SEC Order and Chairman's Statement Provide Further Guidance for Token Offerings

December 20, 2017

SEC's cease and desist order against Munchee Inc. was issued alongside a statement by SEC chairman on cryptocurrency and ICO markets.

Following its investigative report in the DAO case[1], the U.S. Securities and Exchange Commission ("SEC") has now provided further guidance on when a token constitutes a security — this time, as a part of a cease and desist order (the "Order") against Munchee, Inc.'s ("Munchee") initial coin offering. The Order provides substantive guidance on the application of U.S. securities laws to the process of offering tokens through which a growing number of entrepreneurs seek to raise capital to fund the development of new businesses. The SEC chairman, Jay Clayton, concurrently issued a public statement expressing his general views on the cryptocurrency and ICO markets.

SEC Order

Facts

In issuing the Order, the SEC set forth the relevant facts, which included the following:

1. Munchee is a California-based business that created an iPhone application ("Munchee App") for people to review restaurant meals.
2. Munchee offered and then sold digital tokens ("MUN" or "MUN token") issued on the Ethereum blockchain in order to raise approximately $15 million in capital so that it could improve the Munchee App and recruit users to eventually buy advertisements, write reviews, sell food and conduct other transactions using MUN tokens.
3. In connection with the offering, Munchee described how MUN tokens would increase in value as a result of Munchee's efforts and stated that MUN tokens would be traded on secondary markets including one in the U.S.
4. Munchee published its White Paper ("MUN White Paper") that described MUN tokens, the offering process, how Munchee would use the offering proceeds to develop its business, the way in which MUN tokens would increase in value, and the ability for MUN token holders to trade MUN tokens on secondary markets.

5. In the MUN White Paper, on the Munchee Website and elsewhere, Munchee and its agents further emphasized that Munchee would run its business in ways that would cause MUN tokens to rise in value and emphasized to purchasers how they could benefit from those efforts.
6. Munchee also stated that it would work to ensure that the MUN token would be traded on secondary markets which would include at least one U.S. exchange within 30 days of the offering.

SEC Analysis

In the Order, the SEC applied the tests from the U.S. Supreme Court case, *SEC v. W.J. Howey Co.* ("*Howey*") to determine when an instrument constitutes an "investment contract" under U.S. securities laws. The SEC found that purchasers of the MUN tokens would have reasonably viewed the offering as an opportunity to profit based on the MUN White Paper as well as comments made by Munchee on Facebook and other social media on the expected appreciation of the MUN tokens. It also found that purchasers had a reasonable expectation of obtaining a future profit from buying MUN tokens if Munchee was successful in developing its business. The SEC held that purchasers would reasonably believe that they could profit by holding or trading MUN tokens, regardless of whether they ever used the Munchee App or otherwise participated in the MUN "ecosystem".

The SEC also noted that the marketing of the MUN tokens did not use the Munchee App or otherwise specifically target current users of the Munchee App to promote how purchasing MUN tokens might allow them to qualify for higher tiers and bigger payments on future reviews. Nor did Munchee advertise the offering of MUN tokens in restaurant industry media to reach restaurant owners and promote how MUN tokens might let them advertise in the future. In applying the test in *Howey*, the SEC observed that the targeted purchasers were people with an interest in tokens or other digital assets that had recently created profits for early investors in initial coin offerings ("ICOs"). These purchasers were accessible through forums aimed at people interested in investing in Bitcoin, including BitcoinTalk.org, a message board for investing in digital assets.

Referencing the experience of Munchee's founders, who had worked at prominent technology companies, and their skills running businesses and creating software, the SEC found clear evidence that MUN token purchasers would have had the reasonable expectation that Munchee and its agents would expend significant efforts to develop an application and "ecosystem" that would increase the value of their MUN tokens. The MUN tokens would also pass the test from *Howey* requiring "purchasers to benefit from the efforts of others" because the stated goal in the MUN White Paper was that the value of MUN tokens would depend on Munchee's ability to develop the Munchee App and create a valuable "ecosystem" that would inspire greater use of the MUN tokens. In effect, the "reasonable expectation of profit" test had been met because the proceeds of the MUN token offering were intended to be used by Munchee to build the "ecosystem" which would create demand for MUN tokens and make MUN tokens more valuable.

Munchee would undertake changes to the MUN token so that people could buy and sell services using MUN tokens and the MUN token could be used to recruit restaurants willing to sell meals for MUN tokens. Investors therefore reasonably expected that they would profit from the resulting increase in value. This feature, coupled with the promise

of a secondary trading market for the MUN tokens shortly after the offering, led the SEC to conclude that investors' profits were to be derived from the significant entrepreneurial and managerial efforts of others — specifically, Munchee and its agents.

In the final analysis, the SEC observed that Munchee had offered and sold securities to the general public without filing a registration statement under U.S. securities laws or the availability of an exemption from registration requirements. Despite the violation of U.S. securities laws, the SEC decided not to impose a civil penalty in light of Munchee having ceased to offer its tokens shortly after being contacted by the SEC and making restitution by returning to purchasers the proceeds that it had received.

Determinative Test

The following material considerations from the Order provide useful guidance to determine whether a token constitutes a security under U.S. securities laws:

- Is the token a "pre-functional utility token", a term that has been used by some commentators to describe a token offered at a time when further work by the issuer of the token is required in order to develop the "system" within which participants in the network (in Munchee, the restaurants, food critics and reviewers, restaurant customers and others) are expected to exchange the token for goods and services?
- Are the future efforts of the issuer of the token and any promise to establish a trading system for the token expected to result in the increase in value of the token?
- Is the token offering targeting investors in tokens and cryptocurrencies as opposed to users or participants in the system?

If the answers are yes, then the token at hand may well constitute a "security" token, which if offered for sale would require compliance with registration requirements under U.S. securities laws.

Public Statement by SEC Chairman

On the same day that the SEC issued the Order, SEC Chairman Jay Clayton issued a statement regarding the cryptocurrency and ICO markets ("Statement"). After observing that the cryptocurrency and ICO markets have grown rapidly and that ICOs can be effective ways for entrepreneurs to raise funding for innovative projects, the Statement expresses concern over the reduced investor protection in these markets compared to traditional securities markets. Some important takeaways from the Statement include the following:

- **Form over substance.** Replacing a traditional corporate interest such as a share in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction but it does not change its substance.
- **Utility.** Simply structuring a token to have some "utility" does not prevent a finding that the token constitutes a security.

- **Expectation of Profits.** Offerings that involve marketing efforts emphasizing the potential for profits based on the entrepreneurial or managerial efforts of others will likely attract the token in the realm of a security.
- **Are cryptocurrencies securities?** The answer to this question depends on the character and use of the specific digital asset. The Statement analogizes recent token sales to, and distinguished between, tokens that represent participation interests in a book-of-the-month club versus a yet-to-be-built publishing house: the book of the month club token sale might not implicate securities laws but would be an efficient way for the club's operators to purchase more books and pay for distributing them to the members, whereas the publishing house had yet to secure authors, books or distribution networks. The token in the former fact scenario may not constitute a security while the latter token likely would.

Comment

We anticipate that both the Order and the Statement may cause Canadian securities regulators to provide additional guidance on what forms of distributed ledger or blockchain-enabled tokens will constitute a security under Canadian securities laws, continuing a period of enhanced regulatory scrutiny of crypto-assets in Canada.[2]

The Order and the Statement also highlight the ongoing struggle faced by regulators as they seek to facilitate innovative ways to raise capital and promote growth, while also ensuring investors and markets are protected.

We encourage those involved in the blockchain community and other market participants to be mindful of applicable securities laws and to contact us with any questions.

The author wishes to acknowledge and thank Charles Malone, Practice Support Lawyer in BLG's Securities and Capital Markets Group, for his review and editing of this bulletin.

[1] Please see our recent bulletin: To Be or Not To Be (a Security): Regulatory Oversight of Crypto-Assets (August 1, 2017)

[2] Please see our recent bulletin: CSA Increases Regulatory Clarity in the Cryptic World of Digital Currencies (August 28, 2017)

By

Manoj Pundit

Expertise

Capital Markets, Digital Assets

BLG | Canada's Law Firm

As the largest, truly full-service Canadian law firm, Borden Ladner Gervais LLP (BLG) delivers practical legal advice for domestic and international clients across more practices and industries than any Canadian firm. With over 800 lawyers, intellectual property agents and other professionals, BLG serves the legal needs of businesses and institutions across Canada and beyond – from M&A and capital markets, to disputes, financing, and trademark & patent registration.

blg.com

BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

The information contained herein is of a general nature and is not intended to constitute legal advice, a complete statement of the law, or an opinion on any subject. No one should act upon it or refrain from acting without a thorough examination of the law after the facts of a specific situation are considered. You are urged to consult your legal adviser in cases of specific questions or concerns. BLG does not warrant or guarantee the accuracy, currency or completeness of this publication. No part of this publication may be reproduced without prior written permission of Borden Ladner Gervais LLP. If this publication was sent to you by BLG and you do not wish to receive further publications from BLG, you may ask to remove your contact information from our mailing lists by emailing unsubscribe@blg.com or manage your subscription preferences at blg.com/MyPreferences. If you feel you have received this message in error please contact communications@blg.com. BLG's privacy policy for publications may be found at blg.com/en/privacy.

© 2026 Borden Ladner Gervais LLP. Borden Ladner Gervais LLP is an Ontario Limited Liability Partnership.