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When Does Software Become Securities?

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The SEC Munchee Order and Chairman's Statement

On December 11, 2017, the U.S Securities and Exchange Commission ("***SEC***") issued a cease and desist order ("***Order***") against Munchee, Inc.'s ("**Munchee**") $15 million Initial Coin Offering ("***ICO***"). The SEC determined that the tokens were investment contracts, and thus securities, primarily because a purchaser of the tokens would have had a reasonable expectation of obtaining a future profit based upon Munchee's efforts, including Munchee revising its app and creating an "ecosystem" using the proceeds from the sale of the tokens. On the second day of sales of MUN tokens, the company was contacted by SEC staff. Munchee determined within hours to shut down its offering, did not deliver any tokens to purchasers, and returned to purchasers the proceeds that it had received. For a detailed description of the Order, please see our previous blog post here. The SEC chairman, Jay Clayton, concurrently issued a public statement ("**Statement**") expressing his general views on the cryptocurrency and ICO markets. It should be noted that the Order does not have the weight of a federal court decision. Munchee consented to the Order without admitting or denying any of the findings therein. Furthermore, the Statement is personal to the chairman, and "does not reflect the views of any other Commissioner or the Commission." That said, the Order and the Statement provide us with the SEC's assessment and chairman's perspective as to whether ICOs constitute the sale of securities, and how to conduct an ICO without running afoul of securities laws.

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Several important aspects of the Order and Statement stand out:

- The SEC and its chairman dispelled the theory that a blockchain token cannot be regulated as a security if it has utility. Many companies undertaking token sales have proceeded under the belief that a token that achieved a functional state on a particular platform (e.g. to unlock services on a software platform) could not be deemed an investment contract. Not so, the SEC found. The SEC stated that even if the MUN tokens had a practical use at the time of the offering, the tokens would still be investment contracts. The Order sites several cases to support the proposition that, "[w]hether a transaction involves a security does not turn on labelling – such as characterizing an ICO as involving a 'utility token' – but instead requires an assessment of 'the economic realities underlying a transaction.'" This calls into question the approach of many companies that issue a Simple Agreement for Future Tokens ("***SAFT***") as an investment contract, seek a securities exemption for the SAFT, but then convert the SAFT into tokens once they become functional with the expectation that the tokens will not be treated as securities. Mere functionality will not preclude a finding by the SEC that the tokens are securities.
- In the Order, the SEC did not find or require Munchee to concede that Munchee or any of its agents engaged in fraud. Many pundits believed that the SEC would focus its enforcement efforts solely on "bad actors" that engage in securities fraud involving ICOs. Not so.
- In line with the SEC's DAO Report (discussion here), the Order and Statement did not offer any bright-line rules for evaluating whether an ICO involves the sale of a security, and reiterated that all of the relevant facts and circumstances must be taken into consideration when evaluating whether a transaction involves a security.

With the MUN token, the SEC found that it was a security because the prospective buyers would have had a reasonable expectation of profit because the software developers were going to use the ICO proceeds to build the platform and incentivize use of the platform and the MUN tokens. However, software developers have been selling software licenses to distributors for over fifty years, those distributors have expected profits from the

retail market, and the software developers have been using the revenue to develop their software and platforms further. So what's the difference between this and Munchee? When is it a security and when is it just a software distribution?

Answer: in Munchee's case, the SEC stated that the development team gave the investors and potential "retail" buyers an expectation that the token would rise in value from the efforts of the development team over time. In particular, the SEC noted:

- Early stage purchasers would receive discounts of 10% and 15% off the offering price, thereby further eliciting an expectation of profit
- Munchee stated that MUN tokens would be traded on secondary markets
- Munchee described a timeline of development milestones it would reach in 2018 and 2019
- Munchee's White Paper described the way in which MUN tokens would increase in value, and even included a pictorial flowchart illustrating how it would occur
- Munchee specifically marketed to people interested in digital assets and the profits derived therefrom, rather than people who might have wanted to buy advertising or increase their "tier" as a reviewer on the Munchee app
- The MUN token offering documents were translated into multiple languages so that Munchee could reach potential investors in other countries where the Munchee app was not available — such purchasers of the token would have no reason to buy the tokens except with the expectation of profits based on Munchee's efforts
- Munchee noted that it would "burn" MUN tokens in the future, thereby taking them out of circulation and increasing the value of the remaining tokens

Furthermore, the SEC noted that the MUN token did not promise investors any dividends or other periodic payments as was expected with the DAO. The reasonable expectation of appreciation of value of MUN tokens as a result of Munchee's efforts was enough for the tokens to constitute securities.

The chairman's Statement provided similar guidance. The Statement analogized recent token sales to, and distinguished between, tokens that represent participation interests in a book-of-the-month club versus a yet-to-be-built publishing house: the book of the month club token sale might not implicate securities laws but would potentially be an efficient way for the club's operators to purchase more books for the club and pay for distributing them to the members, whereas the publishing house had yet to secure authors, books or distribution networks. The chairman also noted that offerings are particularly troubling where the promoters emphasize that the tokens will be able to trade on secondary markets.

All in all, these recent developments mark the importance for companies undertaking ICOs to practice great care when structuring and marketing their blockchain tokens. Expressing the legitimate utility of a functional token might not be enough to escape characterization as a security if marketing leads token purchasers to reasonably expect to profit based on the efforts of others.

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