy in order to use it, or follow the manual instructions below

Step 1: Access the google sheet or refer to the copy of the framework in the Appendix.

Step 2: Review each characteristic and determine whether or not it applies to the token.

Step 2: For the criteria that apply, add or subtract the corresponding points to get a total for **each** element.

Step 3: You now have three point scores, one for each element. Your lowest point score represents your **overall risk score**.

Please remember that this methodology produces nothing more than an estimate. You should seek your own legal advice, tailored to your own specific situation and considerations.

Part 2: Best practices in token sales

The following principles help inform and protect buyers, and increase the chances of a successful token sale, especially for a sale which occurs before there is a live network using the token. They are guidelines and are not designed for any specific situation. Please consult your legal and other advisors.

Most of these best practices **do not directly affect** whether a token is a security under the *Howey Test*

Principle 1: Publish a detailed white paper	
How?	● Describe the protocol and the network ● Identify a clear and compelling reason for the token to exist ● Provide a detailed technical description of the proposed implementation ● Set clear expectations for total token supply and distribution ● Have an independent expert review the white paper
Why?	A white paper defines the network and its use cases. It is critical for buyers to be able to understand the characteristics and functionality of the token they are buying, the challenges and risks of development, and the benefits of using the network.

Principle 2: For a presale, commit to a development roadmap	
How?	● Provide a detailed development roadmap ● Include estimates of time and costs for each stage of the project ● Include a breakdown of estimated expenses by category ● Allocate funding for each stage of development and consider restricting access to funding until milestones are achieved ● List the names of key members of the development team and advisors ● Be transparent about remuneration paid to key members of the development team and advisors ● Quantify early contributions of members of the development team and advisors ● Between sale and launch of the network, report back to token holders periodically on progress against the development roadmap ● Set aside funds for independent security audits and a bug bounty program
Why?	A clear development roadmap gives buyers confidence that the proceeds of the sale will be properly used for the project and that the network will be launched, meaning that they will be able to use the tokens as intended. Setting aside funding for each stage of the project helps establish structure and allows buyers to assess the likelihood of success. Using blockchain features to restrict the development team's access to funding can deliver more transparency.

	Members of the development team and advisors should be paid full and fair value for their services, through a combination of money and tokens. Quantifying the value of contributions, especially early contributions (pre-crowdsale) provides transparency. Identifying the development team and advisors helps potential buyers assess the credibility of the project and its potential for success. It reduces the likelihood of fraud. *Note: Many aspects of Principle 2 only apply to token sales which occur before there is a live network using the token*

Principle 3: Use an open, public blockchain and publish all code	
How?	● Use an open and transparent blockchain ● Use open source software ● Where possible, commit to using standard or well-known token contracts (e.g. ERC20) ● Do not use a private or unintelligible blockchain, or one for which the developer is the sole or primary transaction validator ● Commit to undertake an independent security audit before launch
Why?	Building with open source software and using an open, public blockchain provides transparency, enables real participation from token holders and independent developers, allows for auditing, and helps prevents fraud. Enabling real and meaningful participation in the network from a diverse set of independent parties may also strengthen the arguments against the second and third criteria of the *Howey* test, because participants are less reliant on the initial developers.

Principle 4: Use clear, logical and fair pricing in the token sale	
How?	● Set a maximum number of tokens to be sold in the crowdsale ● Use a pricing mechanism which does not increase over time. Consider a Dutch Auction or similar mechanism to price tokens fairly ● Set a cap for the amount to be raised ● Set a minimum amount and refund buyers if the minimum amount is not met ● Denominate the price in one currency (e.g. ETH or BTC)
Why?	The total proceeds from a crowdsale should not exceed the estimated costs of development. A crowdsale should be capped at the number and price of tokens required to raise this amount. Pricing mechanisms which increase over time can encourage irrational behavior (e.g. FOMO) and do not treat buyers equally. Setting the price in a single currency reduces the potential for confusion and arbitrage.

Principle 5: Determine the percentage of tokens set aside for the development team	
How?	Decide on the percentage of the total token supply that represents a fair reward for the work of the development team and advisors. Release those tokens to the development team incrementally over time (contingent on their continued work on the project)**.**
Why?	Concentrating too many tokens in the hands of the development team and other contributors increases the risk of centralization of control of the network. On the other hand, setting aside too few tokens does not align the interests of the development team with the interests of other token holders. Releasing tokens to the development team over time aligns their interests with other users over a longer period. Releasing tokens to the development team over time also reduces the risk of affecting the market - it prevents large numbers of tokens from flooding the market at one time.

Principle 6: Avoid marketing the token as an investment	
How?	● Do not promote the token as an investment that will increase in value ● Promote the token based on its functionality and the use case for the network ● Avoid analogies with existing investment language and processes - e.g. ‘ICO’ ● Provide appropriate disclaimers about the token as a product, not as an investment.
Why?	Marketing a token as a speculative investment, or drawing comparisons to existing investment processes, may mislead or confuse potential buyers. It may also increase the likelihood that the token is a security. Using a short, relevant disclaimer which accurately describes the risks of the tokens, protocols and network is useful. Long, legalistic disclaimers about the risks of investment are not helpful to buyers and may provide the impression that the token is an investment.

Part 3: Detailed Securities Law Analysis

Securities Law Analysis of Blockchain Tokens

You should not rely on this Memorandum as legal advice. It is designed for general informational purposes only, as a guide to certain of the conceptual considerations associated with the narrow issues it addresses. You should seek advice from your own counsel, who is familiar with the particular facts and circumstances of what you intend and can give you tailored advice. This Memorandum is provided "as is" with no representations, warranties or obligations to update, although we reserve the right to modify or change this Memorandum from time to time. No attorney-client relationship or privilege is created, nor is this intended to be attorney advertising in any jurisdiction.

This outline sets forth our analysis as to whether cryptographic blockchain tokens (known as "Blockchain Tokens") with certain features (in our parlance, "rights" versus "investment interests") would be considered a "security" for purposes of Section 2(a)(1) of the Securities Act of 1933 ("Securities Act") and Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act").

In order to analyze Blockchain Tokens under the federal securities laws, we start with the broad definition of "security" contained in Section 2(a)(1) of the Securities Act: "any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement … *investment contract* … or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing" (emphasis added).[1]

Based on that definition and our reading of relevant case law, as well as on our understanding of the facts and our review of the materials you provided on the structure of Blockchain Tokens, we conclude that appropriately designed Blockchain Tokens would not be deemed to meet the definition of security and, accordingly, that the federal securities laws would not apply to the initial distribution and subsequent trading of such Blockchain Tokens.[2]

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[1] We note that the Supreme Court has stated that the definitions of "security" under the Securities Act and the Exchange Act are treated as being the same, despite some technical differences. SEC v. Edwards, 540 U.S. 398 (2004) (*citing* Reves v. Ernst & Young, 494 U.S. 56, 61 n.1 (1990)).

[2] Our analysis is based on our discussions with you, the materials you provided and the law as it exists as of the date hereof. We have not considered any state or non-US law analysis, including that of federal preemption related to state blue sky laws, and this outline relates solely to the definition of security under the federal securities laws. We do not express any view on any other body of law or legal construct, including without limitation the franchise laws of any state. We are unaware of any court cases, SEC rules or releases that directly address the question discussed in this memorandum as to whether Bitcoin Tokens should be characterized as a securities for purposes of Section 2(a)(1) of

We stress that this conclusion is dependent on the particular features of the relevant Blockchain Token. Accordingly, this outline first lists various rights that a Blockchain Token might have that we believe support the conclusion that it is not a security, as well as various investment interests a Blockchain Token might have that we believe would make such an instrument more likely to be considered a security. We then summarize the relevant legal principles for determining what constitutes a security, and why we conclude, based on those principles, that properly designed Blockchain Tokens are better considered something other than a security. Finally, we analogize these types of Blockchain Tokens to the rights of a franchisee or licensee, who would not be treated as a security-holder.

I. Nomenclature

A. We understand that Blockchain Tokens can have different features depending on how they are designed, but at a basic level each Blockchain Token is associated with one or more computer systems.

B. For purposes of this analysis, we have adopted two specific terminologies:

1. Because they are associated with one or more computer systems, when discussing Blockchain Tokens for purposes of the analysis, we use the term "system" to include any computer system, network, platform, application, software or protocol.

2. When considering whether a Blockchain Token could be deemed to constitute a security, we use the term "rights" to indicate features a Blockchain Token might have and likely not meet the definition of security—these rights may be individual rights or a bundle of rights granted to the holder of the Blockchain Token. We sometimes refer to these as "non-security Blockchain Tokens." We use the term "investment interests" to indicate the features that a Blockchain Token may have that would, in our view, increase the likelihood that it would be considered a security. We sometimes refer to these as "Blockchain Token securities."

II. A Preliminary List of Rights and Investment Interests

A. While we broadly discuss features that may result in a Blockchain Token being viewed as a non-security, a further analysis based on the individual facts and circumstances of each relevant Blockchain Token (and its

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the Securities Act. As such, the SEC or a court could reach an alternative conclusion different from those provided in this memorandum.

system) generally would be required to appropriately determine whether a particular Blockchain Token would constitute a security and fall under the federal securities laws.

B. We generally believe that a Blockchain Token with one or more of the following rights likely should not meet the definition of security (non-security Blockchain Token):

1. Rights to program, develop or create features for the system or to "mine" things that are embedded in the system;

2. Rights to access or license the system;

3. Rights to charge a toll for such access or license;

4. Rights to contribute labor or effort to the system;

5. Rights to use the system and its outputs;

6. Rights to sell the products of the system; and

7. Rights to vote on additions to or deletions from the system in terms of features and functionality.

C. We believe that a Blockchain Token with one or more of the following investment interests likely should constitute a security Blockchain Token:

1. Ownership interest in a legal entity, including a general partnership;

2. Equity interest;

3. Share of profits and/or losses, or assets and/or liabilities;

4. Status as a creditor or lender;

5. Claim in bankruptcy as equity interest holder or creditor;

6. Holder of a repayment obligation from the system or the legal entity issuer of the Blockchain Token; and

7. A feature allowing the holder to convert a non-security Blockchain Token into a Blockchain Token or instrument with one or more investment interests, or granting the holder an option to purchase one or more investment interests.

D. We believe that non-security Blockchain Tokens can be issued in different classes where each class has different bundles of rights (whether overlapping or not), so long as the class does not include investment interests.

E. We believe that the combination of investment interests with rights into the same Blockchain Token likely would result in a Blockchain Token security.

F. We note that an ownership interest in a fund or other legal entity vehicle that buys non-security Blockchain Tokens would still constitute ownership of a security, even if the fund would not be deemed to own any securities.

G. We have considered the question of whether issuance of a Blockchain Token prior to the existence of a system would constitute a security. We have not found conclusive law on the subject, but believe that the better view is that a non-security Blockchain Token does not become a security merely because the system as to which it has rights has not yet been created or completed. Although not specifically mentioned in any case law, there is a significant school of thought that argues in favor of having the launch of the system and of the associated Blockchain Tokens occur as close in time as possible in order to reduce the likelihood that the Blockchain Tokens will constitute securities. We do not express a view on the viability of this line of reasoning, but note that it potentially implicates the common enterprise element of the *Howey* test and the "risk of loss" analysis, each discussed below.

III. Analysis under the *Howey* Test

A. Based on the background above, we consider below whether a Blockchain Token would fall under the definitions of security outlined in the Securities Act and the Exchange Act, as well as subsequent case law further defining the term security.

B. The seminal Supreme Court case for determining whether an instrument meets the definition of security is SEC v. Howey, 328 U.S. 293 (1946). The Supreme Court has reaffirmed the *Howey* analysis as recently as 2004 in SEC v. Edwards, 540 U.S. 398 (2004).

C. *Howey* focuses specifically on the term "investment contract" within the definition of security, noting that it has been used to classify those instruments that are of a "more variable character" that may be considered a form of "contract, transaction, or scheme whereby an investor lays out money in a way intended to secure income or profit from its employment."

Howey, 328 U.S. at 298; Golden v. Garafolo, 678 F.2d 1139, 1144 (2d. Cir. 1982) (stating "investment contract" has been used as a way to classify instruments that do not fit other categories); *see also* Black's Law Dictionary (10th ed. 2014).

D. From our understanding of them, Blockchain Tokens seem most likely to be analyzed as an investment contract. Some of the investment interests listed above are more properly characterized as traditional types of securities, so their combination with a non-security Blockchain Token likely produces a Blockchain Token security.

E. Not every contract or agreement is an "investment contract" and the Supreme Court developed a four-part test to determine whether an agreement constitutes an investment contract and therefore a security.

F. The Court articulated the test as follows: A contract constitutes an investment contract that meets the definition of security if there is (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits; (iv) solely from the efforts of others (e.g., a promoter or third party), "regardless of whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the physical assets used by the enterprise." Howey, 328 U.S. at 298-99. In order to be considered a security, all four factors must be met. *See* Edwards, 540 U.S. at 390.

G. We provide our analysis of a non-security Blockchain Token below, based on each *Howey* factor:

1. *Investment of Money*. Under *Howey*, and case law following it, an investment of money may include not only the provision of capital, assets and cash, but also goods, services or a promissory note. *See, e.g.*, Int'l Bhd. Of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979); Hector v. Wiens, 533 F.2d 429, 432-33 (9th Cir. 1976); Sandusky Land, Ltd. V. Uniplan Groups, Inc., 400 F. Supp. 440, 445 (N.D. Ohio 1975).

(a) Given the broad definition of a money investment and the fact that non-security Blockchain Tokens will be distributed through a sale by the issuer to the buyers with the price set per token, we conclude that this factor should be satisfied.[3] We reach this conclusion notwithstanding the

[3] However, in *Teamsters*, the court found, in the pension benefits context, that providing labor in return for possible benefits appeared to be more akin to obtaining a livelihood rather than making an investment. Teamsters, 439 U.S. at 560. Analogously, if Blockchain Token users are granted the

fact that there may be a cap on the total amount raised and purchased.

2. *Common Enterprise*. Different circuits use different tests to analyze whether a common enterprise exists. Three approaches predominate: (i) horizontal; (ii) narrow vertical and (iii) broad vertical. We define each and then discuss below.

   (a) Under the horizontal approach, a common enterprise is deemed to exist where multiple investors pool funds into an investment and the profits of each investor correlate with those of the other investors. *See e.g.*, Curran v. Merrill Lynch, 622 F.2d 216 (6th Cir. 1980). Whether funds are pooled appears to be the key question, and thus in cases where there is no sharing of profits or pooling of funds, a common enterprise may not be deemed to exist. *See e.g.*, Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (finding discretionary future trading account was not investment contract because there was no pooling of funds); Wals v. Fox Hills Dev. Corp., 24 F.3d 1016 (7th Cir. 1994) (promoter of condominium timeshare did not pool profits and thus no common enterprise existed).

   (b) The narrow vertical approach looks to whether the profits of an investor are tied to a promoter. *See* SEC v. Eurobond Exchange Ltd., 13 F.3d 1334 (9th Cir. 1994) (imposition of profit limitations on investors through requiring promoter to receive excess return rate tied promoter's fortunes to investors).

   (c) The broad vertical approach considers whether the success of the investor depends on the promoter's expertise. If there is such reliance, then a common enterprise will be deemed to exist. *See e.g.*, SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) (promoter's recommendations regarding certain futures contracts demonstrated investor reliance on promoter's expertise).

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right to mine in order to earn the eventual rights or rewards to a token, it might be reasonable to conclude that no investment of money had occurred.

(d) Analysis under the approaches:

(i) Under the horizontal approach, the Blockchain Token may be considered a common enterprise where the reward for work—through mining or otherwise—correlates to the reward received by other participants. Thus, although the issuer has some control over the protocol, the rewards received by the token holders (e.g., through the receipt of more tokens or other forms of rewards) would likely be correlated.

(ii) Under either of the vertical approaches, however, a common enterprise may not exist given the decentralized nature of the Blockchain Token framework, whereby Blockchain Token holders depend on their own efforts (mining or otherwise), rather than the issuer's expertise (even though in certain cases the issuer may control or influence technical permissions or changes to the protocol). Thus, depending on the level of control of exerted by the issuer, the less of a reliance on the issuer's expertise, may result in the view that a Blockchain Token should not be viewed as having a common enterprise.

(e) Given the diverging approaches, the law on the "common enterprise" element is somewhat unclear and not easily susceptible to analysis. Putting things in more practical terms: In one sense, it would appear that the system is a common enterprise because it involves the efforts of Blockchain Token holders (and perhaps others) to create, update and enhance a system that is used by the Blockchain Token holders and third parties. On the other hand, it is possible to conceive of a system that does not rely on concerted effort to create, update or enhance such as where independent actors use the base code for a variety of unrelated activities (for example, IBM's Watson can be used for many different purposes by independently operating groups).

(f) Nevertheless, it would seem to us to be the case that where the issuer of the particular Blockchain Tokens uses the funds derived from the issuance to create, support or

maintain the system, a court might find the common enterprise element satisfied.

(i) This may similarly apply in the case of a presale made prior to the launch of the system. For example, one court has found that a purchase agreement that was entered into prior to the construction of a resort community demonstrated a common enterprise. This was in part because the construction company was pooling presale purchase commitments in order to obtain financing to fund the project, and thus the completion of the project was dependent on generating sufficient investor interest. *See* Wooldridge Homes, Inc. v. Bronze Tree, Inc., 558 F. Supp. 1085 (D. Colo 1983).

(ii) Although not definitive in this regard, depending on how the presale is structured, and whether the construction of the system is contingent on those funds, it may increase the likelihood that this element would be met.

(iii) That said, we believe the better view is that a non-security Blockchain Token's character is not changed merely because it is sold before the system is constructed or in order to raise funds for construction of the system. We view presales as more akin to buying the right to use the system in the future, as opposed to receiving some type of investment interest. We think the analysis should hinge on whether the Blockchain Token holder can exploit directly the system for his/her own creative purposes or to produce a good or service sold to others (that is, profit from the rights separate from others using the system). We do not believe it is dispositive that the holder may sell the Blockchain Token prior to doing so; it is the fact that s/he could exploit the system that makes the difference.

(iv) An alternative test, known as the "risk capital test," considers whether an investment may be viewed as passive and relying on the efforts of others. Specifically, this test looks at four factors: (i) whether funds are being raised for a business

venture or enterprise; (ii) whether the transaction is offered indiscriminately to the public at large; (iii) whether the investors are substantially powerless to effect the success of the enterprise; and (iv) whether the investor's money is substantially at risk because it is inadequately secured. *See* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811 (1961). The risk capital test applies to a limited number of jurisdictions, and typically has been applied in the context of original "start-up" capitalization—particularly where membership is nothing more than a sale of right to use the existing facilities—i.e., where "the benefits of the membership have materialized and have been realized by other members prior to any capital raised by the sale of [the memberships]." *See* Jet Set Travels Club v. Corporation Com'r, 21 Or. App. 362 (1975). Thus, in these select jurisdictions, depending on the structure of the presale, there is some risk that the use of funds to raise capital may be viewed as a security, although this would be mitigated where some of the benefits have already been realized by other holders. We note that these cases involved memberships that did not allow for commercial exploitation for profit of the eventual club, but rather created only a personal right of use. We understand that non-security Blockchain Tokens will allow for the exploitation of the system by the holder, much like a licensee has rights to commercially exploit the license.

3. *Expectation of Profits*. Under this element, profit refers to the type of return or income an investor seeks on their investment (rather than the profits that the system or issuer might earn).[4] Thus, for purposes of Blockchain Tokens, this could refer to any type of return or income earned as a result of being a Blockchain Token holder, which would be narrowed to the extent it is derived passively, i.e., from the efforts of others. Since courts consider this factor through the lens of the "efforts of others" factor, we analyze

[4] More specifically, profits may include all manner of returns, such as dividends, other periodic payments or the increased value of the investment—whether it is a variable or fixed return. *See e.g.*, Edwards, 540 U.S. at 390.

this prong along with the fourth factor below. In other words, just because there is a return or profit, does not mean that the investment contract is a security. It is the essentially passive nature of the return, as determined by the "efforts of others" analysis, that results in an "investment contract" and security as opposed to a simple contract instrument.

4. *Solely from the Efforts of Others.* Typically, courts have been flexible with the word "solely," such that, in addition to the literal meaning, it also will include significant or essential managerial or other efforts necessary to the success of the investment. *See e.g.*, SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482-83 (9th Cir. 1973); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) (holding that where promoters retain immediate control over the essential managerial conduct of an enterprise, rather than remote control similar to a franchise arrangement, this element is met); *but see* Hirsch v. Dupont, 396 F. Supp. 1214, 1218-20 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977) (indicating that solely should have literal application).

   (a) We analyze the "expectation of profits" and "solely from the efforts of others" factors below:

      (i) The expectation of profits resulting from the purchase of a Blockchain Token would primarily relate to whether the holder receives (i) rights and/or (ii) investment interests. While non-security Blockchain Token holders may receive money or other forms of financial incentives by virtue of holding the token, we believe that any such incentives are derived through their own efforts, rather than through a passive investment (as would be the case with a Blockchain Token security).

      (ii) Essentially, each of the rights allows the non-security Blockchain Token holder to utilize, contribute to or license the use of the system in various ways, none of which would be considered a passive investment. Rather, we see the non-security Blockchain Token holders as active participants, like franchisees or licensees.

      (iii) Furthermore, although an issuer may have some managerial oversight over the system and the

distribution of the Blockchain Tokens, if the holders retain voting rights related to changes to the protocol and other legal rights enforced through technical permissions, this would seem to strengthen the view that token holders have no reliance on the efforts of others. That said, security holders often have voting rights, so we do not view this point as being definitive.

(iv) We note that appreciation in the value of a non-security Blockchain Token after issuance, due to secondary trading, does not change our view that it is not an investment contract. For example, the value of license or franchise right can increase over time due to the secondary market. Such increases in value derive both of the efforts of the holder and from the system itself, so we do not view such changes as decisive.

(v) We note that the manner in which the sale of a Blockchain Token occurs, particularly the promotion and marketing, may also affect the "expectation of profits" analysis. For example, if the language used to promote the Blockchain Token includes words like "investment," "returns" or "profits," the purchasers of the Blockchain Token may be more likely to expect profits from the efforts of others than if the Blockchain Token is promoted on the basis of the usefulness of the rights attaching to it.

(b) Courts have also analyzed the existence of voting rights through this *Howey* factor. Whether voting rights are determinative of a security will be based on the facts at hand. For example, where (i) the holder is provided with rights that provide it with significant managerial control—i.e., the ability to participate in decisions that will affect the success of the enterprise; (ii) the holder has the resources and expertise to make a meaningful contribution; and (iii) the holder does, in fact, participate in management

decisions, the instrument is less likely to be considered a security.[5]

(i) Thus, in our view, similar to our analysis above, the existence of voting rights itself should not result in a Blockchain Token being deemed a security. Rather, whether a determination would need to be made as to whether the holder would be viewed as passive or reliant on the efforts of others. Given that holders of non-security Blockchain Tokens play a more active role by using, contributing to or licensing the use of the system, it is less likely that the voting rights in this regard would be viewed as a security.

IV. Other Analytical Frameworks

A. *Reves* and Loan Versus Security. We considered several other analytical frameworks, including the rubric for analyzing whether a loan is a security under the Securities Act and Exchange Act definitions. The Supreme Court articulated this analysis in Reves v. Ernst & Young, 494 U.S. 56 (1990) through its "family resemblance" test. Given that *Reves* focused on the term "note" rather than "investment contract" in the definitions of security, which was later distinguished by the *Edwards* court on these grounds, we determined that this analysis would not be a substantive addition to the outline.[6]

1. That said, we do note that the first factor of the *Reves* test scrutinizes the motivations of the lender and the borrower to determine whether they are motivated by commercial purposes or for an investment. We view this element as similar to the "efforts

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[5] *See, e.g.*, Williamson v. Tucker, 645 F.2d 404 (5th Cir.), cert. denied, 454 U.S. 897 (1981); Odom v. Slavik, 703 F.2d 212, 215 (6th Cir. 1983) (noting that "[t]he managerial powers vested in general partners and the express right of inspection of documents gives them the kind of leverage and ability to protect themselves that takes them outside the intended scope of the '34 Act"); *see also* Klaers v. St. Peter, 942 F.2d 535 (8th Cir. 1991) (finding no security where non-managing partners collectively had 80% voting power on "any items of partnership business which will substantially affect" the partners); Stewart v. Ragland, 934 F.2d 1033 (9th Cir. 1991) (finding no security even though each well was managed by an independent contractor after an examination of the "intricacies of the operating agreement" that laid out significant managerial powers retained by the non-operators, who were sophisticated investors).

[6] Edwards, 540 U.S. at 390 (noting that *Reves* applies to the term "note" as opposed to "investment contract").

of others" factor from the *Howey* test, and believe that non-security Blockchain Tokens are "commercial" in nature, rather than "investment" in nature, for the reasons described in Section III.[7]

B. System License. Another potential framework by which to consider non-security Blockchain Tokens is by using the analogy of a software license, where the rights associated with the Blockchain Tokens could be considered in line with the contractual contours of such a license.

1. Software licenses typically are governed by contract law, and one way in which to categorize software may be through focusing on the legal rights of the licensor and what rights may be granted to the licensor. For example, the licensor's rights would include the ability to grant or distribute all, some or none of the rights attached to the use of the software code (originally the licensor's intellectual property), as well as the right to exclude certain parties from using any of those rights. Thus, the licensee would receive either all of these rights, or a portion of these rights, depending on what the licensor grants.

2. For the purposes of Blockchain Tokens, this structure would be applicable in the following manner: (i) the issuer acts as the licensor of the system, which includes the underlying protocol, as well as the associated rights; (ii) the token holder acts as the licensee, who receives those rights (or a portion of those rights) in order to use the underlying protocol and the overall system; and (iii) any associated rights provided to each token holder are accomplished through the initial issuance of the tokens (akin to negotiating a software licensing contract between two parties).

C. Franchise Law. Although we do not suggest that Blockchain Tokens fall under federal or state franchise law requirements, in thinking about the rights that might be included in a non-security Blockchain Token, we drew an analogy to franchise law.

1. Under the franchise structure, a franchisor operates as the overarching organization that owns the intellectual property of the franchise (and business plan) and has the authority to sell the

[7] Under *Reves*, if the purpose is, for example, to "facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash flow difficulties, or to advance some other commercial or consumer purpose," it is unlikely to be deemed a security. *See* Reves, 494 U.S. at 66.

franchise right to a potential franchisee. The franchisee is the person to whom these rights are granted.

2. In receiving these rights, the franchisee pays money to the franchisor, which can be an initial fee, an ongoing royalty or both.

3. Typically, state and federal laws governing franchises require franchisors to provide to prospective franchisees detailed information about the franchise. The disclosure obligations under the various federal and state franchise laws are primarily to mitigate the risk of loss to franchisees that make a capital contribution to the franchise.

   (a) The Federal Trade Commission ("FTC") rules require a franchisor to provide a prospective franchisee with disclosures related to the trademark being used, the total investment needed to begin operations, the provisions of the franchise agreement and other related disclosure items related to receiving the franchise rights. 16 C.F.R. pt. 436.

   (b) New York franchise law has detailed disclosure requirements for the prospectus that the franchisor must provide to the prospective franchisee. N.Y. Gen. Bus. Law § 683, et seq.

   (c) California state law requires that a franchise agreement include certain protective rights for the franchisee should the franchisor terminate the franchise prior to its expiration date. The purpose of these provisions is to mitigate the loss of investment in the case of unlawful termination by a franchisor. Cal. Bus. & Prof. Code § 20020-22.

4. In a franchise, the franchisee puts forth the effort and work directly to build up the business in his/her location and the control or management of the franchisor is more remote. Thus, courts have held that a franchise interest should not be considered an investment security. *See* Koscot Interplanetary, 497 F.2d at 485; Lino v. City Investing, 487 F.2d 689 (3d. Cir. 1973).

5. We view the holder of a non-security Blockchain Token as being similar to a franchisee in that the rights granted by the Blockchain Token allow the holder to contribute to a system in a manner remote from the issuer of the Blockchain Tokens. In essence, the issuer provides the Blockchain Token holder with rights in the

system by virtue of the associated Blockchain Token, rather than through a passive investment interest.

(a) We believe that, despite the more decentralized framework of Blockchain Tokens, the franchise analogy is still useful based on how the initial issuer grants its intellectual property—i.e., the system and its underlying protocol—to each individual token holder. Under the franchise model, a franchisor grants its intellectual property (which may also include a business plan) to a franchisor. While a franchise results in a more uniform application of the intellectual property or business plan by each franchisee, in the Blockchain Token context, analogously, the token holder is granted access to a system, which is the baseline framework by which the token holder operates.

(b) Further, we think it is useful to consider whether the use of disclosures—both to inform token holders of their rights (e.g., voting rights and other systems rights) and to demonstrate the nature of the Blockchain Token—may be useful to incorporate at the time of the issuance of the tokens.

V. Conclusion

A. Based on the above, we believe that an appropriately designed Blockchain Token that consists of rights and does not include any investment interests should not be deemed to be a security, subject to the specific facts, circumstances and characteristics of the Blockchain Token itself.

B. Rather, given our analysis in the above, it should be characterized as a simple contract, akin to a franchise or license agreement.

* * *

We hope this outline has been helpful. Please feel free to contact us with any further questions.

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Further reading

1. Naval Ravikant, The Bitcoin Model for Crowdfunding
2. Peter Van Valkenburgh, Framework for Securities Regulation of Cryptocurrencies
3. Fred Ehrsam, How to Raise Money on a Blockchain with a Token
4. Marco Santori, Appcoin Law: ICOs the Right Way
5. Nick Tomaino, Discussing Cryptotoken Best Practices
6. William Mougayar, Best Practices in Transparency and Reporting for Cryptocurrency Crowdsales

Last updated December 7, 2016

APPENDIX: A Securities Law Framework for Blockchain Tokens

To estimate how likely a particular blockchain token is be a security under US federal securities law

Refer to: full legal analysis

Instructions

Step 1: Review each characteristic and determine whether or not it applies to the token

Step 2: Select Y or N for each characteristic

Step 3: Review results at the bottom of this page

Element 1: Investment of Money

Is there an investment of money?				
Characteristic	**Points**	**Explanation**	**Examples**	**Y or N**
There is no crowdsale. New tokens are given away for free, or are earned through mining	**0**	Tokens which are not sold for value do not involve an investment of money. For example, if all tokens are distributed for free, or are only produced through mining, then there is no sale for value.	There was never any token sale for Bitcoin. The only way to acquire new bitcoin is via mining. A token which is randomly distributed for free	
Tokens are sold for value (crowdsale)	**100**	Tokens which are sold in a crowdsale, at any time, regardless of whether sold for fiat or digital currency (or anything else of value) involve an investment of money	A token which is sold for bitcoin in a crowdsale. A token which is sold for ether in a crowdsale.	

Total for Element 1 **0**

Element 2: Common Enterprise

What is the timing of the sale?				
Characteristic	**Points**	**Explanation**	**Examples**	**Y or N**
Pre-deployment	**70**	A sale of tokens before any code has been deployed on a blockchain is more likely to result in a common enterprise where the profits arise from the efforts of others. This is because the buyers are completely dependent on the actions of the developers, and the buyers cannot actually participate in the network until a later time.	A developer has an idea for a new protocol, writes a white paper and does a crowdsale.	
The protocol is operational on a test network	**60**	If there is a functioning network there is less likely there is to be a common enterprise where the profits arisef rom the efforts of others. The closer the sale is to launch of the network, the less likley there is to be a common enterprise.	A developer has an idea for a new protocol, writes a white paper and deploys a working test network before doing a crowdsale.	
Live network is operational	**50**	If the token is sold once there is an operational network using the token, or sold immediately before the network goes live, it is again less likely to result in a common enterprise	The crowdsale is done at the same time the network is launched.	

What do token holders have to do in order to get economic benefits from the network?				
Characteristic	**Points**	**Explanation**	**Examples**	**Y or N**
All token holders will always receive the same returns	**25**	If returns are paid to all token holders equally (or in proportion to their token holdings) regardless of any action on the part of the token holder, then their interests are more likely aligned in a common enterprise	'HodlToken' holders are automatically paid an amount of ETH each week, based on fees generated by other users of the network 'FoldToken' does not pay any return, and there is no way to earn more tokens within the network (but they can be bought, sold or traded)	

There is a possibility of varying returns between token holders, based on their participation or use of the network	**-20**	If token holders' returns depend on their own efforts, and can vary depending on the amount of effort they each put in, then there is less likely to be a common enterprise	'CloudToken' holders can earn more tokens by providing data storage on the network, or can spend tokens to access data storage. Holders who do not provide data storage do not earn any more tokens.	

Total for Element 2 **0**

Element 3: Expectation of Profit

What function does the token have?

Characteristic	Points	Explanation	Examples	Y or N
Ownership or equity interest in a legal entity, including a general partnership	**100**	Tokens which give, or purport to give, traditional equity, debt or other investor rights are almost certainly securities. ***If one or more of these characteristics apply, the token is almost certainly a security, notwithstanding the results of the other elements***	A developer releases and sells 100 'BakerShares' tokens. Each token entitles the holder to 1 share in Baker, Inc. A developer releases and sells 100 'BakerProfit' tokens. Each token entitles the holder to 1% of the profits of Baker, Inc. for the next year. A developer releases and sells 100 'BakerDebt' tokens. Each token entitles the holder to principal and interest repayments based on the initial token sale price.	
Entitlement to a share of profits and/or losses, or assets and/or liabilities	**100**			
Gives holder status as a creditor or lender	**100**			
A claim in bankruptcy as equity interest holder or creditor	**100**			
A right to repayment of purchase price and/or payment of interest	**100**			
No function other than mere existence	**100**	A token which does not have any real function, or is used in a network with no real function, is very likely to be bought with an expectation of profit from the efforts of others, because no real use or participation by token holders is possible. Voting rights alone do not constitute real functionality.	A developer releases and sells 100,000 'SocialCoin' tokens to fund the development of a new Social Network. However, SocialCoin is not required to access the network and has no real function after the sale.	
Specific functionality that is only available to token holders	**0**	A token which has a specific function that is only available to token holders is more likely to be purchased in order to access that function and less likely to be purchased with an expectation of profit.	'CloudToken' is the only way to access and use a decentralized file storage network.	

Does the holder rely on manual, off-blockchain action to realize the benefit of the token?

Characteristic	Points	Explanation	Examples	Y or N
Manual action is required outside of the network (e.g. off-blockchain) in order for the holder to get the benefit of the token	**80**	A token whose value depends on someone taking specific manual action outside of the network means that the token is not functional in and of itself. Instead, the token relies on a level of trust in a third party taking action off-blockchain. This sort of token is more likely to be bought for speculation - i.e. the expectation of profits.	A developer releases and sells 'FreightCoin', which will allow the holder to pay FreightCoin to access capacity on a new real-world freight network. The network relies on legal contractual relationships and manual actions. (This alone does not make FreightCoin a security)	
All functionality is inherent in the token and occurs programmatically	**0**	A token which is built with all the necessary technical permissions means that the token holder does not rely on manual actions of any third party. This means that the buyers are more likely to purchase the token for use rather than with the expectation of profit from the efforts of others.	Holders of 'SongVoteToken' can sign transactions on the network as votes for their favorite new songs and earn rewards for doing so.	

What is the timing of the sale?				
Characteristic	**Points**	**Explanation**	**Examples**	**Y or N**
Pre-deployment	**20**	A sale of tokens before any code has been deployed on a blockchain is more likely to result in buyers purchasing for speculative reasons with the expectation of profit, rather than practical use cases.	A developer has an idea for a new protocol, writes a white paper and does a crowdsale.	
The protocol is operational on a test network	**10**	If the sale occurs after code has been deployed and tested, the token is closer to being able to be used	A developer has an idea for a new protocol, writes a white paper and develops a working test network before doing a crowdsale.	
Live network is operational	**0**	If the token is sold once there is an operational network using the token, or immediately before the network goes live, it is more likely to be purchased with the intention of use rather than profit.	The live network is launched before the crowdsale.	

Can the token holders exercise real and significant control via voting?				
Characteristic	**Points**	**Explanation**	**Examples**	**Y or N**
Token holders as a whole are able to control the development team's access to funds	**-20**	If the collective approval of token holders is required in order for the development team to access the funds raised in the crowdsale, then any value realized by the token holders is more closely tied to their own decisions, and less reliant on the efforts of others.	A development team sells 100,000 Tokens for a total of 100,000 ETH. 50,000 ETH will be released from the token contract to the development team immediately, but the remainder is only released once milestones are met, which requires approval of a majority of the token holders each time. If the milestones are never met, the remaining ETH will be returned to the token holders.	
Token holders as a whole are able to vote on significant decisions for the protocol	**-10**	If the collective approval of token holders is required in order to make significant changes to the protocol, then any value realized by the token holders is more closely tied to their own decisions, and less reliant on the efforts of others.	Changes to the protocol require a vote by token holders.	

Note: Voting rights must be in addition to functionality. A token with voting rights alone and no other real functionality is very likely to satisfy element 3

How is the token sale marketed?				
Characteristic	**Points**	**Explanation**	**Examples**	**Y or N**
Marketed as an 'Initial Coin Offering' or similar	**50**	It is not possible to prevent some buyers from buying a token purely for speculation. However, marketing the token as an investment leads buyers to believe they can profit from holding or trading the token, rather than from using the token in the network. Using terms like 'Initial Coin Offering' or 'ICO', and investment-related language like 'returns' and 'profits' encourages buyers to buy a token for speculation, rather than use.	'ProfitCoin' includes potential of 'high ROI' and 'investor profits' in its marketing material.	
Marketed as a Token Sale	**0**	Marketed as a sale of tokens which give the right to access and use the network		
There is no economic return possible from using the network	**-100**	If there is genuinely no economic return possible for the token holders, then there is unlikely to be a common enterprise. This will be rare.	Backers contribute to a cause and receive a 'thank you' token which has no economic value.	

Results

Guide		Your results	
Total Points	**How likely is the element to be satisfied?**		
0 or less	Very unlikely	Total for Element 1	**0**
1 - 33	Unlikely	Total for Element 2	**0**
34 - 66	Equally likely and unlikely	Total for Element 3	**0**
67 - 99	Likely		
100 or more	Very likely	**Overall Risk Score**	**0**

A token will only be a security if it satisfies all three elements. The higher the point score for each element, the more likely the element is to be satisfied.

For many blockchain tokens, the first two elements of the Howey test are likely to be met. The third element has the most variables and the most different outcomes depending on the characteristics of the particular token.

Important notes

Please remember that this methodology produces nothing more than an estimate. The Overall Risk Score and the categories of likelihood are a guide only.

The Howey test has not yet been directly applied by the courts to any digital currency or blockchain token. The Howey test as applied by the courts does not involve any points-based calculation. The points system is intended as a guide - to highlight the characteristics of a token which are relevant to the securities law analysis.

This Framework should be read together with the full legal analysis. This Framework and the full legal analysis may be updated in the future as the law in this area develops.

You should not rely on this Framework as legal advice. It is designed for general informational purposes only, as a guide to certain of the conceptual considerations associated with the narrow issues it addresses. You should seek advice from your own counsel, who is familiar with the particular facts and circumstances of what you intend and can give you tailored advice. This Framework is provided "as is" with no representations, warranties or obligations to update, although we reserve the right to modify or change this Framework from time to time. No attorney-client relationship or privilege is created, nor is this intended to be attorney advertising in any jurisdiction.

Last updated December 7, 2016