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SEC eats away at Munchee "utility tokens": guidance for ICOs

Capital Markets Alert

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The SEC has issued an enforcement order regarding Munchee's token offering, and SEC Chairman Jay Clayton has released a general public statement on cryptocurrencies and ICOs.

For those who previously read our alert about the SEC's report in the DAO, much of this might not be a surprise – although the SEC staff did answer the call of discussing so-called "utility tokens."

The SEC action against Munchee is notable because Munchee had at least some argument that its tokens had utility. The concept of the Munchee app is crowd-sourced restaurant reviews, and the app was built before the token offering. The Munchee tokens (MUN) were designed to function as an internal currency for "use in the Munchee app for rewards and interactions." Munchee also issued a white paper, replete with disclaimers and carefully avoiding terms such as "ICO" and "investors"; its management and advisory team has relevant technical and industry experience.

For those of us working in this space, this fact pattern is familiar – and did not feel like the edge cases that had previously caught the ire of the SEC, such as a massive loss of investor capital or a recidivist promising 1,354 percent profit in less than 29 days.

So what takeaways can other potential token issuers glean from the Munchee order? How much "utility" is needed?

Almost every token issuer wants its tokens to be "utility tokens," not "security tokens." For those new to this space, don't be confused by the industry parlance, which was created just a few months ago and has taken off like wildfire. Fundamentally, **the concept is that a token with "utility" should carry an expectation of use, not an expectation of profits**, under the *Howey* test for investment contracts. (See our prior alert discussing the elements of this test.)

Here are some guideposts to consider when evaluating your token's claims of utility:

1. **What if my app is already built?** The Munchee order acknowledges that Munchee had "created an iPhone application ('app') for people to review restaurant meals." Many issuers want to argue they are selling a "minimally viable product" that has immediate utility in the hands of the holder. The SEC clearly regarded the app alone as inadequate and decided to highlight this fact at the very beginning of the order summary. The SEC order emphasized that the app was subject to improvement, that the ecosystem and its participants (advertisers, reviewers, restaurants) did not exist, and that MUN could not buy any goods or services. At a minimum, the SEC is signaling that an adequately advanced version of the app is needed with meaningful use for the token at the time of the offering.
2. **What if I give my tokens "more" utility at issuance?** The SEC was clearly not enamored of Munchee's "utility token" argument. Paragraph 35 was logically unnecessary to the SEC's conclusion. The SEC stated: "Even if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security." Even more notable, the SEC broadly characterized the US Supreme Court ruling in *Forman* for the proposition that "purchases of 'stock' *solely* for purpose of obtaining housing" is not the purchase of an "investment contract" (emphasis added). This suggests that **if there is an expectation of profits**, even if that is secondary to the more predominant expectation of use, then a token may be a security. While we may debate this, or hope that the SEC did not really mean this in a paragraph that is technically unnecessary to the order, it is difficult to ignore – especially given that the SEC said basically the same thing in the DAO report.
3. **What if my "*Howey* test score" shows my token has a low risk of being a security?** One of the more amusing things we have seen around the ICO craze has been the creation of a very thoughtful spreadsheet attempting to reduce the analysis of whether a token is a security to a series of yes/no questions where answers are ascribed values that are summed into likelihood of being a security. Many companies populate this spreadsheet as part of their Internet research about ICOs, before calling counsel. While as securities lawyers we appreciate that this device has focused attention on a key issue, there is an obvious garbage-in-garbage-out problem. The SEC chose to mention that Munchee had conducted this exercise and stated that the sale of its tokens "does not pose a significant risk of implicating the federal securities laws" – which obviously is inconsistent

with the SEC order. This seems like apt caution for the hundreds of token issuers who have reached the same self-serving conclusion.

4. **Can I sell my tokens to crypto-investors?** As the Munchee order illustrates, the SEC may regard selling to crypto-investors as indicia of selling securities. If you are selling a prepaid use right, then why not sell this right to the end user? The SEC noted that Munchee did not market or sell to current users of the Munchee app, in restaurant industry media or to restaurant owners. Selling large amounts of products or services to identifiable investors is not how people typically sell software seat licenses, concert tickets, prepaid products or other non-security assets.
5. **Should I build in deal features that cause price appreciation?** The SEC profiled several features of Munchee's token model that may cause token value appreciation – from creating a tiered membership plan that increases reviewer payouts based on the amount of tokens they hold (which constrains supply), to "burning" tokens in certain situations (which reduces supply), to promising to support trading on secondary markets (which allows capturing appreciation and may reduce any illiquidity discount), to supporting liquidity by buying and selling token from its own holdings (which promotes liquidity). These types of features make a token feel like an investment vehicle, not a use right.
6. **Lots of non-security assets increase in value – from homes to baseball cards. Can I discuss this in my token sales materials?** This is the sort of language that causes purchasers to expect profits. The SEC cites lots of examples of this from Munchee in ordering them to cease sales of tokens – from simply stating MUN would rise in value, to its description of deal features designed to achieve this outcome, to endorsing statements of third parties recounting significant gains, to comparisons of MUN to prior ICOs and digital assets that created profits. People don't sell non-investment assets with extensive allusions to increased asset value.
7. **Should I keep it out of my white paper and just discuss token appreciation on Telegram?** There is no real difference. The SEC almost showed off how much social media and non-offering document review it conducted. The Munchee order cites a wide variety of disclosure outlets – from websites, to promotional videos, to articles, to blog posts, to podcasts, to Tweets, to Facebook posts. In addition to the direct marketing efforts of the Munchee team, the SEC highlighted Munchee's endorsement of other people's public touting of the opportunity to profit and the more than 300 people promoting the MUN offering through social media (including translating MUN offering documents into multiple languages for countries in which the app was unavailable).

There are many other interesting aspects of the Munchee order and the public statement from Chairman Clayton, such as:

- The SEC plainly characterized the exchange of bitcoin or Ether for MUN as an investment of money.
- The SEC did not meaningfully discuss the "common enterprise" element of the *Howey* test (an element that many practitioners have emphasized in great detail).
- SEC Chairman Jay Clayton provided the following entertaining example of what may and may not be a utility:

> For example, a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.

If you are considering a token offering, talk to your securities counsel about whether your tokens are securities and how to sell them compliantly. If you have already sold tokens hoping they were utilities, or have received an inquiry from the SEC, talk to your securities counsel. Note that Munchee entered into a settled order that did not name any of its officers or directors and avoided a civil penalty – in part, because Munchee immediately shut down token sales, returned investor funds and cooperated with the SEC staff.

Find out more by contacting either of the authors.

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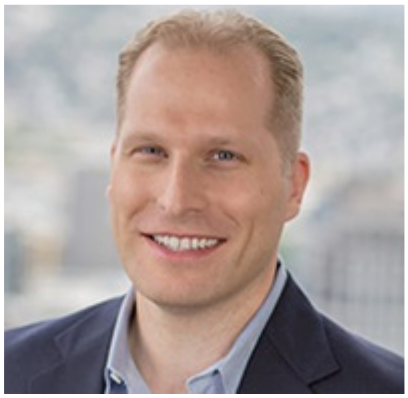

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