



## Digital Assets and Securities Laws

The Securities Division has received many inquiries regarding initial coin offerings (ICOs) and token sales. In an ICO or token sale, a participant purchases digital assets which may be referred to as coins, tokens, cryptocurrencies, or similar names. The money raised in an ICO or token sale may be used to fund a start-up or other business enterprise. Some of the digital assets sold in ICOs are traded through online platforms that function as secondary markets.

It is important to understand that the offer and sale of digital assets in ICOs or other token sales is frequently subject to regulation under state and federal securities laws. All offers and sales of securities must be registered or exempt from registration under both state and federal securities laws. In addition, both state and federal securities laws require companies or entities conducting a securities offering to tell each potential investor all material information about the venture, its organizers, and the risks of the investment that a reasonable person would want to know in order to make an informed investment decision. Failure to comply with state or federal securities laws may result in administrative, civil, or criminal penalties. The Washington Securities Division is available to answer general questions regarding the treatment of digital assets under state and federal securities laws. Individuals and entities contemplating a sale of digital assets or providing advice regarding the purchase or sale of digital assets are encouraged to consult with an attorney with experience in securities laws.

### The Definition of “Security” under the Securities Act of Washington

The threshold question in any analysis involving the application of the securities laws is whether the instruments in question, digital assets in this case, are securities. The definition of a “security” under the Securities Act of Washington is well established and very broad.<sup>1</sup> In addition to traditional securities like stocks and bonds, the definition includes less precise concepts like investment contract and risk capital.<sup>2</sup> The seminal case defining an “investment contract” is *SEC v. W.J. Howey Co.*<sup>3</sup> The U.S. Supreme Court’s *Howey* case and subsequent case law determined that an investment contract exists when:

1. there is an investment of money
2. in a common enterprise
3. with the expectation of profits
4. to be derived from the efforts of others.<sup>4</sup>

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<sup>1</sup> See RCW 21.20.005(17)(a) (2011).

<sup>2</sup> *Id.*

<sup>3</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301, 66 S. Ct. 1100 (1946).

<sup>4</sup> See *id.* at 301. See also *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975); *Tcherepnin v. Knight*, 389 U.S. 332 (1967)



Washington courts have followed the *Howey* investment contract test.

The definition of “security” under the Securities Act of Washington also includes an “investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture.”<sup>5</sup> This is known as the “risk capital” test. Unlike the investment contract test that requires an expectation of *profits*, the risk capital test requires only an expectation of some *valuable benefit*.<sup>6</sup> The overwhelming majority of Washington securities cases are brought under the investment contract test, but issuers that seek to offer and sell digital assets in Washington must consider, like issuers of more traditional securities, whether the instrument that they seek to sell meets the definition of security, including under the investment contract test and the risk capital test.

### **The SEC’s Framework for Analyzing Whether a Digital Asset is a Security**

In recent years, the Securities and Exchange Commission (SEC) has provided significant guidance on evaluating whether a digital asset is a “security” under the investment contract test. The most comprehensive is the SEC’s “Framework for ‘Investment Contract’ Analysis of Digital Assets” published on April 3, 2019 (“[Framework](#)”).<sup>7</sup>

In applying the four-element investment contract test to digital assets, the Framework notes that the “investment of money” element of the investment contract test is typically satisfied in the sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, “whether in the form of real (or fiat) currency, another digital asset, or other type of consideration.” Moreover, the Framework notes that the “common enterprise” element typically exists in a token sale “because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter’s efforts.”

The Framework spends the majority of its analysis on the “expectation of profits” and the “derived from the efforts of others” elements of the investment contract test. The Framework notes that a purchaser of a digital asset may have an expectation of profits when, similar to a traditional share of stock in a company, the digital asset gives the holder the right to share in the income or profits of the business. In addition, the Framework notes that this element of the investment contract test would likely be met if the purchaser expects the digital asset to increase

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<sup>5</sup> RCW 21.20.005(17)(a) (2011).

<sup>6</sup> *Id.* (emphasis added); see generally *In the Matter of Determining Whether There Has Been A Violation of the Securities Act of Washington* by: Jason Brown and Your Local Market, LLC, S-12-1009-14-SC01 (Apr. 17, 2014), available at <https://dfi.wa.gov/documents/securities-orders/S-12-1009-14-SC01.pdf>.

<sup>7</sup> Framework for ‘Investment Contract’ Analysis of Digital Assets, Securities and Exchange Commission, Division of Corporation Finance, available at <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> (modified Apr. 3, 2019).



in value. This may be demonstrated if the issuer markets the digital asset in a manner that focuses on speculation or resale value, or if purchasers are motivated to purchase by the potential of the digital asset to increase in value. Moreover, the Framework notes that when an issuer of digital assets “provides essential managerial efforts that affect the success of the enterprise” the “derived from the efforts of others” element of the investment contract test is met. For example, the Framework suggests that a digital asset purchaser may be relying on the efforts of others if a digital asset issuer is responsible for developing, operating, or promoting the network, especially if these tasks are necessary for the network and the digital assets to function. The Framework further provides an extensive list of other possible considerations relevant to the analysis of each of these elements.

Issuers should use the Framework and related cases to determine whether the digital assets they issue are securities before offering and selling those digital assets to investors. The Washington Securities Division would likely consider the factors outlined in the Framework in evaluating whether a particular asset meets the definition of security under the Securities Act of Washington.

### **Examples of the Application of the Investment Contract Test to Digital Assets**

In July 2017, the SEC issued an investigative report, referred to as the [DAO Report](#), cautioning entities that offers and sales of digital assets may be subject to the requirements of the federal securities laws.<sup>8</sup> In the DAO Report, the SEC applied the investment contract test to determine whether the issuance of DAO tokens constituted a sale of securities. The SEC concluded that the investment contract test was satisfied because investors in the DAO contributed Ether to a common enterprise (i.e., the DAO organization) with a expectation of profit derived predominantly from the managerial efforts of others.<sup>9</sup> More generally, the DAO Report reminded entities issuing digital assets that: “Whether 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.”

Similarly, the Washington Securities Division has applied the investment contract test to ICOs and determined that the sale of tokens constituted the sale of securities under the Securities Act of Washington.<sup>10</sup> In one enforcement action, the Division examined a sale of tokens by a company

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<sup>8</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Securities and Exchange Commission, Release No. 81207 (July 25, 2017) at 11-13, *available at* <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

<sup>9</sup> *Id.* at 11-14.

<sup>10</sup> *See e.g.*, In the Matter Determining Whether There Has Been a Violation of the Securities Act of Washington by: Unikrn, Inc. and Unikrn Bermuda Ltd., S-18-2441-20-CO01 (Sept. 24, 2020) *available at* <https://dfi.wa.gov/documents/securities-orders/S-18-2441-20-CO01.pdf>; In the Matter Determining Whether There Has Been a Violation of the Securities Act of Washington by: YOcoin Limited d/b/a YOcoin and GoYOcoin, Inc., S-18-2519-20CO01 (Aug. 20, 2020), *available at* <https://dfi.wa.gov/documents/securities-orders/S-18-2519->



located in Washington.<sup>11</sup> The Division's investigation determined that the issuer planned to use the investor funds for ongoing development of the platform, on which the tokens would operate, and that if the platform were not built, the enterprise could not be successful. In addition, the Division's investigation determined that the issuer's marketing campaign emphasized the potential for long-term value in the token over time by means of the issuer's "skilled management team." Based on the ICOs and token sales that the Division has investigated, many digital assets are securities.

As of January 2021, to the Division's knowledge, the SEC has only opined that two cryptocurrencies are *not* securities.<sup>12</sup> In June 2018, William Hinman, Director of the SEC's Division of Corporation Finance, gave a [speech](#) in which he offered guidance to issuers contemplating an ICO or other sale of digital assets.<sup>13</sup> In that speech, Director Hinman stated that most tokens that have been sold in ICOs appear to be securities,<sup>14</sup> a statement also publically expressed by SEC Chairman Jay Clayton.<sup>15</sup> However, Director Hinman suggested that Bitcoin and Ether (as they existed in 2018), did not meet the definition of a security under the investment

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[20-CO01.pdf](#); In the Matter Determining Whether There Has Been a Violation of the Securities Act of Washington by: RChain Cooperative and Lucius Gregory Meredith, S-18-2463-20-CO01 (Feb. 26, 2020) *available at* <https://dfi.wa.gov/documents/securities-orders/S-18-2463-20-CO01.pdf>; In the Matter Determining Whether There Has Been a Violation of the Securities Act of Washington by: Broad Investments LLC and Guoyong Liu, S-18-2458-18-CO-01 (Apr. 1, 2019) *available at* <https://dfi.wa.gov/documents/securities-orders/S-18-2458-18-CO01.pdf>; In the Matter Determining Whether There Has Been a Violation of the Securities Act of Washington by: Duber Technologies Washington, Inc.; Glenn S. Ballman, S-18-2475-19SC01 (Dec. 18, 2019) *available at* <https://dfi.wa.gov/documents/securities-orders/S-18-2475-19-SC01.pdf>.

<sup>11</sup> In the Matter Determining Whether There Has Been a Violation of the Securities Act of Washington by: Unikrn, Inc. and Unikrn Bermuda Ltd., S-18-2441-20-CO01 (Sept. 24, 2020) *available at* <https://dfi.wa.gov/documents/securities-orders/S-18-2441-20-CO01.pdf>.

<sup>12</sup> See Digital Asset Transactions: When Howey Met Gary (Plastic), William Hinman, Director of Corporation Finance, Securities and Exchange Commission, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), *available at* <https://www.sec.gov/news/speech/speech-hinman-061418>; Clayton Interview with CNBC (June 6, 2018), *available at* <https://www.cnbc.com/amp/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html>? ("Cryptocurrencies: These are replacements for sovereign currencies, replace the dollar, the euro, the yen with bitcoin," Clayton said. "That type of currency is not a security.").

<sup>13</sup> Hinman Speech, *supra* note 12.

<sup>14</sup> *Id.* ("I will begin by describing what I often see. Promoters, in order to raise money to develop networks on which digital assets will operate, often sell the tokens or coins rather than sell shares, issue notes or obtain bank financing. But, in many cases, the economic substance is the same as a conventional securities offering. Funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument – usually by selling their tokens in the secondary market once the promoters create something of value with the proceeds and the value of the digital enterprise increases.").

<sup>15</sup> In early 2018, SEC Chairman Jay Clayton testified during a Senate hearing "I believe every ICO I've seen is a security." Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission, U.S. Senate Committee on Banking, Housing, and Urban Affairs (Feb. 6, 2018), *available at* <https://www.banking.senate.gov/hearings/virtual-currencies-the-oversight-role-of-the-us-securities-and-exchange-commission-and-the-us-commodity-futures-trading-commission>.

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contract test because they each had a sufficiently decentralized structure so that the “reliance on the efforts of others” element of the investment contract test was not met.<sup>16</sup>

### **Whether Utility Tokens Are Securities**

Many tokens sold in ICOs and token sales have some attributes of what the industry has termed a “utility token.” A utility token may include an entity-specific digital asset that can be used to purchase or access products or services on the entity’s network or platform. The fact that a digital asset is intended to have a practical use does not preclude the token from being a security.<sup>17</sup> Neither does its labelling as a “utility token” preclude such a determination.<sup>18</sup> The SEC’s [Framework](#) includes a helpful discussion of how the “use or consumption” of a digital asset may impact the analysis of whether or not it is a security.<sup>19</sup>

In addition, as of January 2021, the SEC’s Division of Corporation Finance has issued three no-action letters regarding the sale of utility tokens.<sup>20</sup> In these letters, which briefly describe the features of the tokens, the SEC stated that it would take no action to assert the registration provisions of the Securities Exchange Act of 1934 against the issuers of the described utility tokens. In taking this position, the SEC noted that the utility tokens at issue were immediately useable for their intended function and sold for consumptive use rather than speculative purpose. The SEC also noted that the issuers would not use the proceeds from the sale of the utility tokens to develop their networks or platforms. In conclusion, while there are a limited number of utility tokens that do not meet the definition of a security, issuers must proceed with caution.

### **Persons Who Offer, Sell, or Provide Advice Concerning Digital Assets That Are Securities**

Persons who offer or sell digital assets that are securities (“digital asset securities”) may be required to be licensed as a broker-dealer or investment adviser. With limited exceptions, a person<sup>21</sup> who is engaged in the business of effecting transactions in securities for the accounts of

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<sup>16</sup> Hinman Speech, *supra* note 12.

<sup>17</sup> See *Munchee, Inc. Securities Act Release No. 10445*, 2017 WL 10605969 (Dec. 11, 2017), *available at* <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

<sup>18</sup> *See id.*

<sup>19</sup> *Framework, supra* note 7.

<sup>20</sup> *TurnKey Jet, Inc., SEC No-Action Letter* (Apr. 3, 2019), *available at* <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm>; *Pocketful of Quarters, Inc., SEC No-Action Letter* (July 25, 2019), *available at* <https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1>; *IMVU, Inc., SEC No-Action Letter* (Nov. 17, 2020), *available at* <https://www.sec.gov/corpfin/imvu-111920-2a1>.

<sup>21</sup> A person includes an individual, corporation, a partnership, a limited liability company, a limited liability partnership a joint stock company, a trust where the interest of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government.



others or that person's own account must register as a broker-dealer.<sup>22</sup> In addition, a person who effects transactions for a broker-dealer must register as a securities salesperson.<sup>23</sup> Examples of broker-dealer activities include facilitating the exchange of a digital asset security between persons or between a person and a platform, providing trade execution, and engaging in the private placement of digital asset securities or ICOs. Broker-dealers are regulated by the SEC, through FINRA, and each state. The following links provide additional information on applying for a license from [FINRA](#) and [Washington](#).

An investment adviser license is necessary for any person who for compensation advises others as to whether they should invest in securities or issues reports concerning securities, including digital asset securities.<sup>24</sup> An investment adviser representative is any person employed by an investment adviser that makes recommendations or otherwise renders advice, manages accounts or portfolios, or determines which recommendation or advice regarding securities should be given.<sup>25</sup> Examples of persons who may need to register as an investment adviser or investment adviser representative are those that make personalized recommendations to others on which digital asset securities to purchase or sell or those that manage a pool of digital asset securities. Investment advisers are regulated by the SEC or the state depending on the amount of an investment adviser's assets under management. Investment advisers that manage assets less than \$100 million are regulated by the states and those that manage assets of \$100 million or more are regulated by the SEC. The following links provide additional information on applying for a license from the [SEC](#) and [Washington](#).

## Conclusion

The securities laws exist to protect investors and are therefore broadly interpreted. Those wishing to offer, sell, or provide advice concerning digital assets should be aware that such activities may fall under the purview of these laws. While there is now a good deal of guidance available, it's always a good idea to consult with an experienced lawyer before venturing into the digital asset space. In addition, the Division is always available answer questions and discuss the application of these laws.

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<sup>22</sup> See RCW 21.20.005(1).

<sup>23</sup> See RCW 21.20.005(15).

<sup>24</sup> See RCW 21.20.005(8).

<sup>25</sup> See RCW 21.20.005(9).