

ICO'S, DAO'S, AND THE SEC: A PARTNERSHIP SOLUTION

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In the summer of 2017, a new method of funding startup businesses exploded from a small capital market to one worth billions. “Initial Coin Offerings” (“ICOs”) can appear to be a simple crowdfunding campaign or a public stock offering at the same time and, until recently, have been conducted with no regulatory oversight. Due to the high risk of fraud, the SEC has begun cracking down on ICOs, requiring many issuers to register their “ICO tokens” as securities or halt trading entirely. This Note looks at the regulatory precedents and factors that the SEC has considered to decide whether a token is a security, and proposes an alternative legal system to securities law that may be better suited for regulating certain types of ICO tokens. This Note concludes that, for ICOs that raise money for a decentralized autonomous organization—in which all token purchasers hold equal management rights—uniform partnership law is the ideal mode of regulation.

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I. INTRODUCTION

Would you invest in a company in which all management is replaced by the remote control of all investors? That was the question “The DAO,” a conceptual investment fund designed to operate a decentralized autonomous organization almost entirely through digital code, asked the public.¹ Participants buy in to the fund by purchasing digital tokens, then introduce, view, and vote on pitches; the company’s smart code then automatically executes the winning projects.² The idea

¹ David Siegel, *Understanding the DAO Attack*, COINDESK, <https://www.coindesk.com/understanding-dao-hack-journalists/> [perma.cc/3MFC-74HU] (last updated June 27, 2016, 5:52 PM).

² *Id.*

was to create a democratic enterprise, but the plan hit a snag when a hacker exploited the company's code and trapped about \$50 million of investors' money.³ The implications of The DAO's plan, and the magnitude of its ensuing failure, were large enough to draw the attention of the Securities and Exchange Commission (the "SEC"), leading to a decision that has since confused the future of blockchain startups⁴: tokens or virtual currencies sold in an Initial Coin Offering ("ICO") might be treated as securities under federal securities law.⁵

The SEC's decision to evaluate The DAO's ICO as an investment contract failed to properly take into account the innovative purpose of The DAO: to introduce an organizational form that is decentralized, autonomous, and democratic; a form closely resembling a general partnership, but open to the entire public. In its report on The DAO, the SEC may have placed a premature road block in the way of new blockchain business models by requiring such businesses to register with a central, responsible authority. While the SEC is trying to protect investors, the public may be better served by relying on partnership law to regulate decentralized ICOs. A new general partnership form should be recognized—the "Decentralized Partnership"—with the potential to use blockchain technology to facilitate meaningful control across widely dispersed participants of all socio-economic backgrounds.

³ Klint Finley, *A \$50 Million Hack Just Showed that the DAO Was All Too Human*, WIRED (June 18, 2016, 4:30 AM), <https://www.wired.com/2016/06/50-million-hack-just-showed-dao-human/> [perma.cc/AF47-X5XX].

⁴ Blockchain startups refer to emerging companies with business models premised on the use of blockchain technology. Blockchain technology is a database system of creating, updating, distributing and maintaining records via a network of independent record-keepers, that eliminates the need for centralized storage systems. See Nolan Bauerle, *What is Blockchain Technology?* COINDESK, <https://www.coindesk.com/information/what-is-blockchain-technology/> [perma.cc/3DHX-XJPH].

⁵ SEC. & EXCH. COMM'N, RELEASE NO. 81207, REPORT OF INVESTIGATION: THE DAO (2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf> [perma.cc/RN28-FY3D] [hereinafter THE DAO REPORT].

This Note will first define an ICO and place it in the context of federal securities law. Next, this Note will survey how three types of ICOs commonly made available to the public—(1) Utility Tokens, (2) Dividend Tokens, and (3) Decentralized Partnership Tokens—fit into current securities definitions. Finally, this Note will analyze the SEC’s report on the DAO and proposes an alternative solution: using a partnership form to define and regulate decentralized partnership tokens.

II. WHEN ICO’S MIGHT BE SECURITIES

From the Industrial Revolution to the Internet Age, new technologies have coincided with new financial markets.⁶ Now, decentralized blockchain businesses have introduced the ICO market. In an ICO, a company raises money by issuing digital tokens in exchange for currency, typically Bitcoin or Ether. The tokens are blocks of code (often referred to as smart contracts)⁷ that give token-holders automated rights within the company, like participating in a service or receiving a share of profits. ICOs have been tracked since 2003, but between April 2016 and November 2017, the all-time cumulative sum of money raised in ICOs increased from \$56 million to over \$3.5 billion.⁸ However, as the market

⁶ The rise of the limited liability corporation and the London Stock Exchange were essential prerequisites to the Industrial Revolution. See John Steele Gordon, *How the Industrial Revolution Began*, BARRON’S, <https://www.barrons.com/articles/how-the-industrial-revolution-started-1423887383> [perma.cc/44UJ-D24F] (last updated Feb. 13, 2015, 11:16 PM). New pension fund investment rules that allowed the meteoric rise in the availability of venture capital funds helped spur a new era of technological advancement. See generally Paul A. Gompers, *The Rise and Fall of Venture Capital*, BUS. AND ECON. HISTORY, Vol. 23, no. 2, <https://www.thebhc.org/sites/default/files/beh/BEHprint/v023n2/p0001-p0026.pdf> [perma.cc/VQ4P-2YF7].

⁷ Alyssa Hertig, *How Do Ethereum Smart Contracts Work?*, COINDESK, <https://www.coindesk.com/information/ethereum-smart-contracts-work/> [perma.cc/Z5LL-TW94].

⁸ *All-Time Cumulative ICO Funding*, COINDESK ICO TRACKER, <https://www.coindesk.com/ico-tracker/> [perma.cc/7AS6-42JL] (last updated Nov. 26, 2017).

grows, the fear of fraud and its impact on the economy grows, which in turn draws the attention of regulators.⁹ In response to the rapid ballooning of the ICO market, the SEC has attempted to fit nascent, experimental business models into decades-old rules. Such a regulatory approach can become a road block to innovation rather than the reasonable speed bump it is intended to be.

A. Defining a Security

The Securities Exchange Act of 1934 (the “Exchange Act”) defines a “security” as, among other things, “any note, stock, treasury stock, security future . . . [or] investment contract.”¹⁰ The SEC has clarified and defined these examples, in turn, through promulgated interpretations and judicial review of the scope of the Securities Act.¹¹ When evaluating whether to regulate a new investment instrument, both the SEC and the courts consider the purpose of the Exchange Act, which was designed “to eliminate serious abuses in a largely unregulated securities market.”¹² As of the SEC’s release of The DAO Report release, the *Howey* Test for investment contracts (the “*Howey* Test”) has been used to determine whether ICOs are securities.¹³

⁹ Once the securities market had clearly become large enough to affect interstate commerce, Congress passed the Securities and Exchange Act of 1934, 15 U.S.C. § 78b (2010) to protect investors and the economy as a whole from fraud and misrepresentation. Since the ICO market ballooned in the summer of 2017 and showed signs of large-scale fraud and hacking, the SEC has applied the Securities and Exchange Act to regulate many ICOs. See THE DAO REPORT, *supra* note 5; Munchee Inc., Securities Act Release No. 10445, (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf> [perma.cc/YP4R-F9A2].

¹⁰ Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 77b(a)(1).

¹¹ *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975) (“The task has fallen to the Securities and Exchange Commission (SEC), the body charged with administering the Securities Acts, and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes.”).

¹² *Id.* at 849.

¹³ THE DAO REPORT, *supra* note 5, at 11.

1. The *Howey* Test

“An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”¹⁴ The actual form of the contract is not a determinative factor, but instead the economic realities of the agreement should be paramount.¹⁵ Over time, the *Howey* Test has been broken down into four factors that must be met in order to declare an investment contract a security: (1) there must be an investment of money;¹⁶ (2) in a common enterprise;¹⁷ (3) with the reasonable expectation of profits;¹⁸ and (4) derived predominately through the managerial efforts of others.¹⁹

The first part of the *Howey Test* may require asking whether the contract was entered into for purposes of investment profit or consumption.²⁰ Similar contract forms can be classified as investments or consumption, the distinction depending in part on the economic purpose driving the transaction. In *Forman*, tenants entering into real estate contracts were not given the protection of the SEC in part because the arrangement was for the purpose of occupying the space rather than investing in its value.²¹ But in *Howey*, real

¹⁴ SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946). Note that the *Howey* Test is used in the same way to identify securities under both the Securities Act of 1933 and the Exchange Act, as the definitions of securities in those acts are “virtually identical.” Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985).

¹⁵ In keeping broad definitions, the Acts allow for new technologies—like ICOs—to facilitate new capital markets. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (“form should be disregarded for substance”); *Forman*, 421 U.S. at 848–49 (“the emphasis should be on economic reality” and “Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto”).

¹⁶ *Forman*, 421 U.S. at 852.

¹⁷ SEC v. SG Ltd., 265 F.3d 42, 49–52 (1st Cir. 2001).

¹⁸ SEC v. Edwards, 540 U.S. 389, 394–96 (2004).

¹⁹ SEC v. Int’l Loan Network, Inc., 968 F.2d 1304, 1308 (D.C. Cir. 1992).

²⁰ *Forman*, 421 U.S. at 858.

²¹ *Id.*

estate contracts that primarily offered returns from harvesting oranges on the property were considered investment contracts under the Securities Act.²²

Additionally, the first factor of the *Howey* Test asks whether an investment was of “money.”²³ The SEC has taken the position, with judicial affirmation, that “money” in this context is a fluid concept that can include goods and services like virtual currencies.²⁴

The second factor of the *Howey* Test asks whether the investment is in a “common enterprise.”²⁵ Circuit courts differ on the proper approach for determining the existence of a common enterprise.²⁶ Some circuits look to “horizontal commonality,” which requires shared interest of investors seeking to pool their capital to share profits and losses.²⁷ Other courts examine any “vertical commonality,” whether the returns on the investment are woven between the investor and the manager of the investment.²⁸

The third factor of the *Howey* Test looks into the “reasonable expectation of profits.”²⁹ “Profits” here refers to the “profits that investors seek on their investment, not the profits of the scheme in which they invest.”³⁰ These profits can be variable or fixed, and do not require cash returns such as dividends.³¹ Similar to the first factor, courts examine whether the investors were “attracted” to the contract

²² SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

²³ *Id.*

²⁴ THE DAO REPORT, *supra* note 5, at 11.

²⁵ SEC v. SG Ltd., 265 F.3d 42, 49–52 (1st Cir. 2001).

²⁶ *Id.* at 49–50.

²⁷ See, e.g., Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994) (“A common enterprise within the meaning of *Howey* can be established by a showing of ‘horizontal commonality’: the tying of each individual investor’s fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits.”).

²⁸ *SG Ltd.*, 265 F.3d at 49.

²⁹ THE DAO REPORT, *supra* note 5, at 11.

³⁰ SEC v. Edwards, 540 U.S. 389, 394 (2004).

³¹ *Id.* at 394–95 (“profits’ in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment”).

primarily by the promise of returns, regardless of the form of those potential returns.³²

The fourth and final factor of the *Howey* Test has broadened since *Howey*. Originally, *Howey* asked whether the profits were derived “solely from the efforts of the promoter or a third party.”³³ The word “solely” has been replaced by circuit courts with a more flexible standard, “predominately.”³⁴ Courts have broadened this standard to prevent promoters from avoiding securities regulation by offering investor’s trivial participation rights in investment contracts.³⁵ Circuit courts adopting this flexible interpretation of the *Howey* Test’s fourth prong have allowed the SEC to take jurisdiction over investment contracts that offer participation rights, and even impose obligations such as voting, active marketing and sales, and other methods of participation in the venture.³⁶

2. Partnership Stakes as Securities

As a result of the expansion of the term “solely,” soliciting investors to join investment contracts as partners, either general or limited, can be treated as issuing securities.³⁷

³² *Id.* at 395–96.

³³ SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (emphasis added).

³⁴ SEC v. Int’l Loan Network, Inc., 968 F.2d 1304, 1308 (D.C. Cir. 1992). Other circuit courts have used different words to convey essentially the same sentiment: that the profits need not be derived “solely” from the efforts of the promoter or a third party, and that some involvement by the investors in the profit-generating activity does not foreclose the finding of an “investment contract” under *Howey*. See, e.g. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479–83 (5th Cir. 1974); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 481–82 (9th Cir. 1973). The Supreme Court has not yet commented on how far the *Howey* Test may depart from “solely.”

³⁵ Sometimes these participation rights may appear substantial. For example, individuals who invested in the scheme in *Glenn W. Turner Enterprises, Inc.* had the responsibility and ability to pitch new investors and makes sales in furtherance of the scheme, but the court determined that these “rights” were a façade for fraud. *Glenn W. Turner*, 474 F.2d at 478, 482.

³⁶ See *id.* at 482; see also SEC v. Merchant Capital, L.L.C., 483 F.3d 747 (11th Cir. 2007).

³⁷ See *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981).

Courts have often applied the *Howey* Test to partnership agreements to determine if such agreements are securities, with a special focus on whether the profits are derived from the efforts of others, or if the investor seeking securities protection lacks “meaningful partnership powers.”³⁸ *Williamson v. Tucker*, the leading precedent on *Howey*’s application to partnerships, states:

[G]eneral partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.³⁹

The *Tucker* panel deduced this standard by surveying past courts’ determinations of when partnership agreements could be considered investment contracts, with a focus on the impact of a large imbalance in “meaningful control” between the partners.⁴⁰

Later courts have interpreted *Tucker* to stand for the proposition that control issues may arise when “investors may be so lacking in requisite expertise, so numerous, or so dispersed that they become utterly dependent on centralized management, counteracting a legal right of control.”⁴¹

Additionally, the *Tucker* court’s reasoning is not limited to joint ventures or partnership forms, and the Second Circuit

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.* at 419–24.

⁴¹ *United States v. Leonard*, 529 F.3d 83, 90 (2d Cir. 2008) (citing *Williamson*, 645 F.2d at 423–24).

expanded it in *Leonard* to cover innovative, “relatively new” organizational forms like the LLC.⁴² The *Howey* Test, as applied to partnerships by *Tucker*, and with an emphasis on relative control as urged by *Tucker* and *Leonard*, may thus be a helpful lens to consider whether certain ICOs (like The Dao) should be regulated as securities.

3. Stock-Like Investments Distinguished from Investment Contracts

“[A]pplying the *Howey* Test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts’ enumeration of many types of instruments superfluous.”⁴³ The decision in *Landreth* makes it clear that applying the *Howey* Test is not always appropriate,⁴⁴ which implies that lower courts and the SEC, when evaluating an investment instrument, should first ask a threshold question: to which instrument in the list of securities instruments should the one in question be compared. In *Landreth*, the instrument was called a stock, quite clearly resembled a stock, and so should have been treated as a stock rather than an investment contract under the *Howey* Test.⁴⁵

The court in *Landreth* “identified those characteristics usually associated with common stock as (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.”⁴⁶ When an investment instrument bears such features and is marketed as a “stock,” it would be expected by the investor that securities laws apply.⁴⁷

⁴² *Id.* at 89.

⁴³ *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985).

⁴⁴ *Id.* at 691–92.

⁴⁵ *Id.* at 693–94.

⁴⁶ *Id.* at 686.

⁴⁷ *Id.* at 693.

As not all ICOs function in the same manner as The DAO's ICO, nor offer the same incentive structure, deciding bodies should keep in mind that there is not necessarily an appropriate one-test-fits-all approach for evaluating ICOs under securities law. As discussed below, some ICO tokens are so closely related to the traditional stock features outlined in *Landreth* that using a *Landreth* stock test rather than *Howey's* investment contract test may more appropriately identify these tokens' securities designation.⁴⁸

B. What Is an ICO?

An ICO is a method of raising venture funding from the general public by issuing a unique digital token in exchange for some form of currency, often Ether or Bitcoin.⁴⁹ The token confers some assortment of automated rights⁵⁰ on the token holder in relation to the company issuing the token. A company will typically offer a finite number of such tokens, and then token-holders can resell the tokens and transfer the rights to other individuals. Though not legally required, the standard market practice is to issue a white paper that explains what the company does, what rights the company's token or virtual currency provides, and how purchasers may expect to receive a return. The standard white paper also open-sources the code of the company's blockchain so that purchasers can examine the security features and

⁴⁸ *Id.* at 686; SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

⁴⁹ A common method of issuing a token through an ICO is by building the token on the Ethereum blockchain. The company issuing the ICO can create the token with a few lines of standard Ethereum code. Then they issue the token in exchange for Ether. The benefit of issuing an ICO this way is that the Ether can then be used to gain use of the Ethereum blockchain, which means the company does not need to build its own network from scratch in order to process and operate the tokens. For more information on Ethereum as a platform for ICOs, visit www.ethereum.org.

⁵⁰ Tokens operate as smart contracts—using the token unlocks certain source code that makes some action executable “automatically,” without the need for an intermediary to execute the contract.

functionality of the company.⁵¹ Companies and funds can raise millions of dollars and gain thousands of blockchain participants⁵² in a short amount of time through the ICO market. But while all ICOs raise money to fund operations, not all ICOs do so in the same manner.

The market consisted of three distinct classes of ICOs in 2017. Each of these classes offer distinct uses and rights in their ICOs, with varying degrees of opportunity for direct profit.

1. Class One: The Utility Token

The first class can be called the “Utility Token.” In this class of ICO token, the participants purchase tokens in order to become a customer of or contributor to the company’s blockchain service; any financial returns would come from the actual participation of the token holder in the service or from trading the tokens in a secondary market to others who may want to use the service. There is no right to a share of the company’s profits.⁵³ Whether a Utility Token is a security is

⁵¹ See, e.g., Christoph Jentzsch, *Decentralized Autonomous Organization to Automate Governance*, <https://download.slock.it/public/DAO/WhitePaper.pdf> [perma.cc/NK6A-YUHU]; see also 2017 BLOCKCHAIN TECHNOLOGY AND DIGITAL CURRENCY NATIONAL INSTITUTE, at E-4 (American Bar Ass’n ed., 2017), <https://www.americanbar.org/content/dam/aba/events/cle/2017/spring/ce1704btd.authcheckdam.pdf> [perma.cc/JUT9-8CRB].

⁵² The typical ICO is issued by a company with a product or service founded on an application of blockchain technology. Such technology requires a large network of users to contribute bandwidth and even participate in the activities of the blockchain in order to be useful. For example, the Bitcoin blockchain requires thousands of independent participants to verify transactions and mine new Bitcoin. In many ICOs, the tokens contain code that grants the token holder access to the issuing company’s blockchain, allowing participation in the activities of the company. See generally *A Beginner’s Guide to Blockchain Technology*, COINDESK, <https://www.coindesk.com/information/> [perma.cc/Z43D-T5S9]; *Investor Bulletin: Initial Coin Offerings*, SEC, https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings [perma.cc/WF7L-YRFJ] (last modified July 25, 2017).

⁵³ STORJ LABS (BVI) LTD. TERMS OF TOKEN SALE 1, <https://storj.io/sale-terms.pdf> [perma.cc/FGG3-BN44] (“Ownership of Tokens carries no rights,

difficult to predict as decisions are limited, but based on the DAO Report and a recent SEC decision regarding the Munchee ICO, the determining factors may be the functionality of the token and the manner in which the company promotes the token.⁵⁴

The Utility Token should not be presumptively considered a security by the SEC. Storj is a file storage company, and its ICO offers an example of a Utility Token. A Storj token holder can use Storj to buy or sell file storage on personal computers.⁵⁵ The Storj token might not pass the first factor of the *Howey Test*—Storj token purchasers are not *investing* money. Purchasers are primarily motivated by the opportunity to participate in the Storj blockchain. Users must have Storj tokens in order to buy and sell file storage through the Storj platform. This is more similar to the consumption contract in *Forman* than the investment contract in *Howey*.⁵⁶

However, there is potential for Storj token purchasers to be motivated by money, so further examination of this token is necessary. The Storj token is likely considered an investment in a common enterprise, insofar as purchasing the token results in horizontal commonality—the token holders profit based on the activities of the network of token holders—thereby satisfying the second factor of *Howey*.

However, the third part of the *Howey Test*, the reasonable expectation of profits, is difficult to meet. The Storj White Paper makes clear that there is to be no expectation of profiting financially from the company's activities; Storj

express or implied, other than the right to use Tokens as a means to enable usage of and interaction with the Network, if successfully completed and deployed. In particular, you understand and accept that Tokens do not represent or confer any ownership right or stake, share or security or equivalent rights, or any right to receive future revenue shares, intellectual property rights or any other form of participation in or relating to the Network and/or Company and its corporate affiliates. . . .”).

⁵⁴ The issuer's dogged promotion of their token as a for-profit investment and trading opportunity was a critical factor repeated throughout the SEC's report. *See generally* Munchee Inc., *supra* note 9.

⁵⁵ STORJ LABS (BVI) LTD. TERMS OF TOKEN SALE, *supra* note 53, at 1.

⁵⁶ *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

solicits the Storj token as a means of engaging in the Storj blockchain.⁵⁷ There may be derivative profits based on the holder's actual use of the Storj token, but the *Howey* Test refers to "profits that investors seek on their investment, not the profits of the scheme in which they invest."⁵⁸ There are no direct returns from an investment in the performance of Storj as a company, like a dividend or some other profit share. A token holder must purchase Storj tokens, then create and provide storage space and a consistent Internet connection in order to profit; returns come from the amount of storage contributed by the token-holder, not the amount of Storj tokens owned.⁵⁹

The fourth factor of the *Howey* Test also fails to paint a Storj token as a security. Any profits derived from the Storj token is earned by user participation in the blockchain, not "predominately" from the efforts of the Storj promoters or third parties.⁶⁰ If a token holder does nothing with his token, there will never be an expectation to profit. In fact, the holder may consume all tokens by purchasing storage space with them. The Storj developers have simply created a platform, and the token holders are members of the network who are free to profit or purchase based on their own agenda. It is possible that a secondary market develops in which token holders can sell their Storj for Bitcoin or other currencies at a profit, but these transactions would be independent of the initial offering of the token and there is no promotion or

⁵⁷ STORJ LABS (BVI) LTD. TERMS OF TOKEN SALE, *supra* note 53, at 1 ("The purpose of the Tokens is to facilitate the provision and receipt of data storage and related services. . . . you understand and accept that Tokens do not represent or confer. . . any right to receive future revenue shares. . . . The Tokens are not intended to be a digital currency, security, commodity or any other kind of financial instrument.").

⁵⁸ SEC v. Edwards, 540 U.S. 389, 394 (2004).

⁵⁹ It may be possible that secondary market trading could develop and become profitable for Storj investors, based on demand for the service. However, the positioning and marketing for why investors should buy Storj tokens is not to receive profit from trading, but to buy more storage space on other user's disks. STORJ LABS (BVI) LTD. TERMS OF TOKEN SALE, *supra* note 53.

⁶⁰ SEC v. Int'l Loan Network, Inc., 968 F.2d 1304, 1308 (D.C. Cir. 1992).

marketing by Storj claiming that this practice would be profitable. So, any regulation thereof would be derivative (and outside the scope of this Note).

The Utility Token model, as represented by Storj, is analogous to the franchise business model. Investors pay Storj for the right to use the Storj platform to buy and sell their own file storage space. Token holders are responsible for their own Internet connection, their own hardware, their own taxes, and ultimately, how much profit they can earn. *Crowley v. Montgomery Ward & Co.*⁶¹ and *SEC v. Aqua-Sonic Products Corp.*⁶² dealt with how to evaluate franchise agreements as investment contracts. In the first case, the “contributions of franchisees significantly and substantially affect[ed] the profits expected from the enterprise,” and so the franchise agreement was not a security.⁶³ Conversely, the economic reality of *Aqua-Sonic Products Corp.* was that the licensees had no sales experience and very little, if any, actual ability to control their sales.⁶⁴ The Utility Token model falls closer to the *Montgomery Ward Co.* end of the franchise spectrum, in that the profits expected by a token holders vary in proportion to their contribution to the network, rather than by the number of tokens they hold.

i. Differentiating Pre-Functional Utility Tokens by Marketing Messages

In December of 2017, in its biggest ICO action since The DAO Report, the SEC ordered the California-based app developer Munchee to cease its ICO and return funds to investors.⁶⁵ The Munchee token can be classified as a Utility Token, as its function was to facilitate payments for advertising and reward users for posting restaurant reviews in the Munchee restaurant-review app.⁶⁶ The SEC found this

⁶¹ *Crowley v. Montgomery Ward & Co.*, 570 F.2d 875 (10th Cir. 1975).

⁶² *SEC v. Aqua-Sonic Products Corp.*, 687 F.2d 577 (2d Cir. 1982).

⁶³ *Crowley*, 570 F.2d at 881.

⁶⁴ *See Aqua-Sonic Products Corp.* 687 F.2d at 585.

⁶⁵ *Munchee Inc.*, *supra* note 9.

⁶⁶ *Id.* at 4.

ICO to be a violation of section 5(a) of the Securities Act by promoting and selling an unregistered security.⁶⁷ This decision should be narrowly read in regards to Utility Token ICOs, however, because the token did not actually offer any functionality at the time of issuance, and the overwhelming promotion of the token was as a vehicle for secondary market trading profits. These two factors separate the Munchee token from many other Utility Tokens.

These issues with the Munchee ICO differentiate it from other ICOs like Storj in a way that skews the *Howey* Test's third and fourth factors ((3)the expectation of profits derived (4) from the managerial efforts of others) against Munchee. While Storj white papers promote the Storj token as a means to engage with Storj services,⁶⁸ Munchee explicitly advertised the prospect of token-value appreciation profits on secondary markets.⁶⁹ A Munchee token purchaser could not actually participate in the service, as the token was not functional at the time of ICO issuance.⁷⁰ But Munchee still promised to create an "eco-system" that would enhance and protect the secondary market value of the token, even before the token became functional.⁷¹ In sum, the SEC found Munchee token purchasers were motivated by the prospect of the token's appreciation, not by a desire to use it in connection with Munchee's products. And since the expectation of profit could only have come from Munchee's business growth, their token clearly was a security under the third and fourth *Howey* Test factors.

Munchee's precedential value, therefore, may be limited to its facts. Promotions centered on the prospect of financial gain and limited token functionality were central to the Munchee case and will not necessarily be present in all Utility Token ICOs. The Munchee ICO, therefore, serves as an example of claims to avoid if an issuer of Utility Tokens wishes to avoid securities regulations. This is not to say that a pre-functional

⁶⁷ *Id.* at 2.

⁶⁸ STORJ LABS (BVI) LTD. TERMS OF TOKEN SALE, *supra* note 53 at 1.

⁶⁹ Munchee Inc., *supra* note 9, at 4–6.

⁷⁰ *Id.* at 4.

⁷¹ *Id.*

Utility Token used to raise money for development of a network will always be a security under Munchee. The token promoter could “lock up” the token from being transferred or sold on secondary markets until it becomes functional, for example.⁷² This might decrease any expectation of profits during the non-functional period, which in turn might help avoid designation as a security. Either way, functionality and manner of promotion may become essential determining factors in SEC regulation of ICOs.⁷³

2. Class 2: The Dividend Token

Polybius Bank held an ICO to raise capital for its regulated, blockchain-technology driven bank.⁷⁴ The bank plans to offer traditional banking services like commercial banking as well as modern services like peer-to-peer lending, all without any physical location.⁷⁵ The Polybius token issued in the ICO (“PLBT”) confers a “right to receive a part of distributable profits” of Polybius Bank.⁷⁶ This type of token, distributed as a means of raising money in exchange for a

⁷² For example, Storj used such a lockup of reserved Storj tokens in order to “rearchitect” their token system, improve utility and stabilize pricing. Storj.io, *An Announcement About Storj Token Lock-ups*, STORJ BLOG (Dec. 19, 2017), <https://blog.storj.io/post/168735310988/an-announcement-about-storj-token-lock-ups> [perma.cc/P4X6-JFW4].

⁷³ For more examples of Utility Token ICOs, see the white papers of Aventus (an event ticketing blockchain), Civic (an identity fraud prevention and know-your-client blockchain), and Unikrn (an eSports gambling blockchain supported by Mark Cuban). See ALAN VEY & ANNIKA MONARI, AVENTUS, A BLOCKCHAIN-BASED EVENT TICKETING PROTOCOL (2017), <https://aventus.io/doc/whitepaper.pdf> [perma.cc/V9J3-9WRW]; CIVIC TECHNOLOGIES, INC., CIVIC WHITEPAPER (2017), <https://tokensale.civic.com/CivicTokenSaleWhitePaper.pdf> [perma.cc/NN9F-75NJ]; UNIKRN, INC., UNIKOINGOLD: A DECENTRALIZED ESPORTS GAMING TOKEN (2017), https://static.unikrn.com/4242/unikrn_bm/doc/whitepaper_en.pdf [perma.cc/9T9Y-U3K6].

⁷⁴ See POLYBIUS, POLYBIUS PROSPECTUS: A PROJECT OF A REGULATED BANK FOR THE DIGITAL GENERATION (2017), <https://polybius.io/media/prospectus.pdf> [perma.cc/B3JU-6WL3] [hereinafter POLYBIUS PROSPECTUS].

⁷⁵ *Id.* at 1.

⁷⁶ *Id.* at 3.

share of profit, is a “Dividend Token” and is facially the kind of investment an investor would refer to as a security. For this reason, a token marketed with the primary purpose of distributing dividends can be considered a security under the reasoning of *Landreth*, without necessarily resorting to the *Howey* Test.

As discussed above, *Landreth* stands for the proposition that, while not all “stocks” are necessarily securities, investments marketed as “stocks” and having features closely resembling traditional stocks are covered under the Securities Acts.⁷⁷ Though the holding in *Landreth* is limited to investments marketed as “stocks,” its reasoning regarding investor expectation and factual similarities between a Dividend Token and a traditional stock should establish a *prima facie* case that Dividend Tokens are securities. This should shift the burden to the token issuer to show that the token is not a security. After all, the securities test focuses on the “substance” and “economic reality” of the investment, rather than the “form.”⁷⁸ The economic reality of a Dividend Token is that investors expect few participation rights but proportional profit-sharing rights.

A Dividend Token like that issued by Polybius resembles non-voting common stock. The Polybius token explicitly confers the right to “receive dividends contingent upon an apportionment of profits”—one of the functional characteristics of stocks noted in *Landreth*.⁷⁹ The Polybius token does not confer voting rights, although other Dividend Tokens do.⁸⁰ Though the ICO price of the Polybius token was

⁷⁷ *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985) (“As we have observed in the past, this definition is quite broad . . . and includes both instruments whose names alone carry well-settled meaning, as well as instruments of ‘more variable character [that] were necessarily designated by more descriptive terms,’ such as ‘investment contract’ and ‘instrument commonly known as a ‘security.’”).

⁷⁸ *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

⁷⁹ *Landreth*, 471 U.S. at 686; POLYBIUS, POLYBIUS TOKEN WHITEPAPER (2017), https://polybius.io/media/tw_en.pdf [perma.cc/NS9E-5JPX] [hereinafter POLYBIUS WHITEPAPER].

⁸⁰ *Polybius Whitepaper*, *supra* note 79. For a list of more Dividend Tokens and their features, see Jim Reynolds, *Which Cryptocurrencies Pay*

set at ten dollars per token, the price in secondary trading is negotiable and the tokens have the capacity to appreciate in value based on the outlook on dividend value.⁸¹ It is unclear whether, at this time, the tokens may be pledged or hypothecated.

With such a close comparison to a traditional stock, and with the primary investment purpose of distributing profits, Dividend Token issuers should be on notice that their tokens are securities. In fact, the Polybius white paper contains a disclaimer that implies that Polybius believes its token is a security under U.S. law, and seems to be seeking Regulation S safe harbor by barring U.S. persons from purchase.⁸²

Since investors will look at these ICOs and believe that they look very much like common stock, Dividend Token issuers like Polybius have acknowledged that U.S. securities laws apply and—unlike Polybius—have opted to register their ICOs.⁸³

3. Class 3: The Decentralized Partnership Token

Imagine a driverless car that picks up and drops off passengers who hail it through an app in exchange for a fee. Now imagine there is no central owner or operator of the car, but instead a decentralized network of investors who automatically receive a portion of the profits earned by the car.⁸⁴ The business is decentralized, meaning no single entity

Dividends?, INVESTITIN.COM (June 26, 2017), <https://www.investitin.com/cryptocurrency-dividends/> [perma.cc/E629-38HZ].

⁸¹ POLYBIUS PROSPECTUS, *supra* note 74, at 3.

⁸² *Id.* at 20. Whether in practice the ICO actually complied with Regulation S is outside the scope of this Note, as it deals with the administrative challenges of pseudonymous blockchain transactions.

⁸³ Jaron Lukasiewicz, *The Basics on FACTS: A New Model for Compliant ICOs*, COINDESK (Oct. 29, 2017, 3:04 PM), <https://www.coindesk.com/basics-facts-new-model-compliant-icos/> [perma.cc/WS25-NBJB].

⁸⁴ This thought experiment is often used to explain the concept of a decentralized autonomous organization. Alyssa Hertig, *What is a DAO?*, COINDESK, <https://www.coindesk.com/information/what-is-a-dao-ethereum/> [perma.cc/6TXB-RMS3].

has control. Rather, the entire network of participants owns control. It is autonomous because there is no human operator, instead the business is run by automatically executable code. The only human intervention is in the initial coding and promotion. It is an organization because of the common rights and purposes of the investors. DAO business models are possible today (although not *yet* in driverless cars) by using the Ethereum blockchain platform and ICOs, but they create a unique regulatory challenge.

“The DAO” is the most notorious example of such a business model. The DAO was set up to function as an open-source, decentralized venture capital fund (though not limited only to venture investments). First, The DAO was created with simple, vague code, just enough to demonstrate the concept and issue an ICO. In the ICO, The DAO raised millions of dollars from thousands of investors, who became the network of decentralized token holders and de facto operators of The DAO fund. After that, the goal was to have the token holders introduce code to finalize the executory capabilities of the fund. Every token holder had the right to be a “Contractor” and “pitch” a block of code that represents a smart contract investment (a hypothetical example could be code that automatically invests \$10 million of DAO funds into the S&P 500 and then winds down the investment automatically by \$1 million each month, distributing any profits to token holders).⁸⁵ The DAO used “Curators” to ensure the code does what it intends to do and control the pace of pitches. Then, token holders voted on each smart contract pitch. If a pitch reached quorum, the code would automatically execute the smart contract.⁸⁶

There was to be no management, only the maintenance “Curators.” There were no management fees or profit participation fees. There was no planned gap between owning the fund token and controlling the fund activities. When investors purchased a DAO token, they did so for three reasons: (1) to profit from the fund’s investments; (2) to control

⁸⁵ See Jentzsch, *supra* note 51, at 2.

⁸⁶ *Id.*

the fund's investments; and (3) to participate in an experimental business model that can set an example for innovation in other markets.

After a hacker exposed a flaw in The DAO's underlying code to trap \$50 million (all of which was later returned to investors using the advantageous features of the blockchain), the SEC determined that the DAO ICO was an illegal sale of unregistered securities.⁸⁷ The SEC further advised that many other ICOs might be treated as securities, and that issuers should seek counsel in registering their tokens as such.⁸⁸

III. THE SEC MISUNDERSTANDS THE DAO

After The DAO was hacked, the SEC issued an investigative report stating that The DAO ICO constituted a security issuing, and therefore should have complied with federal securities laws.⁸⁹ They argued that under the framework of the *Howey* Test, The DAO investors invested money in the common enterprise with the expectation of profiting on the managerial efforts of others, and did not themselves have meaningful control over the enterprise.⁹⁰ In focusing on the efforts of the Curators, the SEC erred in their fact-finding, resulting in a misguided application of the "managerial efforts" factor of the *Howey* Test.

A. The First Factor: Investment of Money

Under the first factor of the *Howey* Test, the SEC determined that there had been an "investment of money."⁹¹ The "investment" aspect of participation in the ICO is obvious—purchasers sought a return on their contribution. The novel issue was whether crypto-currencies like Bitcoin and Ether are "money." The SEC resolved this issue by relying on two precedents, *Uselton v. Commercial Lovelace Motor*

⁸⁷ THE DAO REPORT, *supra* note 5.

⁸⁸ *Id.* at 2.

⁸⁹ *Id.* at 1

⁹⁰ *Id.* at 11–13.

⁹¹ *Id.* at 11.

Freight, Inc. and *SEC v. Shavers*, to argue that virtual currencies are money.⁹² Supporters of Bitcoin and Ether will not likely argue with this position, because it further legitimates the virtual currency market. At some point in the transaction, fiat currency must have been exchanged to procure the Ether (which has a fiat currency value) and invest in The DAO token. DAO token purchasers indisputably invested money in The DAO token.

B. The Second Factor: A Common Enterprise

While the SEC acknowledges “common enterprise” as part of the definition of an investment contract security, it does not discuss whether the DAO ICO is a common enterprise, instead skipping to a discussion of the “managerial effort of others” factor.⁹³ This may be because horizontal commonality seems self-evident—each DAO investor’s success is tied to the success of the other investors. But vertical commonality here is more debatable, and some courts rely primarily on vertical commonality.⁹⁴

“A common enterprise within the meaning of *Howey* can be established by a showing of ‘horizontal commonality’: the tying of each individual investor’s fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits.”⁹⁵ The DAO concept fits this description of a common enterprise. The success of an investment in The DAO is made possible by the investment of the pool of Ether contributed by all investors. All profits are distributed equally across each token, and each token holder receives a pro rata share of profits depending on the number

⁹² *Useton v. Commercial Lovelace Motor Freight*, 940 F.2d 564, 574 (10th Cir. 1991) (holding that cash is not the only form of investment recognized under the *Howey* Test); *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182, at *2 (E.D. Tex. Aug. 6, 2013) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of *Howey*).

⁹³ THE DAO REPORT, *supra* note 5, at 11.

⁹⁴ See *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001) (discussing the use of horizontal and vertical commonality standards by different courts).

⁹⁵ *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994).

of tokens held. In some courts, this will be sufficient to satisfy the common enterprise portion of *Howey*.

Other courts will accept vertical commonality to show a common enterprise. In vertical commonality schemes, “an investor’s fortunes are tied to the promoter’s success rather than to the fortunes of his or her fellow investors.”⁹⁶ The Eleventh and Fifth Circuits recognize broad vertical commonality, which requires a showing that the investor’s returns are “tied to the efficacy of the promoter.”⁹⁷ The court in *Villeneuve* found vertical commonality because the investors could not succeed without advertising services provided by the promoters of the scheme.⁹⁸ The Ninth Circuit, in cases where there is no horizontal commonality, will look to “a strict version of vertical commonality,”⁹⁹ which requires that investors’ fortunes be “interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.”¹⁰⁰ In such an evaluation, the court looks deeper than the contributions of the promoter to the scheme, instead focusing on whether the results of the promoters’ efforts generate the results of the investment.

The DAO ICO might satisfy broad vertical commonality. The *Villeneuve* court found vertical commonality in a scheme where the promoters “provide[d] advertisements, training, products, and [selected] the areas where products are sold,” adding that “[t]he failure to provide any of these services would definitely determine the success or failure of the

⁹⁶ *SG Ltd.*, 265 F.3d at 49.

⁹⁷ *Villeneuve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983), *vacated by reh'g en banc*, 730 F.2d 1403 (1984) (quoting *SEC v. Koscot Int'l, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974)). Although the Eleventh Circuit's en banc rehearing technically vacated its original *Villeneuve* opinion, the full court reached the same result and issued a cursory per curiam opinion that implicitly accepts the original panel's more fully explicated reasoning. *See Villeneuve v. Advanced Business Concepts Corp.*, 730 F.2d 1403, 1404 n.1 (11th Cir. 1984) (en banc).

⁹⁸ *Id.*

⁹⁹ *Hocking v. Dubois*, 885 F.2d 1449, 1459 (9th Cir. 1989) (en banc).

¹⁰⁰ *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973).

scheme.”¹⁰¹ The causal link between the contribution of the promoters and the sales efforts of investors (who were like franchisees in the *Villeneuve* scheme) seems tenuous, yet the court deemed the *Villeneuve* scheme to be a common enterprise.¹⁰² The DAO Curators offer similar threshold services, like approving pitches for voting.¹⁰³ Without Curator approval, token holders cannot vote on a smart contract pitch. Neglecting curation would undoubtedly cause the failure (or at least stagnation) of the scheme, so broad vertical commonality is satisfied here.

However, strict or narrow vertical commonality is not easy to apply in this case. In a case in which an investor’s funds would not be pooled—i.e. no horizontal commonality—the Ninth Circuit found a common enterprise where the success of the investor’s investment depended upon the success of the promoter’s “business operations.”¹⁰⁴ Arguably, this is not the case in The DAO. First, the founders of The DAO provided the minimum code necessary for token purchasers to be able to work together to build their funds. Afterwards, there is no more relationship between the investors and the founders, so investors’ success depends on the new execution code they approve and the investments they choose, independent of the founders.

The Curators were closer to the success of the investors, because they were tasked with ensuring that pitches were suitable for implementation. Investor success required Curators’ services, but was not dependent on those services. An investment could have been approved by Curators and then denied by voters, or approved by voters and be a failure, in each case regardless of the Curators’ operation. Further, the Curators were replaceable by token-holding voters, which further separated Curator performance and investor success.

A final argument against both modes of vertical commonality is that the Curators do not create verticality at

¹⁰¹ *Villeneuve*, 698 F.2d at 1124.

¹⁰² *Id.*

¹⁰³ Jentzsch, *supra* note 51, at 2–3.

¹⁰⁴ *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1229 (9th Cir. 1974).

all, but rather are within the same horizontal, decentralized structure of the DAO. Decentralization is the essential concept of the business model. Further, the Curators are facilitators chosen by the token holders, but do not have power to control the token holders. The Curators' primary purpose is to protect minority token holders from attack by a majority token holder (like voting to take all of the funds, which, in fact, almost occurred before it was stopped by the Curators).¹⁰⁵ One DAO Curator describes his role as "human-training wheels" and envisions a future where Curators are no longer necessary at all.¹⁰⁶ Another Curator saw an even smaller role in protecting from majority attacks, which is just to certify "whether payment addresses are truly associated with proposals" and whether code meets security standards—Curators are not to make a decision based on the profitability of a proposed contract.¹⁰⁷ Hence, Curator control is merely procedural, not substantial.

In most courts, a lack of strict vertical commonality would not defeat the common enterprise factor, since horizontal commonality exists. This may be why the SEC left the common enterprise factor out of the DAO report. However, the discussion of vertical commonality raises important challenges to the SEC's application of the final *Howey* factor, the managerial effort of others.

C. The Third Factor: The Reasonable Expectation of Profits

The third factor's application to The DAO is relatively straightforward, and therefore only received a short paragraph of discussion in the SEC Report.¹⁰⁸ DAO investors were driven to the novel investment model by the potential financial returns. "Profits" means "[p]rofits in the sense of

¹⁰⁵ Jentzsch, *supra* note 51, at 2–3.

¹⁰⁶ Andrew Quentson, *Are The DAO Curators Masters or Janitors?*, COINTELEGRAPH (June 12, 2016), <https://cointelegraph.com/news/are-the-dao-curators-masters-or-janitors> [perma.cc/ALW2-KZ2A].

¹⁰⁷ *Id.*

¹⁰⁸ THE DAO REPORT, *supra* note 5, at 11–12.

income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.”¹⁰⁹ The value of a DAO Token could increase and the token may be traded on another virtual exchange for Bitcoin or possibly even U.S. dollars. At some point in the transactional chain, the return on a DAO investment has real liquidity. There is no doubt that DAO token purchasers invested money with the reasonable expectation of profits.

A counterpoint to note, however, is that profit is not the exclusive purpose for investing in The DAO. There are other virtual currency funds that invest in blockchain technologies, but operate more like traditional hedge funds.¹¹⁰ The difference with The DAO arise in the ownership of control and in the potential to explore the most ambitious possibilities of smart contracts and blockchain technology—like automating investments to execute with no human staff. While this does not overcome the expectation of profits, the numerous, experimental motivations behind The DAO should help guide the SEC in their evaluation of a DAO ICO. After all, *Landreth* lends precedent to the idea that whether investors expect the protection of securities regulations are relevant to the application of the Securities Acts.¹¹¹

D. The Fourth Factor: The Managerial Efforts of Others

The most controversial factor in the SEC’s application of the *Howey* Test to The DAO is the fourth factor. The SEC argued that “The efforts of Slock.it, Slock.it’s co-founders, and The DAO’s curators were essential to the enterprise,” thereby

¹⁰⁹ SEC v. Edwards, 540 U.S. 389, 394 (2004).

¹¹⁰ Taas is a crypto-hedge fund that distributes twenty-five percent of its profits from investing in blockchain assets. There are more recent crypto-investment funds as well that charge traditional management and profit participation fees. See Reynolds, *supra* note 80; Ash Bennington, *Crypto Hedge Fund Costs? Invest \$100k and Here’s How Much You’d Pay*, COINDESK (Sept. 28, 2017, 11:00 AM), <https://www.coindesk.com/crypto-hedge-fund-costs-invest-100k-and-heres-how-much-you-d-pay/> [perma.cc/TYX4-U4D8].

¹¹¹ *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

satisfying the managerial-efforts-of-others factor.¹¹² Further, the SEC found that the “token holders’ voting rights were limited,” while drastically downplaying the importance of the token holders’ “Contractor” power.¹¹³ This is where the SEC erred. The SEC’s interpretation of DAO procedure is antithetical to the concept of the DAO and distorts the economic realities of the investment. This misinterpretation of facts has led to a misapplication of the law.

1. The Efforts of Slock.it, Slock.it’s Co-Founders, and The DAO’s Curators

Slock.it is the group of coders responsible for initiating The DAO. They wrote the code, issued and promoted the ICO, chose the initial Curators and suggested the first pitch, then stepped back to a role limited to answering technical questions about how to participate in The DAO.¹¹⁴ The SEC decided that these were the “undeniably significant” efforts that were “essential” to the “failure or success of the enterprise.”¹¹⁵ While it is undeniably true that The DAO could not have formed without initial programming, the SEC overstated the ongoing involvement of Slock.it, but neglected to consider the founders’ future intent to step aside as soon as the code was running, and even to replace Curators with token-holder-generated code when possible.¹¹⁶ The economic reality of the scheme was that Slock.it and the Curators only contributed to the maintenance of the system, while the “failure or success of the enterprise”—returns on investments—depend long-term upon the token-holding investors themselves.

This part of the *Howey* Test no longer requires the success of the investment to be derived “solely” from the managerial

¹¹² THE DAO REPORT, *supra* note 5, at 12.

¹¹³ *Id.* at 13.

¹¹⁴ *Id.* at 12.

¹¹⁵ *Id.* (citing SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973)).

¹¹⁶ Quentson, *supra* note 106.

efforts of the promoter or third parties.¹¹⁷ Investors can participate in the scheme by means of contributing sales activities or voting on governance, and the investment contract may still be deemed a security.¹¹⁸ However, the limits of just how far the law has moved away from “solely” are unclear. The D.C. Circuit suggests a temporal rule for when the managerial efforts of others is insufficient.¹¹⁹ In this circuit, an “on-going” common enterprise between the investors and managers must be present: “[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.”¹²⁰

The SEC found the contributions of Slock.it essential and the powers of the Curators substantial.¹²¹ They argued that Slock.it’s coding, marketing, ongoing technical support, and promise to put forth the first investment project created an expectance of token-holder reliance upon their managerial efforts.¹²² Additionally, they found that the Curators’ task to white-list or block Contractor pitches overpowered any realistic ability for the token holders to exercise control, while downplaying the ability for token holders to replace Curators.¹²³

The coding of the DAO by Slock.it and the appointment of initial Curators were merely pre-purchase efforts.¹²⁴ After purchase, additional code was to be offered by token holders (when a token holder pitches a smart contract for code to be inserted after a vote, that token holder is referred to as the

¹¹⁷ *Glenn W. Turner*, 474 F.2d at 482.

¹¹⁸ *See id.* at 480 (the investor becomes the salesman in the scheme); *see also* SEC v. Merch. Capital, LLC, 483 F.3d 747 (11th Cir. 2007).

¹¹⁹ SEC v. Life Partners, Inc., 102 F.3d 587 (D.C. Cir. 1996).

¹²⁰ *Id.* at 588.

¹²¹ THE DAO REPORT, *supra* note 5, at 12.

¹²² *Id.*

¹²³ *Id.* at 13.

¹²⁴ The SEC did not discuss the temporal aspect of the initial setup contributions of Slock.It. *See* THE DAO REPORT, *supra* note 5, at 12.

“Contractor” for that pitch).¹²⁵ Any on-going involvement was intended to be—and in reality was—ministerial, not entrepreneurial. Slock.it provided technical support; Curators, even in their screening of pitches, offered only security clearance and compliance. Only token holders—the investors—were entitled to put forth the entrepreneurial efforts and ideas necessary for profit. In practice, Slock.it and the Curators (many of whom helped create the Ethereum blockchain) functioned as they promised in the white paper: they intervened in the code using a hard fork to stop a hack from exploiting minority token holders.¹²⁶ Security is not an entrepreneurial effort; it is a ministerial one. Security does not continuously increase the value of the investment; it is already priced-in to the purchase price of the token. Even screening pitches for security-proper integration with the DAO code does not overshadow the predominance of the investors’ efforts.

The Fourth Circuit provides a convenient analogy to the managerial efforts in The DAO: “[i]f the investment scheme [is] merely to raise cattle for slaughter, the interests purchased by the [investors] may not [constitute] investment contracts.”¹²⁷ Raising the cow is a pre-purchase contribution. Slaughtering the cow and profiting off the meat is the ongoing effort, and the investors have the practical skill and ability to realize these profits without the rancher.¹²⁸

In the DAO case, the code is the cow. Slock.it raised the code only to the point where additional experience and input was needed. The investors could “hire others to care for the” code—Curators—and still the arrangement would not

¹²⁵ Jentzsch, *supra* note 51, at 2–3.

¹²⁶ A hard fork is a blockchain management method which asks each of the record keepers to agree to change the historical information in the blockchain, and can essentially undo unwanted transactions. Matthew Leising, *The Ether Thief*, BLOOMBERG (June 13, 2017), <https://www.bloomberg.com/features/2017-the-ether-thief/> [perma.cc/YMY9-FY3Z].

¹²⁷ *Bailey v. J.W.K. Properties, Inc.*, 904 F.2d 918, 923 (4th Cir. 1990).

¹²⁸ *Id.* at 923–24.

constitute an investment contract.¹²⁹ The token holders are ultimately responsible for and (as discussed below) practically capable of exercising the necessary controls to slaughter the cow—code, pitch, and vote for investments—and realize returns. The pre-purchase contributions of Slock.it and the Curators are simply not the meat of the efforts needed to realize profit.¹³⁰

Cases in which the pre-purchase efforts of managers satisfied the managerial efforts factor of *Howey* involved “significant post-purchase efforts.”¹³¹ Post-purchase, Slock.it only provided “ministerial efforts” like answering technical questions on token-holder forums.¹³² These were helpful in the development of the technology, but not essential to the profitability of future investments. The Curators were tasked with ensuring the security and honesty of the code as well as protecting the voting rights of the minority token holders, which is purely ministerial.¹³³ Neither the post-purchase contributions of Slock.it nor the Curators can be considered “substantial improvements” to the scheme.¹³⁴ Rather, they serve only as general maintenance. As such, the managerial efforts necessary to satisfy the final factor of the *Howey Test* are not present—just as they are not present when a rancher sends a cow to the slaughterhouse.

¹²⁹ *Id.*

¹³⁰ The Fourth Circuit differentiates between schemes in which the pre-purchase selection of assets, like choosing cow embryos, is essential to the success of the enterprise and those, like raising the cow for slaughter, in which the investors are capable of exercising control over the on-going enterprise. *Id.* Slock.it founders do not contribute enough code pre-purchase for The DAO to make any decisions. All asset selection is left up to the token holders, with Curators only serving ministerial purposes.

¹³¹ SEC v. Life Partners, Inc., 102 F.3d 587, 588 (D.C. Cir. 1996).

¹³² *Id.*; see THE DAO REPORT, *supra* note 5, at 12.

¹³³ Jentzsch, *supra* note 51, at 2–3.

¹³⁴ *Life Partners*, 102 F.3d at 588 (quoting *McCown v. Heidler*, 527 F.2d 204, 211 (10th Cir. 1975)).

2. The Expansive Rights of The DAO Token Holders

The SEC further found that, under the managerial efforts factor of the *Howey* Test, the voting rights of the token holders were limited.¹³⁵ These limitations made token holders more reliant on managerial efforts.¹³⁶ This determination substantially underestimates the control rights conferred to token holders. Further, the SEC only makes a cursory exploration of the applicability of the *Tucker* court's partnership agreement evaluation.¹³⁷ A closer look at the comprehensive rights and protections afforded token holders, in the context of a horizontal relationship with Curators, will show that token holders held the essential control of the enterprise. This is especially true when considering expectations of how The DAO would operate in the future.

When evaluating joint ventures and partnerships as investment contracts, courts add additional inquiries under the managerial effects factor of *Howey*, assessing how the partnership agreement actually distributes partnership power.¹³⁸ Whether the investors had expectations of reliance on the entrepreneurial efforts of the promoters or third parties at the time of entering the contract is relevant.¹³⁹ But, in order to demonstrate that the joint business venture is not an investment contract, the investors must show that, when considering the economic reality, they held “meaningful control.”¹⁴⁰

The SEC determined that DAO tokens “did not provide [investors] with meaningful control over the enterprise, because (1) DAO Token holders’ ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to

¹³⁵ THE DAO REPORT, *supra* note 5, at 13.

¹³⁶ *Id.*

¹³⁷ *See id.*

¹³⁸ *See Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981).

¹³⁹ *See id.* at 419.

¹⁴⁰ *Id.*

communicate with one another.”¹⁴¹ This reasoning seems to ignore the other rights conferred upon token holders, like the Contractor right to pitch and promote smart contracts, the right to replace Curators, and the rights to spin-out additional DAOs to protect minority interests.¹⁴²

The marketing and promotion of the DAO led investors to believe that they would be sharing equal, democratic, decentralized control. The reality was that the experimental and novel model needed “training wheels” and safeguards to ensure this democratic and decentralized control would successfully function.¹⁴³ These efforts were technical and governance-focused, not investment-focused. Aside from the initial, exemplary investment concept said to be introduced by Slock.it, the future investment concepts were to be pitched, chosen, and executed by token holders and their code contributions.

The voting rights of the token holders were not just perfunctory, they were the concept and purpose of the business model, and the driving reason for investing in the DAO rather than another ICO. The SEC decided that because token holders could only vote on contracts white-listed by Curators, the voting rights did not constitute meaningful control.¹⁴⁴ However, token holders are responsible for creating and pitching the investment code, in addition to voting on the code. The Curator’s role is described in the DAO White Paper under the minority token holder protection section—their purpose is to protect minority holders from a majority attack.¹⁴⁵ The authority to block pitches is derived from this purpose. Pitches should only be blocked when the code does not do what it purports to do, or if there seems to be a scheme in which the majority funnels money from the fund into their own account.¹⁴⁶ The token-holder vote is still the executory

¹⁴¹ THE DAO REPORT, *supra* note 5, at 14.

¹⁴² See Jentzsch, *supra* note 51.

¹⁴³ Quentson, *supra* note 106.

¹⁴⁴ THE DAO REPORT, *supra* note 5, at 14.

¹⁴⁵ See Jentzsch, *supra* note 51.

¹⁴⁶ See *id.* It is difficult to comment on how this worked in practice, since the hack halted DAO operations before the pitch process could begin.

controller and decision maker for the DAO's investment strategy. The Curators have no power to spend the DAO's funds or to monetize any assets. All of the profit and loss depends upon the action of token holders: Contractors pitching valuable code, and enough token holders voting to approve sound decisions.

The SEC claims that Contractors do not provide voters with the information necessary to make informed decisions.¹⁴⁷ It may be true that Contractor pitches would not be accompanied by an in-depth prospectus. However, the pitches are open-sourced smart contracts. All of the decisions which would be executed by the pitch would be contained within the code, which is visible to all investors. This transparency is at the heart of the DAO. After examining the code, the token holders can then perform the research necessary to evaluate the project. In some ways, this function lends more meaningful control than the delegation of duties in a general partnership. Token holders have the ability, by way of digital code, to simultaneously approve of an investment strategy and perform the exact, unalterable execution of that strategy. This is not a merely perfunctory right. If token holders like a strategy but dislike the execution, they can vote it down and pitch alternative code.

Additionally, the procedural right for token holders in the minority to organize and separate their block into a different DAO fund (automatically transferring their funds) and elect their own Curator adds further weight to voting rights.¹⁴⁸ If the majority and its Curators seek to take advantage or dominate minority token holders, they risk losing those minority funds. This is a secondary safeguard to ensure both that Curators and Contractors respect the democracy of The DAO. In this way, these token holders have more effective minority voting rights than do traditional common stock voters.

The SEC claims that the wide dispersion of token holders and pseudonymity leads to a lack of communication that

¹⁴⁷ THE DAO REPORT, *supra* note 5, at 14.

¹⁴⁸ See Jentzsch, *supra* note 51.

makes the voting-right safeguards and meaningful control ineffective in reality.¹⁴⁹ This understates the Internet's contributions to communications. First, Slock.it hosts an online forum where pitches can be openly debated and discussed by all token holders and the public in general (like a true democracy). There is no evidence that this forum is censored or that minority shareholders would be unable to utilize this forum to organize a voting block necessary to spin-off a DAO.¹⁵⁰ It is difficult to discern why pseudonymity necessarily weighs against organizing a voting bloc, since the forum and token blockchain connects the token holders. The investors purchasing ICO tokens are going through Bitcoin and then Ethereum—they must be technologically savvy. While pseudonymity might block names and addresses, those are not necessary to communicate online. Avatars and online addresses allow information to be shared just as easily, and credibility can be assessed by track record of the avatar just as credibility is assessed by the background of a named person. Dispersion, diversity, decentralization, and even pseudonymity are factors that, online, have the potential to contribute to a democratic business model. They should not be evaluated as presumptively bad for voting power as they would be under more archaic schemes.

3. The Token Holders Have Meaningful Control

Under *Tucker*, it is highly possible with these facts that the DAO Token is not an investment contract because it allows token holders to exercise meaningful control over their investment.¹⁵¹ The rights conferred on the token holders, because they are more than merely perfunctory voting rights, distribute more power than a limited partnership does.¹⁵² Since the token holders are the ones who will necessarily be

¹⁴⁹ THE DAO REPORT, *supra* note 5, at 14.

¹⁵⁰ The SEC says this “potentially” makes it difficult to do so. But it is unclear why, with the Internet savvy of ICO investors, organizing a community online would be unrealistic. *Id.* at 14.

¹⁵¹ See *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981).

¹⁵² *Id.* (satisfying the first condition).

the smart contract coders, the knowledge and experience of token holders are essential to the enterprise.¹⁵³ Finally, the token holders are not dependent on the entrepreneurial efforts of any centralized management.¹⁵⁴ The token holders may one day replace even the need for Curators with their own code.¹⁵⁵ By passing the three *Tucker* conditions on joint ventures or partnerships, The DAO fails the managerial efforts factor of the *Howey* Test, and therefore, is arguably not a security.¹⁵⁶

IV. THE DECENTRALIZED PARTNERSHIP FORM AS A SOLUTION

There may be a localized solution to the risks of fraud and failure in ICO fundraising: partnership law. Under the Uniform Partnership Act § 202, The DAO could be considered a partnership.¹⁵⁷ Investors have bought membership in the DAO—the rights to the DAO code—in the interest of sharing control and profit. Recognizing a Decentralized Partnership form in which a large number of partners can be widely dispersed and yet share meaningful control—and liability—is a natural evolution of law driven by technology. There is no limit on the number of partners that can create a general partnership.¹⁵⁸ By telling token holders that they are partners, rather than securities investors, a better signal is sent to the developing DAO economy: When a company is decentralized, everyone is responsible for each other.

¹⁵³ *Id.* (satisfying the second condition).

¹⁵⁴ *Id.* (satisfying the third condition).

¹⁵⁵ Quentson, *supra* note 106.

¹⁵⁶ *See* United States v. Leonard, 529 F.3d 83 (2d Cir. 2008), for an application of *Tucker* to modern and novel business forms beyond simple partnerships or joint ventures.

¹⁵⁷ UNIF. PARTNERSHIP ACT § 202 (NAT'L CONFERENCE OF COMM'RS ON UNIF STATE LAWS 1997) (amended 2013).

¹⁵⁸ *Id.*

A. The Features of a Decentralized Partnership

A Decentralized Partnership pitches a partnership agreement to the public digitally and disperses it geographically, yet garners a legal status similar to that of a general partnership. The partnership agreement sent out as a smart contract—the ICO token—should address some of the key challenges of a partnership, such as the rights to transfer partnership interest, the sharing of profits, the sharing of liabilities, restriction on dissolution, and the rights and methodology for committing the partnership to action. The decentralized nature of management and operation should be allowed and encouraged, and the solicitation of partnership should not be treated as a security, so long as there is minimal dependence on the token-promoter as a manager and the partners have more than perfunctory voting rights. One way to ensure this would be to grant all token holders proportional rights and limit the initial investment allowed by founding partners.¹⁵⁹ If an entity within the Decentralized Partnership begins to dominate control, it could then be deemed to be the centralized entity responsible for answering to the SEC. This would be yet another protection for minority token holders.

The Decentralized Partnership would share one of the essential characteristics of a general partnership: partners share profits *and* losses.¹⁶⁰ That includes liability for creditor debt and tort debt. This would imply a limitation on pseudonymity and require some method of reaching the personal assets of token holders. Perhaps the tokens themselves could be considered collateral. In a default general partnership, the profits and losses are shared equally, regardless of the amount of contributions to the partnership.¹⁶¹ But this arrangement can be altered by

¹⁵⁹ That is, ensure that the founding partners do not initially hold a majority of tokens, so that the profits of the investors will not be determined by the managerial decisions of the founders.

¹⁶⁰ UNIF. PARTNERSHIP ACT § 401 (NAT'L CONFERENCE OF COMM'RS ON UNIF STATE LAWS 1997) (amended 2013).

¹⁶¹ *Id.*

contract in the partnership agreement.¹⁶² The smart contract contained in the Decentralized Partnership Token serves as the alteration of the default rules via partnership agreement by distributing the rights in section 401 on a pro-rated per-token basis.

The differences between a Decentralized Partnership and General Partnership are most apparent in the right of transfer and exit. While governance rights, as a default, cannot be transferred, the allocation and transfer of governance rights can also be altered by the partnership agreement.¹⁶³ There does not seem to be a limitation on the ability to use a partnership agreement to allow for the free transfer of both economic and governance rights via token.

A default general partnership rule that will be helpful for decentralized partnerships to adopt is pass-through taxation. In such taxation, “[t]ax income or loss is allocated to partners according to the partners’ economic interests in the partnership.”¹⁶⁴ Partners will be responsible for their own taxes, which will make the taxing of ICOs and DAOs easier for both tax payers and tax collectors.

Decentralized Partnership Tokens, as smart contracts, allow for efficient specification of governance rights—like transferability, management authority, and dissolution—that might not be practical in many general partnerships. An organization can choose to be open-access and democratic, explicitly allowing anyone to become a partner regardless of financial background. Many partners would be less concerned about whether a particular partner lacks the personal assets necessary to cover his or her share of liabilities, at least so long as the token sale has raised enough assets to make the

¹⁶² *Id.* at cmt. to § 401 (“All of these rules [in Section 401] are, however, subject to contrary agreement of the partners as provided in Sections 105 through 107”). Note that under this section, the distribution of governance rights can also be altered by agreement.

¹⁶³ While economic rights and governance rights are typically “bifurcated” in a general partnership, these rights—and the right to transfer these rights—can be altered by agreement. *See id.* at cmt. to § 503 (“Unless the partnership agreement otherwise provides . . .”).

¹⁶⁴ *Id.* at cmt. to § 405.

partnership financially viable as an entity. Regarding management authority, a Decentralized Partnership might adopt a one-vote-per-token approach to decision-making and property management, which is a contractual departure from the Uniform Partnership Act default rule that partners represent equal parts regardless of proportional contributions.¹⁶⁵ Alternatively, an organization could decide that token owners vote their tokens as a block, which would grant more democratic rights to minority token holders. Finally, in terms of dissolution, the ease of exit through the transfer of tokens makes tougher dissolution protocols acceptable. Rather than dissolving a partnership by the whim of a single partner, the token could feature a protocol for a majority or super-majority vote to dissolve and automatically wind down partnership assets.

A Decentralized Partnership has an essential quality differentiating the form from a corporation: there is no separation between ownership and control, and as minimal separation between ownership and execution of control as possible.¹⁶⁶ The corporation has the board and management; the Decentralized Partnership has the token holders and, only if necessary, security-clearing curators. A Decentralized Partnership is more difficult to participate in because it requires investors to be informed and to continuously participate to avoid unwanted liabilities or investments. However, the Decentralized Partnership has one extra benefit that aligns with corporate forms: the ability to easily transfer ownership according to the token terms. Tokens can be traded on secondary exchanges, and while these exchanges and transactions may have their own regulatory challenges, the effect of the secondary market is foundational: creating a viable exit strategy. Again, this promotes efficiency and democracy because the threat of minority token holders withdrawing their profits and then selling their tokens,

¹⁶⁵ *See id.* § 401(f).

¹⁶⁶ Fewer agents by way of automation means fewer agency costs for the business, although more time and energy is required of the partners. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* ch. 6 (1936).

perhaps with tokens being purchased by a block, helps keep majority tyranny in check. The corporate form allows for wide fundraising, dispersed ownership, and diversified portfolio ownership. The Decentralized Partnership allows for wide fundraising, dispersed ownership, and a trade-off between more meaningful control and less portfolio diversification. As technology improves and more business models fit into a decentralization and democracy understanding, this trade-off may become less evident.

B. The Organic Internalization of Risk

Being recognized as a partnership establishes not only rights, but duties for the partners in a decentralized autonomous organization. In The DAO, partnership status could help decrease the role of Curators—minority token holders would be protected from majority attacks and fraud through fraudulent conveyance claims, contract law fraud claims, or even breach of fiduciary duty claims. Token holders would all owe each other the duties of honesty, loyalty, and good faith—many of which the Curators are tasked with monitoring. These duties could be enforceable by law, which can decrease the need to rely on Curators. Partners in The DAO will be forced to comply with the duty of loyalty, and thus not take advantage of minority token holders, else face the threat of partnership litigation. This encourages democracy and responsibility while discouraging insider hacking by creating independent causes of action.¹⁶⁷

The threat of liability for all investors can assist the maturation of the decentralized ICO market. Because partners risk personal liability in the event of tort or creditor debts, the partnership founders would need to be transparent as to what risks the partners will be exposing themselves if they are to attract informed partners to the ICO. Additionally, they will need to ensure a higher quality offering because partners face a risk of loss potentially greater than their

¹⁶⁷ With more parties capable of exercising enforcement (including experienced blockchain coders), there is a more credible threat to hackers of being caught.

initial investment. After the ICO is completed, the partners will remain informed and motivated to participate by the threat of losing money—partners will not want to end up in debt based on the decisions of others. This is yet another boon to democracy within the organization. The best performing DAOs will attract the most-informed partners, which will weed out the weakest DAOs over time.

While the threat of liability is a motivator for caution, it is also a major benefit of decentralization. As more partners are added, the magnitude of debt risk decreases because partnership liabilities will be spread out over a larger number of partners. Further, it discourages investors from purchasing too large of a share in the partnership (and thus too much liability), unless they can secure their own majority and control their risk. This could lead to a larger dispersion of ownership and a more diverse democracy.

Designation as a securities transaction creates barriers to decentralization: securities law implicitly requires a responsible central authority—the issuer—to adhere to the affirmative duties of complying with securities laws. Designation as a Decentralized Partnership would have the opposite effect: encouraging continued decentralization to improve profits and spread out liabilities. A Decentralized Partnership facilitated by the right technology (i.e., blockchain) can create economies of scale in the costs (e.g., research and development and communication between partners) of business ownership and liability management, by spreading those costs across many, digitally-connected partners.

C. Positive Externalities

There are several positive externalities that display why Decentralized Partnership designations are not only good for the participating investors, but also for stakeholders in general. Revisit the example of the autonomous car that drives around picking up passengers, sharing profits with ICO token holders. Who is liable in an accident with a pedestrian? If the token is treated as a security, implying at most a limited partnership, it is likely that the original coder of the car, who

presumably issued the car ICO, would be responsible for compensating the pedestrian. In a Decentralized Partnership, all car token holders could be held joint and severally liable for compensating the victim. The tort victim would have more parties to recover from than if they could only look to the original coder—who might be insolvent on his or her own.¹⁶⁸ The cost of this liability would be spread out among more investors, which means the same compensation to the victim with less damage to the business. The victim has more opportunities to recover while no single defendant would be overly burdened by the liability.

Avoiding registration has the potential for an additional egalitarian outcome. As new token issuers begin to register with the SEC, they often do so under safe harbors that limit who may purchase the token.¹⁶⁹ The Kodak tokens will only be available, at least initially, to “accredited investors,” meaning any individuals must have either a net worth greater than \$1 million or annual income greater than \$200,000 for at least two years.¹⁷⁰ These safe harbors, particularly when used by established corporate issuers like Kodak, do little to protect investors, but deny the average investor the right to participate in the new blockchain economy. Exclusionary rules do not fit the democratic and egalitarian goals of decentralized blockchain business models like The DAO. Partnership rules, however, that treat all participants equally, for better or worse, fit the concept perfectly.

¹⁶⁸ The smart contract embedded in the partnership token could help circumvent the liability challenges of pseudonymity. If the business is found liable, the funds could automatically be pulled from token holders' accounts to pay debts. With this threat, partners may be more likely to come forward to their own defense. Another option would be for tokens themselves to be forfeited if the partner does not come forward.

¹⁶⁹ David M. Adlerstein & Joshua Ashley Klayman, *A 21st Century “Kodak Moment”: The Kodak and WENN Digital Security Token Sale*, CROWDFUND INSIDER (Jan. 9, 2018, 10:30 PM), <https://www.crowdfundinsider.com/2018/01/126899-21st-century-kodak-moment-kodak-wenn-digital-security-token-sale/> [perma.cc/JG6M-EGR2].

¹⁷⁰ *Id.*; Definitions and Terms Used in Regulation D, 17 C.F.R. § 230.501(a)(5) (2016).

The SEC should not consider a Decentralized Partnership Token ICO to be a security in the interest of the potential economic benefits of decentralized business models. In the future, it may be better for investors to have personal liability and fewer centralized protections, so they may be warier of the contracts they enter into and the operations they finance. That is an organic way to ensure automated business models, like the driverless taxi, are coded responsibly, without creating unnatural barriers to experimentation.

V. CONCLUSION

Securities designation triggers duties like registration and ongoing disclosures for the issuing entity. For some ICOs, this clearly would be an important safeguard for investor safety. For other ICOs, disclosures would serve no purpose—the purchasers are less interested in governance and more interested in the product or service itself. In some unique cases, a securities designation would even be counterproductive. Choosing a central authority like Slock.it to be a securities issuer is arbitrary when the token purchasers will be the parties actually creating the investment contracts; it is antithetical when an essential purpose of investing in the token is to control a share of ownership; it is damaging when the goal is to experiment with democratic operation. Instead, a Decentralized Partnership form can meet the needs of society at large while allowing participants the freedom and flexibility to experiment with world-changing technology.