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MEMORANDUM

Re: U.S. Securities Law in re BlockMason ICO

Introduction

On July 25, 2017 the U.S. Securities and Exchange Commission (SEC) issued a Section 21(a) investigative report, Release No. 81207 ("the Report"), which provides a framework for understanding which Ethereum-based offerings, including Initial Coin Offerings (ICOs), are within the SEC's authority to regulate as securities, and which are not. The Report caused initial shock in Ethereum-aware media,[1] and the dollar-exchange price of the Ethereum-based private currency Ether ("ETH") dropped 12% on July 25.[2] Reflective analysis, however, by lawyers examining the details of the SEC report in light of relevant U.S. case law,[3] led quickly to an understanding that the Report points to solid ground for ICOs in two major ways: (1) those ICOs offering coins or tokens that fall within the definition of securities can now expect the SEC to be receptive to registration efforts consistent with the long-recognized registered offering process for securities, including private placements and initial public offerings (IPOs); and (2) those ICOs that offer other types of coins or tokens, which do not fall within that definition, can expect to proceed untrammeled by U.S. securities law, while complying with all other applicable legal obligations.

A. Definition of "Security"

The Report rests upon U.S. Supreme Court decisions interpreting the definition of "security" in the 1933 and 1934 securities acts,[4] a definition that includes not only those instruments commonly regarded as securities – such as stock, notes, bonds and other typical equity and debt instruments enumerated in the acts – but also any "investment contract," which is the category the Report analyzes closely in reference to the ICO conducted in 2016

[1] *E.g.*, J. Pearson, "Oh Shit, the SEC Just Ruled that Ethereum ICO Tokens Are Securities," *Vice Motherboard*, July 25, 2017, URL: https://motherboard.vice.com/en-us/article/j5qz88/oh-shit-the-sec-just-ruled-that-ethereum-ico-tokens-are-securities (last visited Aug. 3, 2017).
[2] *See* Chart, "ETH/USD Exchange: Weighted Average," www.ethereumprice.org (last visited Aug. 3, 2017) (price of $225 circa 0100 on July 25; price of $198 circa 2100 on July 25).
[3] *E.g.,* "SEC Enforcement Provides Clarity on When a Blockchain Token Is a Security," *Debevoise & Plimpton Client Update,* July 26, 2017; "SEC Exercises Jurisdiction over Initial Coin Offerings," *Reed Smith Client Alert*, July 27, 2017.
[4] Securities Act of 1933, § 2(a)(1), 15 U.S.C. § 77(b)(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10).

by The DAO, Slock.it UG, a German corporation, and their organizers.[5] Employing the test for investment contract first established by the Supreme Court's decision in *SEC v. W.J. Howey Co*., the Report found The DAO's offering to be an offering of investment contracts. The Report does not hold that all Ethereum token offerings or ICOs are investment contracts. Rather it emphasizes the importance of considering all the facts and circumstances to determine whether a particular ICO is an offer of an investment contract and thus a regulated security:

> Whether or not a particular transaction involves the offer and sale of a security – regardless of the terminology used – will depend on the facts and circumstances, including the economic realities of the transaction.[6]

The Report examines in detail the economic realities of DAO's 2016 ICO transaction, emphasizing that "form should be disregarded for substance" and that each case must be analyzed in terms of its economic reality. Thus it is essential to examine the details of how the Report analyzes the elements of "investment contract" in determining that DAO's ICO was an offering of securities.

B. The Report's Analysis of "Investment Contract"

Courts have commonly broken the *Howey* test into three prongs,[7] analyzing putative investment contracts in terms of (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits to be derived solely or predominantly from the efforts of others (typically from the managerial and entrepreneurial efforts of the organizers). Only by satisfying all three prongs does an instrument qualify as an investment contract under U.S. securities law. The Report discusses each of the three prongs.

1. Investment of money

The Report holds that payment in ETH for tokens is a contribution of value that is equivalent to money and sufficient to satisfy the first prong of the *Howey* test. This conclusion is consistent with federal court decisions cited in the Report, which hold that private currencies such as Bitcoin and other contributions of value are sufficient to satisfy this first prong of the *Howey* test.

2. In a common enterprise

The Report holds that purchasers of DAO Tokens "were investing in a common enterprise." While this element of the *Howey* test has received extensive and varied analysis in the federal courts, the specifics of The DAO's offering enabled the Report to find a common enterprise without entering into any complex analysis of horizontal or vertical commonality as found in many lower court (but not Supreme Court) cases, as discussed further in Part C.2. Factors

[5] Report at 2 n.4, 11-15, *citing, inter alia*, *SEC v. C.M. Joiner Leasing Corp*., 320 U.S. 344, 351 (1943); *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946).
[6] Report at 17-18.
[7] Sometimes four prongs, when the third prong is divided into two parts.

indicative of a common enterprise in The DAO include: (a) the ETH was pooled and available to fund projects, or contracts, and "DAO Token holders stood to share in potential profits from the contracts"; (b) The DAO's objective was to fund projects to produce a return on investment that would inure to token holders; (c) the DAO Token offering was presented by one of its organizers as akin to "buying shares in a company and getting … dividends"; and (d) DAO Tokens conferred certain "voting and ownership rights" upon holders.[8]

3. With a reasonable expectation of profits derived solely or predominantly from the efforts of others

The Report relies on the *Howey* test for investment contract, as restated in subsequent Supreme Court decisions – "an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others" – and as reformulated in its third prong by the 9th Circuit U.S. Court of Appeals: "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[9]

The Supreme Court's original formulation of the test in *Howey* required that investors have an expectation of profits derived *solely* from the efforts of others: "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[10] The Supreme Court's 1975 decision in *United Housing Foundation, Inc. v. Forman* added the phrase "entrepreneurial or managerial" before "efforts of others" without criticizing or rejecting the original "solely" language of the *Howey* test.[11] A further Supreme Court decision in the 2005 case of *SEC v. Edwards* repeated the insertion of entrepreneurial or managerial before efforts of others and elaborated on the definition of "profits."[12] The focus on expectation of profits derived from the entrepreneurial or managerial efforts of others makes clear what was already implicit in *Howey*, that the "others" in the typical case are the organizers-offerors, though in some cases the inducement to invest might relate to efforts of a third party.

Whether the expected profits must derive *solely* from the organizers-offerors or a third party – as opposed to the efforts of the investor – has not been resolved by the Supreme Court to this date. The 2005 *Edwards* decision spoke of the flexibility of the *Howey* test but also repeated the "solely" language of *Howey* without criticizing it or departing from it. The nuances of these Supreme Court decisions, as well as the varying positions of the federal circuits, are discussed in further detail in Part C.3.

In the case of The DAO, it was easy for the Report to conclude that the managerial efforts of the organizers were the "undeniably significant" ones giving rise to reasonable

[8] Report at 1, 4, 5, 11-12.
[9] *Id.* at 11, *quoting SEC v. Glenn W. Turner Enters., Inc*., 474 F.2d 476, 482 (9th Cir. 1973).
[10] *Howey, supra*, 328 U.S. at 301.
[11] 421 U.S. 837, 852 (1975) ("profits" include but are not limited to "capital appreciation resulting from the development of the initial investment" and "participation in earnings resulting from the use of investors' funds"), *quoting Forman, supra,* 421 U.S. at 852.
[12] 540 U.S. 389, 393 (2004).

expectations of profits for investors, and that the efforts of investors were an insignificant factor. The Report cites a multitude of facts and circumstances indicating that token holders' expected profits derived from the managerial efforts of The DAO and its organizers. The Report found that the DAO "would earn profits by funding projects that would provide DAO Token holders a return on investment." Token holders could also expect to profit by selling their tokens on secondary markets that the organizers had solicited to trade tokens prior to the offering period. The organizers' presentation of the token offering as equivalent to investing in a company for shares and future dividends, as well as "rewards," created expectations of profits from an investment. As the Report summarizes, "Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts required to make The DAO a success." The DAO's claim that token holders would play a significant role in influencing the future value of their tokens, by voting on project proposals, ran up against the SEC's investigatory finding that "curators" selected by the offerors in fact exercised decisive control over the vetting of project proposals for voting, and that The DAO skewed the voting process in the direction of a "yes" vote for those proposals selected by the curators.[13]

Specific findings in the Report supporting the conclusion that expected profits derived undeniably from the efforts of the organizers and curators included the following: (a) the organizers and the curators selected by them were the ones who "put forth project proposals that could generate profits for The DAO's investors"; (b) the organizers "led investors to believe that they could be relied on to provide the significant managerial effort required to make The DAO a success"; (c) in the practical operation of The DAO, investors "had little choice but to rely on their [organizers and curators] expertise"; (d) voting rights for token holders were limited in a way to make the token holders "substantially reliant on the managerial efforts" of the organizers and curators; and (e) token holders did not have real control over the profitability prospects of the rights they had acquired.[14]

Thus the Report was able to conclude that the "undeniably significant" basis of profit expectations for investors was the effort of the offerors:

> By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO's Curators, as described above. Their efforts, not those of DAO Token holders, were the "undeniably significant" ones, essential to the overall success and profitability of any investment into The DAO.[15]

On the other hand, an important element of the Supreme Court's application of the *Howey* standard, crucial for analyzing whether future Ethereum ICOs are investment contracts and thus securities, went unmentioned in the Report, undoubtedly because The DAO's offering did not involve any aspect of purchasing a product. This element appears as a decisive factor

[13] Report at 4-6, 12-15.
[14] *Id.* at 12-15.
[15] *Id.* at 15.

in the reasoning of the Supreme Court's 1975 *Forman* decision, in the concluding sentence of this passage:

> The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in *Joiner, supra* (sale of oil leases conditioned on promoters' agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin v. Knight, supra* (dividends on the investment based on savings and loan association's profits). In such cases the investor is "attracted solely by the prospects of a return" on his investment. *Howey, supra*, at 300, 66 S.Ct., at 1103. By contrast, *when a purchaser is motivated by a desire to use or consume the item purchased* – "to occupy the land or to develop it themselves," as the *Howey* Court put it, *ibid*. *– the securities laws do not apply*.[16]

Crucially, a purchaser of rights to use any software- and network-based service may well be motivated by a desire to use the item purchased, and in the case of a network with limited capacity, consume some portion of that capacity in the course of exercising the usage rights that have been purchased. It was not possible for the The DAO to invoke and rely upon this element of the third prong of the *Howey* test, because DAO had only concepts and future hopes to sell to purchasers, not market-ready products and services. Enterprises that have developed products and services, on the other hand, are able to motivate purchasers by a desire to use or consume the products and services that are offered for purchase, licensing or token-based usage. This element becomes all the more significant when the product or service can be further developed and enhanced, marketed or sold or sublicensed, by the purchasers of rights to use it, whether those rights are sold in the form of tokens or any other manner.

C. Court Decisions Applying the Howey Test for "Investment Contract"

The three-pronged "investment contract" standard established by *Howey* has received extensive discussion in a large number of cases in the lower federal courts over the course of eight decades. This section identifies interpretations by the lower courts that may affect analysis of Ethereum ICOs within each particular circuit, and focuses in detail on variations among the federal circuits as to the second and third prongs of the *Howey* test.

1. First Prong: Investment of money

There is no basis for arguing that ETH or other crypto- or private-currencies are not money within the meaning of the first prong of the *Howey* test. The key issue is whether consideration, i.e. value, is contributed by participants in an Ethereum ICO. The Supreme Court has repeatedly affirmed that the *Howey* test is flexible enough to cover newly emerging environments for investment schemes, so there is no point in quibbling over what is "money." There is no realistic chance of the Supreme Court or any court disagreeing with the First

[16] 421 U.S. at 852-53 (emphasis added).

Circuit's interpretation of *Howey's* first prong as turning upon whether an investor "chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security."[17] The Supreme Court has held that the first prong requires only "tangible and definable consideration in return for an interest that had substantially the characteristics of a security."[18]

2. Common enterprise

Whether an Ethereum ICO meets the second prong of the *Howey* test may well depend on complex nuances of how the lower federal courts have interpreted "common enterprise" – including concepts involving a distinction between "horizontal" and "vertical" commonality – concepts that the Supreme Court has not yet ruled upon, and which the Report did not rely upon. Precision of analysis as to the second prong is especially important when an Ethereum ICO involves the marketing of a product or service. Such cases present the real possibility, indeed likelihood, that purchasers of tokens that represent and confer rights to use the product or service use, along with rights to consume associated network capacity, are motivated by the value of that use and consumption, as well as by the further value of rights to develop, enhance, build upon, and market the usage rights embodied in such tokens.

In analogous instances of software licensing and sublicensing by value-added resellers, there is typically no "common enterprise" between licensor and sublicensor, nor between OEM and VAR. Such relationships are commonplace between separate and independent enterprises that may well cooperate as to development, sharing of source code and documentation and marketing assets – yet do not pool their ownership, nor aggregate resources or profits. Nor do the economic fortunes of users, developers and distributors typically bear a direct relationship to the fortunes of the original creator, provider or licensor.

Analysis of any such cases or analogies requires a circuit-by-circuit examination the approaches followed by the various courts of appeals and district courts in each federal circuit.

a. First Circuit

The 1st Circuit, in finding that horizontal commonality satisfies the second prong of the *Howey* test, summarized the variety of approaches among the circuits:

> Courts are in some disarray as to the legal rules associated with the ascertainment of a common enterprise. *See generally* II Louis Loss & Joel Seligman, *Securities Regulation* 989-97 (3d ed. rev. 1999). Many courts require a showing of horizontal commonality – a type of commonality that involves the pooling of assets from multiple investors so that all share in the profits and risks of the enterprise. *See SEC v. Infinity Group Co.,* 212 F.3d 180, 187-88 (3d Cir. 2000), *cert. denied,* 532 U.S. 905, 121 S.Ct. 1228, 149 L.Ed.2d 138 (2001); *SEC v. Life Partners, Inc.,* 87 F.3d 536, 543 (D.C. Cir. 1996); *Wals v. Fox Hills Dev. Corp.,* 24 F.3d 1016, 1018 (7th Cir.

[17] *SEC v. SG Ltd*., 265 F.3d 42, 48 (1st Cir. 2001), *citing Teamsters v. Daniel, supra,* 439 U.S. at 559.
[18] *Daniel, supra*, 439 U.S. at 560.

> 1994); *Revak v. SEC Realty Corp.,* 18 F.3d 81, 87 (2d Cir. 1994); *Curran v. Merrill Lynch, Pierce, Fenner & Smith,* 622 F.2d 216, 222, 224 (6th Cir. 1980), *aff'd on other grounds,* 456 U.S. 353, 102 S.Ct. 1825, 72 L.Ed.2d 182 (1982). Other courts have modeled the concept of common enterprise around fact patterns in which an investor's fortunes are tied to the promoter's success rather than to the fortunes of his or her fellow investors. This doctrine, known as vertical commonality, has two variants. Broad vertical commonality requires that the well-being of all investors be dependent upon the promoter's expertise. *See Villeneuve v. Advanced Bus. Concepts Corp.,* 698 F.2d 1121, 1124 (11th Cir. 1983), *aff'd en banc,* 730 F.2d 1403 (11th Cir. 1984); *SEC v. Koscot Interplanetary, Inc.,* 497 F.2d 473, 478-79 (5th Cir. 1974). In contrast, narrow vertical commonality requires that the investors' fortunes be "interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *SEC v. Glenn W. Turner Enters.,* 474 F.2d 476, 482 n.7 (9th Cir. 1973).[19]

Horizontal commonality analysis, in other words, focuses on the pooling of assets, profits and risks in a unitary enterprise. Horizontal commonality most obviously exists in the paradigmatic case of an offer of shares by a corporation – in which the revenue from the offering is pooled in the issuing entity, and the investors share in the profits of that entity. By contrast, when rights to use and develop a product or service are sold, the purchasers typically retain their identity and profit-risk profile separate from the seller – even while interacting in ways that typically include customer support, maintenance of the product or service, marketing support for developers and resellers, and other forms of commercially commonplace interaction and cooperation.

b. **Second Circuit**

In the case of *Revak v. SEC Realty Corp*., the 2nd Circuit discussed the concept of horizontal commonality at some length, finding it sufficient to satisfy the second prong of the *Howey* test:

> 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. *See Hart v. Pulte Homes of Michigan Corp.,* 735 F.2d 1001, 1004 (6th Cir. 1984); *Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 682 F.2d 459, 460 (3d Cir. 1982) (investment must be "part of a pooled group of funds"); *Milnarik v. M–S Commodities, Inc.,* 457 F.2d 274, 276 (7th Cir.) (success or failure of other contracts must have a "direct impact on the profitability of plaintiffs' contract"), *cert. denied,* 409 U.S. 887, 93 S.Ct. 113, 34 L.Ed.2d 144 (1972). In a common enterprise marked by horizontal commonality, the fortunes of each investor depend upon the profitability of the enterprise as a whole: Horizontal commonality ties the fortunes of each investor in a pool of investors to the success of the overall venture. In fact, a finding of horizontal commonality requires a sharing or pooling of funds. *Hart,* 735 F.2d at 1004 (citations omitted).[20]

In the following passage, *Revak* further held that broad vertical commonality does not satisfy the *Howey* test, and declined to decide whether a narrow concept of vertical commonality might satisfy *Howey's* second prong:

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[19] *SG Ltd., supra*, 265 F.3d at 49.
[20] 18 F.3d 81, 87 (2d Cir. 1994).

> This Court has not previously considered whether vertical commonality (strict or otherwise) satisfies the common enterprise requirement of the *Howey* test. There is nothing in the record to indicate that the fortunes of the Lake Park purchasers were interwoven with the promoter's fortunes so as to support a finding of strict vertical commonality. Accordingly, we need not address the question of whether *strict* vertical commonality gives rise to a common enterprise. We do consider whether *broad* vertical commonality satisfies *Howey*'s second requirement, and we hold that it does not.
>
> In concluding that the sale of Lake Park units constituted the sale of securities, the district court evidently adopted the broad vertical commonality approach. A critical factor in the district court's analysis is that many of the plaintiffs enlisted the management services of Harvey Freeman & Sons, Inc. to oversee all rental arrangements. Such a service contract may tend to demonstrate that (at least some) investors expected profits to be derived from the efforts of others. The district court relied on the same arrangement to establish a common enterprise, as the broad vertical commonality analysis invites the finder of fact to do. We do not interpret the *Howey* test to be so easily satisfied. If a common enterprise can be established by the mere showing that the fortunes of investors are tied to the efforts of the promoter, two separate questions posed by *Howey* – whether a common enterprise exists and whether the investors' profits are to be derived solely from the efforts of others – are effectively merged into a single inquiry: "whether the fortuity of the investments collectively is essentially dependent upon promoter expertise." *SEC v. Continental Commodities Corp.,* 497 F.2d 516, 522 (5th Cir. 1974). *See Savino v. E.F. Hutton & Co., Inc.,* 507 F.Supp. 1225, 1237-38 n.11 (S.D.N.Y. 1981) (in dicta, broad vertical commonality is inconsistent with *Howey*); *Berman v. Bache, Halsey, Stuart, Shields, Inc.,* 467 F.Supp. 311, 319 (S.D. Ohio 1979) ("a finding of a common enterprise based solely upon the fact of entrustment by a single principal of money to an agent effectively excises the common enterprise requirement of *Howey*").[21]

Federal district courts in the Second Circuit have allowed a showing of narrow vertical commonality to satisfy the second prong of the *Howey* test. The recent Southern District New York decision in *Rocky Aspen Management 204 LLC v. Hanford Holdings LLC* cited *Revak* as allowing a showing of narrow vertical commonality in the sense of "a direct relationship between the fortunes of the investor and seller or promoter of the investment such that 'their fortunes rise and fall together.'"[22]

The 2011 Southern District decision in *Marini v. Adamo* expounded upon *Revak* and commonality in the following extended discussion:

> Courts have applied several different tests to determine whether a common enterprise exists, namely: the horizontal commonality test, the broad vertical commonality test, and the narrow or strict vertical commonality test. *Revak,* 18 F.3d at 87-88. Horizontal commonality involves "the tying of each individual investor;s

[21] *Id.* at 88 (emphasis in original).

[22] 230 F.Supp.3d 159, 165 (S.D.N.Y. 2017), *quoting In re Gas Reclamation, Inc. Securities Litig.,* 659 F.Supp. 493, 501-02 (S.D.N.Y. 1987). *See In re J.P. Jeanneret Assocs.,* 769 F.Supp.2d 340, 359 (S.D.N.Y. 2011) ("Strict vertical commonality exists when the fortunes of the investor are tied to the fortunes of the promoter"); *SEC v. CVB168 Holdings, Ltd.*, 210 F.Supp.3d 421 (E.D.N.Y. 2016).

fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits." *Id.* at 87. Vertical commonality, in contrast, "focuses on the relationship between the promoter and the body of investors," rather than on the sharing or pooling of funds among investors. *Id.* Under the broad vertical commonality test, "the fortunes of the investors need be linked only to the *efforts* of the promoter," while "[s]trict vertical commonality requires that the fortunes of investors be tied to the *fortunes* of the promoter." *Id.* at 88 (emphasis in original) (internal quotation marks and citations omitted). It is undisputed that horizontal commonality does not exist in this case. In addition, the Second Circuit has held that a showing of broad vertical commonality does not satisfy the second prong of the *Howey* test. *Id.* ("If a common enterprise can be established by the mere showing that the fortunes of investors are tied to the efforts of the promoter, two separate questions posed by *Howey* – whether a common enterprise exists and whether the investors' profits are to be derived solely from the efforts of others—are effectively merged into a single inquiry: 'whether the fortuity of the investments collectively is essentially dependent upon promoter expertise.'" (quoting *SEC v. Continental Commodities Corp.,* 497 F.2d 516, 522 (5th Cir. 1974)((additional citations omitted)). Accordingly, this Court need only focus on whether strict vertical commonality exists in this case.

To support a finding of strict vertical commonality, a plaintiff must establish that "'the fortunes of plaintiff and defendants are linked so that they rise and fall together.'" *Jordan (Bermuda) Inv. Co., Ltd. v. Hunter Green Invs. Ltd.,* 205 F.Supp.2d 243, 249 (S.D.N.Y. 2002) (quoting *Dooner v. NMI Ltd.,* 725 F.Supp. 153, 159 (S.D.N.Y. 1989)); *accord, In re J.P. Jeanneret Assocs., Inc.,* 769 F.Supp.2d 340, 360 (S.D.N.Y. 2011) (where investment manager was to be paid, in part, through a performance fee equal to 20% of the profits in the investment account, defendant's compensation was "dependent on the successful performance of the investment account" and strict vertical commonality accordingly existed because "[i]f profits were not generated in a calendar year, or if the profits did not exceed the preferred return, then [defendant] did not receive a performance fee" and therefore "financial compensation was linked to the fortunes of the investors"); *Walther v. Maricopa Intern. Inv. Corp.,* No. 97–cv–4816, 1998 WL 186736, at *7 (S.D.N.Y. Apr. 17, 1998) (finding that "success of [plaintiff's] investments were directly tied to the fortunes of the defendants" and strict vertical commonality therefore existed where defendants "were to be paid only if [plaintiff's] funds made substantial gains," and "[c]onsequently, if [plaintiff's] funds appreciated in value, the defendants were financially compensated," whereas "if [plaintiff's] investment did not perform well, the defendants were not paid" (internal quotation marks omitted)). Stated otherwise, strict vertical commonality exists where there is a "one-to-one relationship between the investor and investment manager" such that there is "an interdependence of *both profits and losses* of the investment." *Kaplan v. Shapiro,* 655 F.Supp. 336, 341 (S.D.N.Y. 1987) (emphasis in original); *see also Lowenbraun v. L.F. Rothschild, Unterberg, Towbin,* 685 F.Supp. 336, 341 (S.D.N.Y. 1988) (noting that "[v]ertical commonality is present when there is interdependence between broker and client for both profits and losses of the investment" and holding that plaintiff had not established vertical commonality because "profits and losses were not interdependent since the broker allegedly profited from the commissions while plaintiffs suffered losses")…[23]

[23] 812 F.Supp.2d 243, 255-56 (S.D.N.Y. 2011) (emphasis in original).

b. **Third Circuit**

The 3d Circuit has accepted horizontal commonality as satisfying *Howey's* second prong, while declining to decide whether vertical commonality can suffice for this purpose. In *SEC v. Infinity Group*, the 3d Circuit wrote:

> We have held that the common enterprise requirement is satisfied by "horizontal commonality." Horizontal commonality is characterized by "a pooling of investors; contributions and distribution of profits and losses on a pro-rata basis among investors." *Steinhardt*, 126 F.3d at 151 (quoting Maura K. Monaghan, An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis, 63 *Fordham L. Rev*. 2135, 2152-53 (1995) (footnotes omitted)). See also *Salver v. Merrill Lynch, Pierce, Fenner & Smith*, 682 F.2d 459, 460 (3d Cir. 1982) (holding that a commodity account is not a "security" because it is not part of a pooled group of funds).[24]

The court added further discussion in a footnote:

> Circuit courts of appeals utilize two distinct approaches in analyzing commonality; "vertical commonality," and "horizontal commonality." "Vertical commonality" focuses on the community of interest between the individual investor and the manager of the enterprise. *See e.g., Long v. Schultz Cattle Co*., 881 F.2d 129 (5th Cir. 1989) ("A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties" (quoting *Glenn W. Turner Enterprises, Inc*., 474 F.2d 476, 482 n.7 (9th Cir. 1973)). "Horizontal commonality" examines the relationship among investors in a given transaction, requiring a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis. *See e.g., Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459 (3d Cir. 1982); *Cooper v. King*, 114 F.3d 1186 (6th Cir. 1997); *SEC v. Lauer*, 52 F.3d 667 (7th Cir. 1995). In *Steinhardt*, we declined to decide if we should adopt a vertical commonality analysis when conducting an inquiry under the commonality prong of *Howey*. *Steinhardt*, 126 F.3d at 151. Inasmuch as we conclude that horizontal commonality exists here, we need not now decide if we should also adopt a vertical commonality analysis.[25]

The 3d Circuit's *Steinhardt* case, cited in the above passages, likewise declined to decide whether vertical commonality could satisfy the second prong of Howey.[26]

d. **Fourth Circuit**

The 4th Circuit has also accepted horizontal commonality as meeting the second prong of the *Howey* test, without ruling whether vertical commonality could also be shown in order to meet the test. *Teague v. Bakker*, 35 F.3d 978, 986 n.8 (4th Cir. 1994).

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[24] 212 F.3d 180, 187 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001).
[25] *Id.* at 187 n.8.
[26] *Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144, 152 (3d Cir. 1997).

e. **Fifth Circuit**

The 5th Circuit has taken a broad approach to vertical commonality, finding *Howey's* second prong satisfied when the economic prospects of all investors are dependent upon the promoter's expertise. The case of *SEC v. Koscot Interplanetary, Inc*. involved a multi-level marketing network, "enticing prospective investors to participate in its enterprise, holding out as a lure the expectation of galactic profits."

The 5th Circuit reasoned as follows:

> As defined by the Ninth Circuit, "[a] common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *SEC v. Glenn W. Turner Enterprises, Inc.*, *supra* at 482 n.7. The critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts.

The court continued:

> "The fact that an investor's return is independent of that of other investors in the scheme is not decisive. Rather, the requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the Koscot meetings and guidelines on recruiting prospects and consummating a sale." *See SEC v. Glenn W. Turner Enterprises, Inc*., *supra* at 482; *United States v. Herr*, 338 F.2d 607 (7th Cir. 1964), *cert. denied*, 382 U.S. 999, 86 S.Ct. 563, 15 L.Ed.2d 487, *rehearing denied*, 383 U.S. 922, 86 S.Ct. 898, 15 L.Ed.2d 679 (1966); *cf.Marshall v. Lamson Bros. and Co.*, 368 F.Supp. 486, 488 (S.D. Iowa 1974); *Mitzner v. Cardet International, Inc. et al.*, 358 F.Supp. 1262, 1265 (N.D. Ill. 1973).[27]

f. **Sixth Circuit**

The 6th Circuit has relied on horizontal commonality and has rejected vertical commonality. *Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.,* 622 F.2d 216, 222-24 (6th Cir.1980), *aff'd on other grounds,* 456 U.S. 353 (1982); *Deckebach v. La Vida Charters, Inc*., 867 F.2d 278, 281-82 (6th Cir. 1989).

g. **Seventh Circuit**

The 7th Circuit has rejected vertical commonality, both broad and narrow, holding that only horizontal commonality can satisfy the second prong of *Howey*. Judge Posner explained in the case of *Wals v. Fox Hills Development Corp*. that "those circuits that believe that only 'vertical commonality' is required to create an investment contract would deem the combination of sale and rental agreement in this case an investment contract."[28] He then

[27] 497 F.2d 473, 478-79 (5th Cir. 1974).
[28] 24 F.3d 1016, 1017 (7th Cir. 1994), citing cases from the 5th, 8th, 9th and 10th Circuits.

identified cases from the 7th and other circuits that require a showing of horizontal commonality:

> Other circuits, including our own, require more – require "horizontal commonality," that is, a pooling of interests not only between the developer or promoter and each individual "investor" but also among the "investors" (the owners of the condominiums, in this case) – require, in short, a wheel and not just a hub and a spoke. *Stenger v. R.H. Love Galleries, Inc*., 741 F.2d 144 (7th Cir. 1984); *Milnarik v. M-S Commodities, Inc*., 457 F.2d 274 (7th Cir. 1972); *Deckebach v. La Vida Charters, Inc*., 867 F.2d 278, 282 (6th Cir. 1989); *Salcer v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 682 F.2d 459 (3d Cir. 1982). The Second Circuit seems to be leaning toward a requirement of horizontal commonality, see *Revak v. SEC Realty Corp*., 18 F.3d 81 (2d Cir. 1994); and in *Long v. Schultz Cattle Co*., 896 F.2d 85, 88 (5th Cir.1990) (per curiam), the Fifth Circuit indicated that it would be willing to reconsider its contrary position announced in *Koscot* and *Cameron* in a suitable case.[29]

Observing that the SEC has "hedged" on the issue of whether to allow a showing of vertical commonality, Judge Posner went on to explain at length the 7th Circuit's rationale:

> Our circuit's position comports better, we believe, with the purpose of the 1933 Act than that of the circuits which dispense with the requirement of establishing horizontal commonality. It is true that real estate is an "investment" in the fundamental sense of an outlay intended to yield benefits over a substantial period of time, conventionally at least a year. The benefits can be pecuniary or nonpecuniary but the combination of the "flexible time" agreement with the "4-share" program converts the condominium owner's investment, even if only temporarily, into a purely pecuniary investment, for the owner obtains no consumption value from his property when he is not occupying it. Even so, the optional character of the "flexible time" and "4-share" agreements makes it difficult to conceive of the sale of the condominium itself as the sale of a security, *Allison v. Ticor Title Ins. Co., supra*, 907 F.2d at 649, and it is the sale of the condominium that the Walses want to rescind. The statutory language ("the term 'security' means any note, stock, treasury stock, bond, debenture, ... investment contract, ... or, in general, any interest or instrument commonly known as a 'security,'" 15 U.S.C. Sec. 77b(1)) suggests that the term "investment contract" has the limited purpose of identifying unconventional instruments that have the essential properties of a debt or equity security. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 690, 105 S.Ct. 2297, 2304, 85 L.Ed.2d 692 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 555-56, 102 S.Ct. 1220, 1223-24, 71 L.Ed.2d 409 (1982). A share of stock, for example, is an undivided interest in an enterprise, entitling the owner to a pro rata share in the enterprise's profits. *United Housing Foundation, Inc. v. Forman, supra*, 421 U.S. at 851, 95 S.Ct. at 2060. The owner of a condominium does not own an undivided share of the building complex in which his condominium is located. He owns his condominium, and if it is rented out for him by the developer he receives the particular rental on that unit rather than an undivided share of the total rentals of all the units that are rented out. The nature of his interest thus is different from that of a shareholder in a corporation that owns rental property. This is true whether he owns

[29] *Id.* at 1018.

> the condominium all year round or owns a temporal slice of it like the Walses, although we cannot find any case on the point.[30]

h. **Eighth Circuit**

The 8th Circuit appears open to accepting vertical as well as horizontal commonality in satisfaction of the second prong of the *Howey* test. *Miller v. Central Chinchilla Group, Inc.,* 494 F.2d 414, 417-18 (8th Cir. 1974).

i. **Ninth Circuit**

The 9th Circuit looks to both horizontal commonality and to the narrow version of vertical commonality. The opinion in *SEC v. Glenn W. Turner Enterprises, Inc*. applied the narrow vertical commonality approach, examining whether "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[31] The 9th Circuit's 1989 *en banc* decision in *Hocking v. Dubois* stated:

> the second prong's requirement of a "common enterprise" has been construed by this Circuit as demanding either an enterprise common to the investor and the seller, promoter or some third party (vertical commonality) or an enterprise common to a group of investors (horizontal commonality)."[32]

The same decision explained horizontal commonality in these terms:

> The participants pool their assets; they give up any claim to profits or losses attributable to their particular investments in return for a pro rata share of the profits of the enterprise; and they make their collective fortunes dependent on the success of a single common enterprise.[33]

The 9th Circuit has recognized that there is no common enterprise when investors and offerors do not share in the profitability of a joint enterprise, i.e., when the success or failure of the promoter does not directly correlate with the success or failure of the investors. *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 462 (9th Cir. 1978) .

j. **Tenth Circuit**

The 10th Circuit does not limit its analysis to the concepts of horizontal and vertical commonality, but rather examines the economic reality of the transaction. *McGill v. American Land & Exploration Co*. held that if

> a transaction is purely a commercial in nature (for example, a commercial loan or a sale of assets), then it does not give rise to a "common enterprise" or a "security." If, on the other hand, a transaction is in reality an investment (that is, a transaction of a type in which stock is often given), then it is a common enterprise."[34]

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[30] *Id.* at 1018-19.
[31] 474 F.2d 476, 482 n.7 (9th Cir. 1973), *cert. denied*, 414 U.S. 821.
[32] 885 F.2d 1449, 1455 (9th Cir. 1989) (en banc).
[33] *Id*. at 1459.
[34] 776 F.2d 923, 925-26 (10th Cir. 1985).

k. **Eleventh Circuit**

The 11th Circuit allows vertical commonality to satisfy *Howey's* second prong. In the case of *Villeneuve v. Advanced Business Concepts Corp*., the court wrote as follows:

> Villeneuve argues that the "common enterprise" element exists under the purchaser agreement. We agree. The common enterprise element is defined as "[o]ne in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc.,* 474 F.2d 476, 482 n. 7 (9th Cir. 1973). Similarly, the former Fifth Circuit, in *Securities and Exchange Commission v. Koscot International, Inc.,* 497 F.2d 473, 479 (5th Cir. 1974), observed that "the fact that an investor's return is independent of that of other investors in the scheme is not decisive. Rather, the requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the [promoter]." After reviewing the record, we conclude that such commonality does exist and is evidenced by the obligation of ABC to provide advertisements, training, products, and to select the areas where products are sold. The failure to provide any of these services would definitely determine the success or failure of the scheme. For these reasons, we find the second element of commonality to exist.[35]

l. **D.C. Circuit**

The D.C. Circuit has held that horizontal commonality suffices for the second prong, without deciding whether vertical commonality suffices:

> we conclude that all three elements of horizontal commonality – pooling, profit sharing, and loss sharing – attend the purchase of a fractional interest through LPI. (We need not reach, therefore, the SEC's alternate contention that the LPI program entails "strict vertical commonality" – another formulation of the common enterprise test recognized in some circuits. See, e.g., *Brodt v. Bache & Co., Inc*., 595 F.2d 459, 461 (9th Cir.1978).)[36]

Comment

Despite the amount of ink spilled in the lower courts over the concepts of horizontal, broad vertical, and narrow vertical commonality, the Supreme Court has analyzed multiple investment contract fact situations without adopting these terms and distinctions. In a case that involves commercially familiar relationships of software-system investor-provider-OEM-licensor with licensee users and sublicensor developers, the Supreme Court would be unlikely to take the radical step of branding those relationships a "common enterprise," and

[35] 698 F.2d 1121, 1124 (11th Cir. 1983).
[36] *SEC v. Life Partners, Inc.*, 87 F.3d 536, 544 (D.C Cir. 1996).

could well find Judge Posner's and the Seventh Circuit's reasoning to be persuasive grounds for rejecting vertical commonality *tout court.*

3. Expectation of profit derived from the entrepreneurial or managerial efforts of others

The key issue in this prong is whether purchasers of tokens in an Ethereum ICO such as BlockMason's have an expectation of profitability or advantage from their purchase based predominantly on (a) their own use and development, including any potential for remarketing, of the usage rights to the product or service that they have purchased in the form of ICO tokens or (b) the entrepreneurial or managerial efforts of the ICO offerors, namely BlockMason, or some other third party. The Supreme Court's opinion in *Howey* stated this prong of test as requiring that investors' profit expectations derive "solely" from the efforts of others. As discussed in this section, many federal circuits have relaxed this requirement by substituting variants of "undeniably significant" or "predominantly" for the Supreme Court's "solely." Interestingly, in the Supreme Court's own cases in the decades since *Howey*, opinions of both majority and dissent continue to repeat the original phraseology of "solely" without criticizing or rejecting it. The SEC Report's adoption of a formulation broader than the Supreme Court's – eschewing "solely" for the broader "undeniably significant" – may well be a broader interpretation of the SEC's statutory authority than the Supreme Court would uphold. But an explicit choice between "solely" and the broader formulations used by lower courts has not yet been made by the Supreme Court; therefore the following section will consider the various stances taken by each of the federal circuits on this issue, as well as presenting the Supreme Court's own successive formulations of the "solely" language in the *Howey* test.

As can be seen, the positions taken by courts vary along a scale from (1) application of the "solely" standard unchanged, to (2) relaxation of the solely standard to allow a finding of an investment contract when the efforts of investors are a *de minimis*, insubstantial factor in the investors' expectations of future profits, to (3) a standard examining whether the managerial and entrepreneurial efforts of offerors are the predominant factor, more significant than the efforts of investors in the investors' expectations of future profits, to (4) holdings that find the third prong satisfied when the efforts of those other than the investors are "the undeniably significant ones," presumably a comparative standard similar to #3 above, but not explicitly so in most cases applying this standard, and finally to (5) holdings that find the third prong satisfied when the expectations of profits derive from the managerial and entrepreneurial efforts of the offerors, in unspecified measure and unspecified comparative weight as to the relative significance with investors' efforts and offerors' or third parties' efforts.

This section presents the standards enunciated by the various federal circuits, followed by an analysis of the Supreme Court's cases applying the *Howey* standard, to assess what standard(s) are most likely to apply to an Ethereum ICO, both initially in the lower courts, and ultimately in the U.S. Supreme Court.

a. **First Circuit**

The 1st Circuit has followed other circuits in relaxing the "solely" standard of *Howey's* third prong. The court's 2001 opinion in *SEC v. SG Ltd*. focuses on what is substantial in creating investor expectations of profits – whether efforts of investors or efforts of promoters – and what is insignificant or "merely incidental." The opinion discusses the Supreme Court's *Forman* decision and its pre-*Howey* decision about an investment contract in the *Joiner* case:

> In *Forman,* the apartment was the principal attraction for prospective buyers, the purchase of shares was merely incidental, and the combination of the two did not add up to an investment contract. 421 U.S. at 853, 95 S.Ct. 2051. In *Joiner,* the prospect of exploratory drilling gave the investments "most of their value and all of their lure," the leasehold interests themselves were no more than an incidental consideration in the transaction, and the combination of the two added up to an investment contract. 320 U.S. at 349, 64 S.Ct. 120. This distinction is crucial, *see Forman,* 421 U.S. at 853 n. 18, 95 S.Ct. 2051, and it furnishes the beacon by which we must steer. Seen in this light, SG's persistent representations of substantial pecuniary gains for privileged company shareholders distinguish its StockGeneration website from the Information Bulletin circulated to prospective purchasers in *Forman.* While SG's use of gaming language is roughly analogous to the cooperative's emphasis on the nonprofit nature of the housing endeavor, SG made additional representations on its website that played upon greed and fueled expectations of profit. For example, SG flatly guaranteed that investments in the shares of the privileged company would be profitable ...[37]

b. **Second Circuit**

The 2d Circuit follows the language of the "solely" standard while relaxing its rigor somewhat. *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027, 1035 (2d Cir. 1974); *SEC v. Aqua-Sonic Products Corp*., 687 F.2d 577, 582 (2d Cir. 1982). The 2nd Circuit has distinguished between transactions in which the offeror solicits passive investors and transactions involving "significant investor control." That opinion, in the 2008 case of *U.S. v. Leonard,* held that *Howey's* third prong is not satisfied if the transaction involves significant investor control affecting profit expectations.[38] These more recent cases indicate a departure from the 1977 decision in *Hirsch v. Dupont* saying that "solely" should be read literally.[39]

c. **Third Circuit**

In the 2001 case of *SEC v. Infinity Group*, the 3d Circuit relied on the original *Howey* test: "Thus, the property transfer contracts between TIGC and its investors are securities if they were (1) 'an investment of money,' (2) 'in a common enterprise,' (3) 'with profits to come

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[37] 265 F.3d 42, 54 (1st Cir. 2001).
[38] 529 F.3d 83, 88 (2d Cir. 2008).
[39] 396 F. Supp. 1214, 1218-20 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977). *See also Endico v. Fonte*, 485 F.Supp.2d 411, 412 (S.D.N.Y. 2007).

solely from the efforts of others.'" The court focused on whether purchasers were "attracted to the investment by the prospect of a profit on the investment rather than a desire to use or consume the item purchased."[40]

In the *Steinhardt* case, the 3d Circuit expressed a willingness to relax the "solely" standard when the investor's profit-related efforts are "nominal or limited and would have 'little direct effect upon receipt by the participants of the benefits promised by the promoters.'"[41] The court's opinion in *Steinhardt* cited the Supreme Court's *Forman* decision for the proposition that *Howey's* third prong "requires that the purchaser be attracted to the investment by the prospect of a profit on the investment rather than a desire to use or consume the item purchased."[42]

d. **Fourth Circuit**

The 4th Circuit's opinion in *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc*., 840 F.2d 236 (4th Cir. 1988) contemplates but does not rely on a relaxation of the "solely" standard of *Howey*. *Rivanna* deserves close attention because the opinion was written by retired Supreme Court Justice Powell, sitting by designation; and Powell had previously, in his time on the Supreme Court, authored the Court's opinions applying the *Howey* test to purported investment contracts, in the *Forman* case and the *Daniel* case. Powell's opinion in *Rivanna* contains a footnote saying "we agree that the term solely – used in *Howey* – must not be given a literal construction in all circumstances." 840 F.2d at 240 note 4. In the text of his opinion analyzing and deciding the investment contract issue in the *Rivanna* case, however, Powell recited the *Howey* standard unchanged and did not explicitly relax the "solely" standard of *Howey's* third prong in analyzing the facts in *Rivanna*. Rather, he wrote:

> The Supreme Court has defined an investment contract as "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 …"[43]

Powell framed the central issue of *Rivanna* in these terms:

> The critical issue on this appeal is whether appellants' general partnership interests in RTU meet the third prong of the *Howey* test – that is, the expectation of profits derived solely from the efforts of others.

Analyzing this central issue of the case, he then wrote:

> General partnerships ordinarily are not considered investment contracts because they grant partners – the investors – control over significant decisions of the enterprise.[44]

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[40] 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001), *quoting Steinhardt, supra*, 126 F.3d at 152.
[41] *Steinhardt, supra*, 126 F.3d at 153, *quoting* SEC, Sec. Act Release No. 5211 (1971).
[42] *Steinhardt,* 126 F.3d at 152. See also *Lino v. City Investing Co*., 487 F.2d 689, 692-93 (3d Cir. 1973).
[43] *Rivanna*, 840 F.2d at 240, *quoting Howey*, 328 U.S. at 298-99.
[44] 840 F.2d at 240.

The implication of this reasoning is that if the investors have control over *significant* decisions that affect their expectations of profits, then *Howey's* third prong is not satisfied. Such reasoning can be understood in terms of *de minimis* analysis that often plays a role in judicial decisions. In the case of the *Howey* test, if investors have only *insignificant, i.e. de minimis,* control or involvement in matters that affect their expectations of profit, then the "solely" standard can be relaxed.

Notably, Powell's note 4 in *Rivanna* does not attempt to suggest in what circumstances "solely" must not be taken literally, and in what circumstances it must be. The resolution of that issue awaits some future case in the Supreme Court, as does the question whether the Court will ultimately allow relaxation of the "solely" standard under a *de minimis* concept or some other rubric.

e. **Fifth Circuit**

In *SEC v. Koscot Interplanetary, Inc*., the 5th Circuit followed the 9th Circuit's opinion in *Turner, supra.* The 5th Circuit opinion explained that the court was addressing "a scheme in which an investor performed mere perfunctory tasks." Relying on the *Howey* opinion's finding that "the promoters *manage, control* and *operate* the enterprise" (emphasis in original), the 5th Circuit held that the proper standard in determining whether a scheme constitutes an investment contract is that explicated by the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc*., *supra.* In that case, the court announced that the critical inquiry is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[45]

Koscot involved a pyramid promotion enterprise with two elements: sale of cosmetics and the recruitment of persons to e distributors. *Id.* at 475-76. The court found: "Many if not all of the persons, seeking to become Koscot distributors are attracted by the lure of money to be earned by high-pressure recruiting of other persons into the Koscot program, rather than the sale of the cosmetics themselves." *Id.* at 476, quoting *SEC v. Koscot Interplanetary, Inc.,* 365 F.Supp. 588, 590 (N.D. Ga. 1973). The task of the investor in Koscot was not a small one. Besides luring a prospect to Koscot's Opportunity Meetings additional effort often was required, *"the amount of which [was] contingent upon the degree of reluctance of the prospect." Id.* (emphasis supplied).[46]

Despite efforts required of the investor to bring new prospects to Koscot meetings and recruit them into the distribution scheme, the court found the success of sales to be dependent on the efforts of the offeror, Koscot, so that an investor "would invariably be powerless to

[45] 497 F.2d 473, 482 (5th Cir. 1974).
[46] *Id.*

realize any return on his investment." The significant factor was that the investor's "act of consummating a sale is essentially a ministerial not managerial one."[47]

f. **Sixth Circuit**

The 6th Circuit relaxed the "solely" standard in the 1983 case of *Odom v. Slavik*, explaining that "when the functions the 'investor' performs are not significant managerial ones, but mere ministerial ones, the schemes will not be excluded from the coverage of the act merely because the profits are not derived, in some strict sense, solely from the efforts of others."[48]

g. **Seventh Circuit**

The 7th Circuit has followed the "solely" standard of *Howey* while acknowledging it is a flexible test, and looking at the economic reality to see if a transaction has the basic nature of an investment. *Kemmerer v. Weaver*, 445 F.2d 76 (7th Cir. 1971). The court found that the investors in that case had a passive role, to put up money and then "sit back and let nature take its course."

h. **Eighth Circuit**

The 8th Circuit applied the "solely" standard in the 1991 case of *Klaers v. St. Peter*, finding that under a partnership agreement, partners had significant degrees of control and involvement, and therefore finding no investment contract under the third prong of Howey.[49]

i. **Ninth Circuit**

In the 9th Circuit case prominently relied upon by the SEC in its Report, the 9th Circuit dropped the term "solely" and instead held that "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Turner, supra,* 474 F.2d at 482. *See also Hocking v. Dubois*, 885 F.2d 1449, 1455 (9th Cir. 1989) (en banc)

j. **Tenth Circuit**

In *Aldrich v. McCulloch Properties, Inc*., 627 F.2d 1036 (10th Cir. 1980), the 10th Circuit reformulated "solely" into "primarily," holding that the subdivided real estate lots purchased by the plaintiffs were "not securities if the purchasers were induced to obtain them primarily for residential purposes – 'to occupy the land or develop it themselves.'" *Id*. at 1040 (quoting *Howey*, 328 U.S. at 300.)

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[47] *Id.* at 485.
[48] 703 F.2d 212, 215 (6th Cir. 1983), *citing, inter alia, Union Planters National Bank v. Commericial Credit,* 651 F.2d 1174, 1181 n.9 (6th Cir. 1981).
[49] 942 F.2d 535 (8th Cir. 1991).

The 10th Circuit has held in the case of franchisees that when a franchise or distributorship is owner-operated, its profits do not typically derive solely or substantially from the efforts of others, and thus do not support a finding of an investment contract. *Meyer v. Dana un Jardin, S.C.*, 816 F.2d 533 (10th Cir. 1987).

k. **Eleventh Circuit**

The 11th Circuit followed the *Howey* "solely" standard unchanged in the 1983 case of *Villeneuve v. Advanced Business Concepts Corp*., reasoning as follows:

> *Howey* provides that the third element is satisfied if the profits are "solely from the efforts of the promoter or third party." *Howey,* 328 U.S. at 299, 66 S.Ct. at 1103. The former Fifth Circuit in *Piambino v. Bailey,*610 F.2d 1306, 1317 (5th Cir. 1980), observed that the Supreme Court in *United Foundation, Inc. v. Forman,* 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975), "reaffirmed the test first enunciated in *Howey,* which had been on the books for thirty years." Although the Supreme Court in *Forman* acknowledged the existence of a broader test enunciated in *Securities and Exchange v. Glenn W. Turner Enterprises, Inc.,* the Court did not rule expressly on the validity of that test.[2] *Forman,* 421 U.S. at 852 n. 16, 95 S.Ct. at 2060 n.16. We adhere to the standard articulated in *Howey,* reaffirmed in *Forman,* and adopted by the former Fifth Circuit in *Piambino.*[50]

A dissent in *Villeneuve* argued that the 11th Circuit should follow the more relaxed standard that its predecessors in the 5th Circuit set in the *Koscot* case, *supra.* In an en banc decision, the 11th Circuit rejected the dissenting view and affirmed the panel decision in *Villeneuve*, basing their reasoning on the substantial effort by the distributor in the transaction:

> We discern no basis for concluding that the profits which Villeneuve expected to realize were to be derived from ABC's entrepreneurial or managerial efforts. We therefore affirm the decision of the district court that the area purchaser agreement in this case is not an investment contract and consequently not a security.[51]

In 1991, retired Justice Powell rendered yet another appellate decision about an investment contract, sitting by designation in the 11th Circuit case of *Rice v. Braniger Organization, Inc.,* 922 F.2d 788 (11th Cir. 1991). In this case involving the sale of equity memberships in real estate, Powell interpreted his *Forma*n decision, explaining that the Supreme Court has held, when parties "purchase something with the primary desire to use or consume it, the security laws do not apply." *Id.* at 790.

l. **D.C. Circuit**

In 1996 the D.C. Circuit restated the *Howey* test as whether a scheme involves an expectation of profits arising from a common enterprise that depends upon the efforts of

[50] 698 F.2d 1121, 1124-25 (11th Cir. 1983).
[51] *Villeneuve v. Advanced Business Concepts Corp*., 730 F.2d 1403 (11th Cir. 1984) (en banc).

others, focusing also on whether the expected profits are in relation to capital appreciation resulting

> from the development of the initial investment. Or a participation in earnings resulting from the development of the initial investment, per *Forman*, or some other way consistent with Supreme Court precedent though the lower courts have given the Supreme Court's definition of a security broader sweep by requiring that profits be generated only "predominantly" from the efforts of others, see, e.g., *SEC v. International Loan Network, Inc*., 968 F.2d 1304, 1308 (D.C.Cir.1992); *Goodman v. Epstein*, 582 F.2d 388, 408 n. 59 (7th Cir.1978), they have never suggested that purely ministerial or clerical functions are by themselves sufficient; indeed, quite the opposite is true. See, e.g., *SEC v. Koscot Interplanetary, Inc*., 497 F.2d 473, 483 (5th Cir.1974); *SEC v. Glenn W. Turner Enterprises, Inc*., 474 F.2d 476, 482 (9th Cir.1973) (efforts of others must be "undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise").[52]

D. U.S. Supreme Court Decisions as to "solely"

The smorgasbord of federal circuit approaches to relaxing the "solely" standard must be tested against the actual language of the entire body of Supreme Court decisions applying the *Howey* test. A detailed examination of those decisions now follows.

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

The Supreme Court's opinion stated the *Howey* test in these terms: "The test [for an investment contract] is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 389 U.S. at 338, quoting *Howey,* 328 U. S. at 301 (brackets in original *Tcherepnin* opinion). The Court continued by applying this formulation of the *Howey* standard to find that investors indeed were reliant solely upon managers-offerors for expected profits.

> Because Illinois law ties the payment of dividends on withdrawable capital shares to an apportionment of profits, the petitioners can expect a return on their investment only if City Savings shows a profit. If City Savings fails to show a profit due to the lack of skill or honesty of its managers, the petitioners will receive no dividends. Similarly, the amount of dividends the petitioners can expect is tied directly to the amount of profits City Savings makes from year to year. Clearly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3(a)(10) and as it was defined in *Howey.*[53]

2. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975)

The Supreme Court's 1975 decision in *United Housing Foundation, Inc. v. Forman* restated the *Howey* test for security vs. non-security in the following terms:

[52] *SEC v. Life Partners, Inc., supra,* 87 F.3d 536.
[53] 389 U.S. at 338-39.

> The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in *Joiner, supra* (sale of oil leases conditioned on promoters; agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin v. Knight, supra* (dividends on the investment based on savings and loan association's profits). In such cases the investor is "attracted solely by the prospects of a return" on his investment. *Howey, supra*, at 300, 66 S.Ct., at 1103. By contrast, when a purchaser is motivated by a desire to use or consume the item purchased – "to occupy the land or to develop it themselves," as the *Howey* Court put it, *ibid*. – the securities laws do not apply.[54]

Three justices dissented from the majority opinion in *Forman*, but like the majority they recited the "solely" standard of *Howey* without proposing to change its wording:

> The essential ingredients of an investment contract have been clear since *SEC v. W. J. Howey Co.,* 328 U. S. 293, 328 U. S. 301 (1946), held that "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *See Tcherepnin v. Knight,* 389 U. S. 332, 389 U. S. 338 (1967). There is no doubt that Co-op City residents invested money in a common enterprise; the only questions involve whether the investment was to be productive of "profits to come solely from the efforts of others." 421 U.S. at 860-61.

The dissenting opinion, written by Justice Brennan, then went on to analyze the issue of profits "solely from the efforts of others" in terms of de minimis, speculative, and insubstantial – precisely the concepts that arise in some of the lower federal court decisions relaxing the "solely" language of *Howey's* third prong:

> Even after deduction of expense – taxes alone take half of the gross – the residue could hardly be *de minimis,* even for an operation as large as Co-op City. Therein lies the patent fallacy of the Court's conclusion that this aspect of the corporation's activities is "speculative and insubstantial." *Ante* at 421 U. S. 856. The District Court rightly recognized that management by third parties is essential in a project so massive as Co-op City. 366 F.Supp. 1117, 1128 (SDNY 1973). Co-op City residents as stockholders were thus necessarily bound to rely on the management of Riverbay Corporation to produce income in the form of rents from the commercial and office space made an integral part of the project.[55]

But this apparent attempt to relax the "solely" standard was made by the *dissent*. Thus its main significance is to highlight that the Supreme Court majority were indeed relying on a strict rather than relaxed interpretation of solely. Nor has Brennan's dissenting view appeared to influence subsequent Supreme Court opinions interpreting and applying the *Howey* test.

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[54] 421 U.S. at 852-53.

[55] *Id*. at 861 (Brennan, J., dissenting).

Finally, a footnote in *Forman* makes explicit that the Supreme Court did not intend to resolve the issue whether or not to relax the "solely" requirement of *Howey's* third prong:

> This test speaks in terms of "profits to come *solely* from the efforts of others." (Emphasis supplied.) Although the issue is not presented in this case, we note that the Court of Appeals for the Ninth Circuit has held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." *SEC v. Glenn W. Turner Enterprises,* 474 F.2d 476, 482, *cert. denied,* 414 U.S. 821 (1973). We express no view, however, as to the holding of this case.

Forman, 421 U.S. at 852 n.16.

3. *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979).

The decision for the Court, written by Justice Powell, states the *Howey* test in these words:

> whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. . . The test is to be applied in light of the substance – the economic realities of the transaction – rather than the names that may have been employed by the parties.[56]

The reasoning of the Court contains this passage:

> The court below found an expectation of profit in the pension plan only by focusing on one of its less important aspects to the exclusion of its more significant elements.[57]

Further:

> When viewed in light of the total compensation package an employee must receive in order to be eligible for pension benefits, it becomes clear that the possibility of participating in a plan's asset earnings "is far too speculative and insubstantial to bring the entire transaction with the Securities Act."[58]

In sum, the *Daniel* decision looks to the economic realities of a transaction, focusing on the significant elements of the transaction and disregarding those aspects that are insignificant, speculative, or insubstantial in the economic understanding of the overall transaction.

[56] 439 U.S. at 558.
[57] *Id*. at 561.
[58] *Id*. at 562, quoting *Forman*, 421 U.S. at 856.

4. *SEC v. Edwards,* 540 U.S. 389 (2004)

A unanimous Supreme Court held in this case that a scheme cannot be excluded from the category of investment contract "simply because the scheme offered a contractual entitlement to a fixed, rather than a variable, return." The Court stated the *Howey* test once again with the "solely" language unchanged and uncriticized:

> The test for whether a particular scheme is an investment contract was established in our decision in *SEC* v. *W. J. Howey Co.,* 328 U. S. 293 (1946). We look to "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others … embraces a flexible rather than a static principle."[59]

The Supreme Court opinion then emphasized the flexibility of the *Howey* test, but did not suggest that the "solely" language is the portion to be flexed, or relaxed. Rather, the decision looked to state law antecedents of the 1933 and 1934 acts' regulation of investment contracts as securities:

> The state courts had defined an investment contract as "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment,'" and had "uniformly applied" that definition to "a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or [a third party]." *Howey*, *supra*, at 298 (quoting *State* v. *Gopher Tire & Rubber Co.,* 146 Minn. 52, 56, 177 N. W. 937, 938 (1920)). Thus, when we held that "profits" must "come solely from the efforts of others," we were speaking of the profits that investors seek on their investment, not the profits of the scheme in which they invest. We used "profits" in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.

This passage indicates that in an Ethereum ICO offering a product- or service-use token, the relevant "expectation of profits" to examine are those of the purchasers and their enterprises, not those of the provider-offeror. The *Edwards* decision further contains a lengthy passage summarizing and explaining the Supreme Court's 1975 *Forman* decision as follows:

> In *United Housing Foundation, Inc.* v. *Forman,* 421 U. S. 837 (1975), we considered whether "shares" in a nonprofit housing cooperative were investment contracts under the securities laws. We identified the "touchstone" of an investment contract as "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," and then laid out two examples of investor interests that we had previously found to be "profits." *Id.,* at 852. Those were "capital appreciation resulting from the development of the initial investment" and "participation in earnings resulting from the use of investors' funds." *Ibid.* We contrasted those examples, in which "the investor is 'attracted solely by the prospects of a return'" on the investment, with housing cooperative shares, regarding which the purchaser "is motivated by a desire

[59] 540 U.S. at 393, *quoting Howey,* 328 U.S at 301.

> to use or consume the item purchased." *Id.,* at 852–853 (quoting *Howey*, *supra*, at 300). Thus, *Forman* supports the commonsense understanding of "profits" in the *Howey* test as simply "financial returns on . . . investments."[60]

The *Edwards* opinion goes on to observe that *Forman's* description of profits did not constitute an exclusive list of possible types of profits. Yet again here, the *Edwards* opinion did not criticize the "solely" aspect of the *Howey* test. Quite the contrary, a later part of the *Edwards* opinion repeated and relied on the third prong of *Howey,* reciting the "solely" element without criticism:

> The Eleventh Circuit's perfunctory alternative holding, that respondent's scheme falls outside the definition because purchasers had a contractual entitlement to a return, is incorrect and inconsistent with our precedent. We are considering investment *contracts*. The fact that investors have bargained for a return on their investment does not mean that the return is not also expected to come solely from the efforts of others.[61]

A 1971 SEC Report

The SEC has long taken the relaxed view of "solely" reflected in the July 25, 2017 Report. In 1971 the commission addressed multilevel distributorship plans as follows:

> It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negative the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action or where the duties assigned would in any event have little direct effect upon receipt by the participant of the benefits promised by the promoters, a security may be found to exist. As the Supreme Court has held, emphasis musts be placed upon economic reality...[citing Howey] ... While the Commission has not taken the position that a franchise arrangement necessarily involves the offer and sale of a security, in the Commission's view a security is offered or sold where the franchisee is not required to make significant efforts in the operation of the franchise in order to obtain the promised return.

SEC, Sec. Act Rel. 5211 (1971).

Comment

While the federal circuits have diluted the "solely" standard in various measures, the Supreme Court has not opted to do likewise, despite repeated opportunities to do so. A plausible explanation can be found in retired Justice Powell's footnote in the 4th Circuit *Rivanna* decision – that the term "solely" should not have a literal construction "in all cases." The Supreme Court's continued application of the solely standard to the cases coming before it, in this view, does not exclude the likelihood of applying a relaxed standard when appropriate exceptional instances present themselves. Such exceptions are most likely to

[60] 421 U. S., at 853.
[61] 540 U.S. at 397 (emphasis in original).

arise when a transaction looks and feels like an investment rather than a commercial transaction – as in the 10th Circuit case summarized in Part C.2.j above. In an investment-like fact situation, the Supreme Court can choose any of various rubrics used in the lower courts – *de minimis*, insubstantial, perfunctory, non-predominant – to prevent minor elements of investor-purchaser involvement from defeating a positive finding under the otherwise demanding "solely" standard of *Howey's* third prong. On the other hand, any case involving a substantial role of investor-purchasers in the use, consumption or development of a product or service unlikely to produce any Supreme Court departure from its consistent pattern of repeated and re-applying the "solely" standard in *Forman*, *Daniels* and *Edwards*.

An Ethereum ICO offeror must certainly contend with the likelihood that the SEC will continue to take a relaxed view of the "solely" standard as it has done from its 1971 Report to its July 2107 Report, and with the expectation that federal district and appeals courts will apply the variation of that standard established by precedent in their particular federal circuit. But all parties must also contend with the entirely realistic possibility that the any relaxation of the "solely" standard by the SEC or the lower federal courts, if appealed to the Supreme Court, could be reversed as inconsistent with Supreme Court precedent. The Court has been historically reluctant to change its precedential interpretations of statutory language, because Congress can perform that task by simple legislation, and Supreme Court precedents interpreting statutes establish expectations that play an important role in economic activity of those who rely on them. The *Howey* Court's "solely" standard, moreover, was taken from previously existing state court interpretations of state statutes:

> This definition was uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of someone other than themselves.

328 U.S. at 298.

The possibility of the Supreme Court reversing is all the more likely if a relaxed version of the "solely" element of the *Howey* test ensnares as an "investment contract" a transaction whose economic reality is akin to familiar non-security relationships of licensor-licensee, OEM and VAR, creator-developer-customer, inventor-reseller-user, or the like.

E. Investment Company Act of 1940

The Report contains a footnote with an advisory about the Investment Company Act of 1940: "Those who would use virtual organizations should consider their obligations under the Investment Company Act."[62] The 1940 Act covers investment companies, both those commonly regarded as such, and those that become "inadvertent investment companies" by falling within the definition of the Act's section 3(a)(1)(C). The Act's definitions of customary and inadvertent investment companies rely on a definition of "security" that

[62] Report at 1 n.1.

includes investment contracts as well as typical categories of equity and debt instruments, and derivatives thereof. If an Ethereum ICO by a virtual organization such as The DAO makes an offer that comes within the definition of "investment contract," then the organization might also come within the definition of an inadvertent investment company. An inadvertent investment company, under section 3(a)(1)(C) of the 1940 Act, is any issuer that

> is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Section 3(a)(2) of the 1940 Act defines "investment securities" as all securities except certain enumerated categories. Thus, if an Ethereum ICO issues a type of token that is not within the *Howey* test for an investment contract, any unsold tokens retained by the Ethereum ICO issuing entity are not securities and cannot constitute any per centum of the issuer's assets under the above statutory definition of an inadvertent investment company. On the other hand, if an Ethereum ICO issues a type of token that satisfies the *Howey test*, and retains tokens aggregating in value to more than 40% of the value of the issuer's total assets, the 1940 Act and regulations under it could potentially apply.

In sum, an Ethereum ICO that does not offer an investment contract or other form of security cannot fall within the definition of inadvertent investment company, even if the offeror is a virtual organization.[63]

F. Trading of ICO Tokens on Exchanges

The Report, in its final section, summarized in one sentence the applicability of U.S. securities laws to exchanges that trade in and create secondary markets for Ethereum ICO tokens:

> In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.[64]

This statement, by its own terms and by the terms of U.S. securities law, applies only to orders for and trades of *securities*. For ICO tokens that come within the definition of "investment contract" and "security," the requirement that trading be limited to registered exchanges is likely to be enforced progressively in the wake of this Report, both within the

[63] *See generally* G. Lins, A. Smith and T. Lemke, *Regulation of Investment Companies* (2017 rev. ed.), ch. 3.
[64] Report at 18.

United States and in other jurisdictions that regulate in a similar manner to the U.S. or are responsive to leadership or pressure from the U.S.

On the other hand, an Ethereum ICO token that does not come within the securities laws' definition of "security" can trade on any exchange, whether registered on not registered.

G. The BlockMason Credit Protocol ICO Analyzed under the Report and U.S. Securities Law

Whether BlockMason's Credit Protocol ICO is an offer of securities depends, under the reasoning of the Report and the standards set by the U.S. Supreme Court, on whether or not BlockMason is offering and selling investment contracts and thus securities. That issue turns on whether the BlockMason offering meets all three prongs of the *Howey* test. What follows is an analysis of each prong in light of the nature of the BlockMason ICO as described in BlockMason's whitepaper of August 14, 2017: i.e., the offering of ICO tokens that confer rights (a) to use the product and associated service known as Credit Protocol (CP); (b) to use and consume network capacity associated with CP; (c) to use applications built to operate with or upon CP, including the app Friend in Debt created and provided by BlockMason; (d) to develop independently other apps built upon CP and upon BlockMason's freeware product Foundation, aided by the open source architecture created by BlockMason for CP and Foundation; (e) to market token holders' own products, apps and services built upon or in interaction with CP and Foundation; (f) to develop any type of joint or cooperative venture with other actual or prospective CP token holders to exploit the rights inherent in CP tokens; and (g) to follow their own profit opportunities according to their own capabilities, operational needs, product and service development plans, marketing capabilities, and risk profiles. In all these uses of the CP tokens, token holders can act independently of BlockMason, while taking advantage of the product and service features apparent in the beta versions deployed by BlockMason prior to the ICO, as well as the open source architecture of CP and Foundation, and the industry-typical maintenance and support offered by BlockMason for these products and services.

1. First prong: investment of money

As explained above, Ethereum ICOs meet the standard of the first prong by receiving valuable consideration in return for tokens. This is true whether the consideration is in the form of ETH, or Bitcoin, or another private currency, or any state-issued fiat currency. The BlockMason ICO is no exception, as it is designed to receive ETH in consideration for the issuance of product-use tokens.

2. Second prong: common enterprise

BlockMason's ICO is most clearly not a horizontal common enterprise: it is not a "pooling of assets from multiple investors so that all share in the profits and risks of the enterprise." *SG Ltd*., supra, 265 F.3d 49. Purchasers of BlockMason's product-use tokens receive no share in the profits of the offeror entity. Nor do they share in its risks, except in

the universal manner that purchasers of a product assume some degree of risk that the selling entity will fall short with respect to maintenance and support of the product. But this is not the type of investment risk that the *Howey* test examines, in which the investors share in the risk of loss of value of the offeror entity as stakeholders in a *common enterprise*, which naturally entails sharing both profits and risks.

Rather than stakeholders in a common enterprise, purchasers of BlockMason tokens are in the position of *customers*, or in the context of rights to use a software- and network-based product and service, in the position of *licensees*. Since they are entitled to develop, customize and re-market these rights of product and service usage, they are further in the position of *sub-licensors*. As in any customary instance of a provider-customer relationship, or licensor-licensee relationship, purchasers of BlockMason ICO tokens retain their own independent identity as individuals and entities. They have their own profit-and-risk profile, separate and apart from that of BlockMason. They can profit by using, developing and re-marketing the product-and-service usage rights that they acquire by purchasing BlockMason tokens, even if BlockMason suffers losses and other risks.

Under the language and standards of all the Supreme Court cases applying the *Howey* standard, which consistently look to horizontal commonality, there is no colorable argument to bring the BlockMason Credit Protocol ICO within the terms of the second prong of the *Howey* test. Because some federal circuits, albeit a minority whose view has never been adopted by the Supreme Court, have applied some form of a "vertical commonality" test, this opinion will also examine whether the BlockMason CP ICO meets the standards that have been occasionally enunciated as "narrow vertical commonality" and "broad vertical commonality."

The concept of vertical commonality requires that profits of investors be "interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties" (narrow verticality),[65] or "that the well-being of all investors be dependent upon the promoter's expertise" (broad commonality).[66] The BlockMason CP ICO does not present a case of vertical commonality, because the profitability of purchasers of tokens depends predominantly upon how they use, develop, market and otherwise exploit the rights they have purchased to use products created and owned by BlockMason and licensed to token holders. The relatively few cases that have found vertical commonality to be relevant to satisfying the second prong of the Howey test have not found vertical commonality in any seller-purchaser or licensor-licensee-sublicensor situation similar to the BlockMason instance. Rather, they have used the concept of "vertical commonality" in situations that do not fit into any familiar commercial paradigm and yet place investors' fortunes at the mercy of offerors whose efforts are overwhelmingly the determining factor in the value of the investments.

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[65] *SG Ltd*., supra, 265 F.3d at 49, *quoting SEC v. Glenn W. Turner Enters., supra*, 474 F.2d at 482 n.7.
[66] *SG Ltd.,* 265 F.3d at 49, *quoting Villeneuve v. Advanced Bus. Concepts Corp*., 698 F.2d 1121, 1124 (11th Cir 1983), *aff'd en banc*, 730 F.2d 1403 (11gh Cir. 1984); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir. 1974).

Making a software license transferrable, or available for copying, development and sublicensing, does not make the license into a security without more: specifically more facts that satisfy the *Howey* test as to common enterprise and expected profits solely or predominantly from the managerial and entrepreneurial efforts of the offerors or third parties. The profits, losses and risk profiles of CP token holders on the one hand, and BlockMason on the other, do not bear any direct or other relationship to each other; as each side comprises independent companies and individuals with decision-making ability under the economic circumstances of the Credit Protocol ICO transaction. These facts stand in stark contrast to the facts of DAO's ICO transaction as summarized in the concluding paragraph of the Report:

> By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO's Curators, as described above. Their efforts, not those of DAO Token holders, were the "undeniably significant" ones, essential to the overall success and profitability of any investment into The DAO.

3. Third prong: reasonable expectation of profits derived solely or predominantly from the efforts of others

As to the third prong of *Howey*, the expectations of profitability and advantage on the part of CP token purchasers in BlockMason's CP ICO are a function of the token holders' own decisions and efforts about how to use and develop the rights they are purchasing, as summarized in detail in above. Token holders are masters of their own destiny and fortunes, as they use the proportion of the CP network capacity they have purchased, as they develop apps that work on the CP network, as they use BlockMason's app Friend in Debt and other apps made by token holders or others, as they market those apps to others under terms they themselves define, and as they make later adjustments, based on experience, to the amount of CP network capacity they wish to utilize and consequently acquire more tokens or dispose of excess tokens. Because they are purchasing usage rights to products and services already available in beta version, token purchasers are dependent on their own evaluation of the products and services, rather than dependent on the future entrepreneurial and managerial efforts of offerors like The DAO that had only plans and promises rather than developed products at the time of their offering.

Moreover, the use of tokens rather than other methods to monetize the inventions, products and services created by BlockMason corresponds in a commercially reasonable way to the economic realities of the transaction. The sale of tokens representing proportional rights to use a network-based product and service provides an important degree of flexibility and adaptability both to BlockMason and those who wish to use and develop CP, Foundation and Friend in Debt. The tokens, with their algorithm-based adjustments over time in amount of network capacity represented by each, provide a means to manage network capacity utilization and thus avoid congestion and service degradation, for a product and service built in a network environment, namely Ethereum, which has known current capacity limitations, including transaction-per-second limits, which affect users of the CP network, and yet may

well be improved over time in ways that call for invocation of the algorithm-based adjustments for per-token utilization rights.

The design of CP tokens also gives flexibility to users and developers, who are all early adopters of a new technology, and who can benefit from the ability to acquire additional capacity from other token holders when needed, and to convey excess capacity to other when not needed. The Report's assessment that The DAO's ICO tokens were securities was based on the totally different economic circumstances involving fund-raising for future company plans rather than marketing of existing products and services to users and developers. Both the SEC and the Supreme Court have repeatedly emphasized that it is the economic realities, rather than terminology such as "token," that are the governing considerations.

Conclusion

Under U.S. securities law, there is no reason for BlockMason to deny persons in the United States the opportunity to purchase CP tokens in the BlockMason ICO as proposed in the BlockMason whitepaper of August 14, 2017.

Respectfully submitted,

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