

When are Coins or Tokens Offered Pursuant to an Initial Coin Offering a Security?

As the initial coin offering (“ICO”) market has grown rapidly and exponentially, the Department of Banking and Securities is providing the following guidance as to whether coins or tokens offered and/or sold pursuant to an ICO are securities. Depending on the specific facts and circumstances of each ICO, the coins or tokens offered and/or sold to Pennsylvania investors may be securities subject to both the registration and anti-fraud provisions of the Pennsylvania Securities Act of 1972 (the “1972 Act.”)

In Pennsylvania, coins or tokens offered and sold pursuant to an ICO will be considered “securities” under Section 102(t) of the 1972 Act if they are “investment contracts.”

What is an Investment Contract? - The “Howey Test”

The United States Supreme Court has defined an investment contract as:

A contract, transaction or scheme whereby a person invests his money into a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.

SEC v. W.J. Howey, 328 U.S. 293, 298-99. The Howey test has been adopted in Pennsylvania. See *Martin v. ITM/International Trading & Marketing Ltd.*, 494 A.2d 451 (Pa. Super 1985). If the coins or tokens issued pursuant to an ICO meet the four prongs of the Howey test, as described below, they will be investment contracts and thus securities under the 1972 Act.

Howey Test, First Prong

The first prong of the Howey test requires an investment of money. The investment need not be in the form of cash. See *Useton v. Comm. Lovelace Motor Freight, Inc.*, 940 F. 2d 564, 574 (10th Cir. 1991). In most ICOs, an investor purchases coins or tokens using either fiat currency or some type of virtual currency. Such an investment would be sufficient to meet the first prong of the Howey test.

Howey Test, Second Prong

The second prong of the Howey test requires that the investment be made in a “common enterprise.” The Howey Court did not define the term, and jurisdictions are divided in interpreting the “common enterprise” requirement. There are presently three tests in use to determine “common enterprise”: 1) horizontal commonality (requiring two or more investors who pool their contributions and receive profits on a pro-rata basis); 2) broad vertical commonality (requiring a common interest between the investor and the promoter or third party such that the fortunes of all investors are tied to the expertise of the promoter or third party); and 3) narrow vertical commonality (requiring the investor and promoter share in the profits). Only horizontal commonality requires a finding of two or more investors.

Pennsylvania courts have consistently addressed the commonality requirement in terms of broad vertical commonality. In *Feninger v. Capital Accumulation Services, Inc.*, 2 Pa. D&C 4th 339 (Dela. Co. 1989), the court stated that the commonality requirement requires “a common interest between the investor and the party soliciting investors (the promoter) or a third party such that the fortunes of all the investors are tied to the expertise and effort of the promoter or third party.” Thus, the coins or tokens offered pursuant to an ICO would meet the second prong of the Howey test if the profits of the investors are linked with those of the promoters of the ICO.

Howey Test, Third Prong

The third prong of the Howey test is that the investment be made with the expectation of profits. “[P]rofits” include “dividends, other periodic payments, or the increased value of the investment.” See *SEC v. Edwards*, 540 U.S. 389, 394 (2004). Potential investors in an ICO are sometimes told by the company offering the coins or tokens that investors can expect a return on their investment or that the investors will be able to participate in a share of the returns provided by the company’s purported business. Additionally, pursuant to some ICOs, investors are told they can purchase products or utilities with the coins or tokens issued in an ICO. Depending on the facts and circumstances of each case, the coins or tokens may thus meet the third prong of the Howey test.

Howey Test, Fourth Prong

The final prong of the Howey test is the requirement that investors’ profits be derived from the efforts of others. If a company issuing coins or tokens pursuant to an ICO has structured the investment in such a way that the investors’ profits are to be derived primarily, if not solely, from the efforts of others, namely the company conducting the ICO, rather than from the Investors’ own efforts, then the coins or tokens issued to investors will meet the fourth prong of the Howey test.

In conclusion, if coins or tokens issued pursuant to an ICO meet the four prongs of the Howey test, the coins or tokens will be considered “investment contracts” and thus securities, and they will be subject to both the registration and anti-fraud provisions of the 1933 Act.