SEPARATING GOVERNANCE TOKENS FROM SECURITIES: HOW THE UTILITY TOKEN MAY FALL SHORT OF THE INVESTMENT CONTRACT

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TABLE OF CONTENTS

† Articles Editor, *Cardozo Law Review*, Volume 43, J.D. Candidate, May 2022, Benjamin N. Cardozo School of Law. I would like to thank Professor Aaron Wright for his inspiration, guidance, and meaningful feedback in pursuing this topic. I am also very grateful to the editors of *Cardozo Law Review* Volume 43 for their exceptional care and tremendous assistance in editing this Note. Finally, I would like to thank my wife for her endless support, without which this Note would not be possible.

INTRODUCTION

Imagine an online banking service governed primarily by its most loyal users.[1] The banking service rewards its users by provisioning them with governance rights based on the extent to which that individual uses the bank's services.[2] The users, who are most consistently impacted by changes to the service, use their governance rights to guide the service's decisions using cooperation, collaboration, and voting.[3] While this may sound futuristic, blockchain-based services such as Uniswap have made it a reality by issuing governance tokens to reward loyal users.[4] Uniswap is a blockchain-based digital asset[5] exchange that allows individuals to swap digital assets such as cryptocurrencies.[6] Users, referred to as "liquidity providers," provide the resources to power the exchange

1 Multi.io Research, *Explained: DeFi Governance Tokens*, MEDIUM: MULTI.IO RSCH. (Nov. 17, 2020), https://medium.com/multi-io/explained-defi-governance-tokens-23a76e4df543 [https://perma.cc/E6Z5-UM9N].

2 *Id.*

3 *Id.*

4 *Introducing UNI*, UNISWAP (Sept. 16, 2020), https://uniswap.org/blog/uni [https://perma.cc/82AW-RAQW]; *How Uniswap Works*, UNISWAP [https://perma.cc/2P9E-AWNK].

5 "A digital asset is anything that is stored digitally and is uniquely identifiable that organizations can use to realize value." *Digital Assets*, GARTNER, https://www.gartner.com/en/finance/glossary/digital-assets [https://perma.cc/AJ8U-E9FF]. While digital assets come in various forms, this Note uses the term "digital asset" to refer in particular to virtual tokens or cryptocurrencies.

6 *How Uniswap Works*, *supra* note 4.

protocol.[7] Liquidity providers deposit cryptocurrencies into a collective pool and, in exchange, receive a payout when the pool is used to fulfill a trade.[8] On September 16, 2020, Uniswap announced a new digital asset called "UNI."[9] Acquiring UNI enables the acquirer to propose and vote on governance questions before Uniswap, such as grants, strategic partnerships, governance initiatives, liquidity pools, and more.[10] Uniswap liquidity providers still receive payouts from their liquidity pools, but the protocol also issues UNI to liquidity providers moving forward.[11] Curiously, UNI was also awarded retrospectively to historical liquidity providers, effectively decentralizing Uniswap's governance to its most loyal users.[12] By 2021, the continued success of Uniswap and similar protocols validated the potential for customer-controlled protocols as Uniswap's total monthly volume exceeded $36 billion in April and the fully diluted value of the UNI token at about $24 billion.[13]

Governance tokens are digital assets[14] that confer the token holder the right to vote on governance questions facing her organization.[15] Acquiring or holding the token is equivalent to becoming a decision-making member of the organization.[16] The token holder's voting weight is typically proportionate to the number of governance tokens she

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7 *Id.*

8 *Id.*

9 *Introducing UNI*, *supra* note 4.

10 *Id.*

11 *Id.*

12 *See id.*

13 Alexander Osipovich, *Peer Trading Rises in Crypto Sector*, WALL ST. J., May 25, 2021, at B11, https://www.wsj.com/public/resources/documents/aPqabJUzW2IeviWrjWSV-WSJNewsPaper-5-25-2021.pdf [https://perma.cc/NRY7-DQ93]. Decentralized exchanges in April of 2021 saw $122 billion in transactions. *Id.* In April of 2020, these exchanges saw less than $1 billion. *Id.*

14 Governance tokens are commonly ERC-20 compliant, meaning that governance token holders will generally procure, hold, and transfer governance tokens much like other digital assets or cryptocurrencies. *See ERC-20 Token Standard*, ETHEREUM (Dec. 3, 2021), https://ethereum.org/en/developers/docs/standards/tokens/erc-20 [https://perma.cc/2USF-LBVG]. *But see Membership*, LAO (Mar. 9, 2021, 6:05 PM), https://docs.thelao.io/membership.html [https://perma.cc/VX7G-L3UT] (restricting membership of venture fund of the LAO's governance token to preapproved members to comply with securities laws and thus disallowing the free transfer of tokens).

15 As an example case study, this Note will examine MakerDAO's governance token, MKR. *See* MAKERDAO, THE MAKER PROTOCOL: MAKERDAO'S MULTI-COLLATERAL DAI (MCD) SYSTEM 1–2, https://makerdao.com/en/whitepaper [https://perma.cc/TNW7-8NPF] ("MakerDAO is an open-source project . . . . managed by people around the world who hold its governance token, MKR. . . . MKR holders manage the Maker Protocol and the financial risks of [MakerDAO's underlying cryptocurrency] to ensure its stability, transparency, and efficiency.").

16 PRIMAVERA DE FILIPPI & AARON WRIGHT, BLOCKCHAIN AND THE LAW: THE RULE OF CODE 137 (2018).

possesses.[17] The Securities and Exchange Commission (SEC) considers many digital assets to be securities under federal law and subject to their regulatory jurisdiction.[18] However, it is less clear that governance tokens should fall under federal securities law. The relevant legal test for securities is the *Howey* test.[19] Governance tokens possess unique characteristics that frustrate a simple *Howey* test application.[20] For example, governance tokens may be issued and disseminated not in exchange for money but to reward loyalty.[21] Additionally, governance tokens may be distributed with no suggestion or expectation that they will appreciate in value.[22] These factors defy a straightforward security classification, and governance token issuers and holders would benefit by knowing whether their governance tokens are subject to the SEC's regulatory authority.

Uniswap was not the first blockchain-based protocol to decentralize governance through the issuance of a governance token and, considering the success of these tokens, will not be the last.[23] This Note addresses a question presented in the growing trend of decentralized governance through the provision and dissemination of governance tokens: Are governance tokens securities?[24] This Note will demonstrate that not all governance tokens are securities and will provide a loose framework for designing and issuing governance tokens that are not subject to the SEC's authority.

Part I of this Note begins by looking at the relevant technical background, namely blockchain, Bitcoin, Ethereum, digital assets,

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17 *Id.*

18 *See, e.g.*, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207, 117 SEC Docket 745, at 11 (July 25, 2017) [hereinafter Section 21(a) SEC Report on The DAO], https://www.sec.gov/litigation/investreport/34-81207.pdf [https://perma.cc/N43U-VYBS].

19 SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

20 *See* discussion *infra* Section II.A.4.

21 Governance tokens may be used to reward protocol participants, enabling them to "capture value directly from DeFi application usage." Multi.io Research, *supra* note 1. These tokens are increasingly being adopted by digital asset protocols. *See* Sid Coelho-Prabhu, *A Beginner's Guide to Decentralized Finance (DeFi)*, COINBASE: THE COINBASE BLOG (Jan. 6, 2020), https://blog.coinbase.com/a-beginners-guide-to-decentralized-finance-defi-574c68ff43c4 [https://perma.cc/XRE7-LBEH].

22 *See, e.g.*, *Introducing UNI*, *supra* note 4 (introducing a governance token (UNI) that "can immediately be claimed by historical liquidity providers [and] users," making a significant number of UNI's first holders entitled to the token without being aware they were earning it, therefore providing no reasonable expectation of profit to result in obtaining the token).

23 *E.g.*, Robert Leshner, *Compound Governance*, MEDIUM: COMPOUND FIN. (Feb. 26, 2020), https://medium.com/compound-finance/compound-governance-5531f524cf68 [https://perma.cc/6H9U-BWFF].

24 Coelho-Prabhu, *supra* note 21 ("Across the DeFi ecosystem, we're also seeing a move towards decentralizing governance and decision-making.").

decentralized applications (dapps), and, finally, case studies of governance tokens. Part I then explores modern securities law and its application to digital assets. Part II analyzes several examples of governance tokens under the *Howey* test. Part III proposes a framework to assist governance token issuers seeking to avoid security classification.

I. BACKGROUND

A. *The Relevant Ecosystem*

1. Blockchain, Ethereum, and Smart Contracts

a. The Need for a Digital Currency

For decades, technologists sought a digital currency that could serve as an electronic cash payment system.[25] Internet commerce's explosion in the 1990s demanded advancements in noncash payment systems.[26] Noncash payment systems of the time, including digital checking and credit cards, have limitations.[27] Both require intermediary financial institutions to process transactions, referred to as trusted third parties.[28] Intermediaries add both cost and time in processing transactions.[29] These payment systems also require that trusted third parties bear the model's costs, including the costs of reversing payments, mediating transactions, and mitigating user fraud.[30]

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25 DE FILIPPI & WRIGHT, *supra* note 16, at 19 ("The essential substrate of cypherpunks' dream was anonymous cash and other untraceable payment systems. Starting in 1983, cypherpunks and other cryptographers began exploring the use of public-private key cryptography to build new monetary systems."); *see also* Joshua B. Konvisser, *Coins, Notes, and Bits: The Case for Legal Tender on the Internet*, 10 HARV. J.L. & TECH. 321, 321 (1997) (arguing for a government-issued electronic currency); Heather C. Alston, Note & Comment, *Will That Be Cash, Credit, or E-Money?*, 1 N.C. BANKING INST. 225, 231 (1997) (describing three prominent electronic payment systems of the time: DigiCash, CyberCash, and First Virtual Holdings).

26 *See* Konvisser, *supra* note 25, at 322.

27 *Id.* at 324–27.

28 *Id.* at 324–25.

29 *Id.* at 327 ("[O]n-line checking transactions take between twenty-four and thirty-six hours to clear.").

30 Satoshi Nakamoto explores these deficiencies in the *Bitcoin Whitepaper*:

> While [commerce on the internet] works well enough for most transactions, it still suffers from the inherent weaknesses of the trust based model. Completely non-reversible transactions are not really possible, since financial institutions cannot avoid mediating disputes. The cost of mediation increases transaction costs, limiting the

Payment systems that rely on trust require increasing trust.[31] The processing of payment transactions via increasing intermediaries also erodes personal privacy by enabling pervasive government and corporate surveillance.[32] Moreover, these systems cannot execute transfers of money amounting to pennies or less, referred to as "microtransactions."[33] As these limitations grew more apparent in internet commerce's growing wake, technologists sought a digital currency that could enable transactions in a manner that was instantaneous, low cost, and anonymous.[34]

One notable early digital currency experiment was DigiCash, a company and digital currency that launched in 1994.[35] The DigiCash company issued the currency and acted as a central clearinghouse, "fixing the supply of money and processing DigiCash transactions."[36] While DigiCash was, in theory, able to satisfy the need for instantaneous, low-cost transactions, it served as the trusted third party for all transactions, making it a centralized, client-server model.[37] The centralized nature of DigiCash proved to be its downfall as a digital currency.[38] When the company bankrupted in 1998, the dream of the

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> minimum practical transaction size and cutting off the possibility for small casual transactions, and there is a broader cost in the loss of ability to make non-reversible payments for non-reversible services. With the possibility of reversal, the need for trust spreads. Merchants must be wary of their customers, hassling them for more information than they would otherwise need. . . . [N]o mechanism exists to make payments over a communications channel without a trusted party.

SATOSHI NAKAMOTO, BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM 1 (2018), https://bitcoin.org/bitcoin.pdf [https://perma.cc/E492-KXW8].

31 *Id.*

32 *See id.*; DE FILIPPI & WRIGHT, *supra* note 16, at 18 ("According to cryptographer David Chaum, founder of the International Association for Cryptologic Research, computing technology, over time, would rob individuals of their ability to monitor and control their information, which governments and corporations would collect and use 'to infer individuals' life-styles, habits, whereabouts, and associations from data collected in ordinary consumer transactions.'" (quoting David Chaum, *Security Without Identification: Transaction Systems to Make Big Brother Obsolete*, 28 COMMC'NS ACM 1030, 1030 (1985))).

33 Konvisser, *supra* note 25, at 326–27. The advent of internet-based commerce "free[d] information distribution from medium and delivery costs . . . mak[ing] possible sales the prices of which are on the order of pennies or less." *Id.*

34 *Id.* at 326–27.

35 *Id.*; DE FILIPPI & WRIGHT, *supra* note 16, at 19.

36 DE FILIPPI & WRIGHT, *supra* note 16, at 19.

37 *Id.* ("DigiCash had a technical limitation. It operated via a client-server model, which required that [the company operating DigiCash] double-check and validate every transaction on the network. The success of DigiCash was intimately tied to, and entirely dependent on, the fate of one company. When that company went bankrupt in 1998, DigiCash crumbled with it.").

38 *Id.*

DigiCash digital currency went with it.[39] Technologists continued seeking a digital currency, but one that could operate on a decentralized model.[40]

b. Bitcoin and the Blockchain

In late 2008, one or more anonymous developers working under the name Satoshi Nakamoto answered that dream with "Bitcoin," a decentralized digital currency.[41] Nakamoto's digital currency moved away from the trusted-third-party model.[42] To do so, Nakamoto built Bitcoin on a "blockchain," a decentralized database.[43] In 2009, Bitcoin and its underlying blockchain were launched as open-source software.[44]

Blockchain advanced computer science by weaving together several existing technologies: peer-to-peer networks, public-private key encryption, and consensus mechanisms.[45] A blockchain is a network of peer-to-peer participants and a decentralized database that stores all Bitcoin transactions on the network.[46] Instead of a single party storing a database, the Bitcoin blockchain is stored redundantly by all computers participating in the network.[47] Bitcoin transactions are bundled into blocks and recorded redundantly by all network participants.[48] A new block is created approximately every ten minutes, and blocks are linked sequentially to compose a blockchain.[49] Network participants each store this distributed database and are continuously working together to reach consensus on incoming Bitcoin transactions such that the network develops the blockchain's records together; thus, all members of the network bear the responsibility of storing and maintaining Bitcoin's state.[50] To incentivize participation in the network, the protocol issues Bitcoin to participants—through newly

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39 *Id.*

40 *Id.* ("In the wake of DigiCash, a growing number of cypherpunks, including Hal Finney, Wai Dai, and Nick Szabo, embarked on a decade-long quest to build an anonymous digital currency that lacked centralized control.").

41 *Id.* at 20. *See generally* NAKAMOTO, *supra* note 30 (proposing a digital currency built on a model that does not rely on trusted third parties).

42 NAKAMOTO, *supra* note 30, at 1 ("What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.").

43 DE FILIPPI & WRIGHT, *supra* note 16, at 20.

44 *Id.* at 20–21.

45 *Id.* at 20.

46 *Id.* at 21.

47 *Id.* at 21–22.

48 *Id.* at 22.

49 *Id.* at 22, 24, 26–27.

50 *Id.* at 22–23.

minted blocks and transaction fees—in return for answering mathematical puzzles for a given block in a process called mining.[51] Mining computations, referred to as "proof of work," are scaled based on the number of participants to ensure that blocks are added roughly every ten minutes.[52] Once a miner solves a block's mathematical puzzle, the miner broadcasts its solution to the network.[53] All the network peers verify the solution and add the block to the collective Bitcoin blockchain.[54] This continuous consensus mechanism solves the need for a centralized trusted party to store and maintain a database, thereby removing the transactional costs that trusted parties bear in reversing payments, mediation, and fraudulent transactions.[55]

Bitcoin refers to both the underlying protocol and its unit of currency, represented by digital assets commonly referred to as tokens.[56] De Filippi and Wright conceptualize Bitcoin with an analogy to email.[57] Both email and Bitcoin are protocols that constitute open and interoperable networks not managed or controlled by a single party or institution.[58] Use of the email protocol, like the Bitcoin protocol, is entirely free and typically accomplished through providers operating over the protocol.[59]

Email users own and manage email addresses, sometimes tied to their own identity and sometimes pseudonymously.[60] Users send and receive email through email providers, such as Gmail.[61] These providers take on the responsibility of storing, receiving, and sending emails on behalf of their users.[62] Users access and read their emails through email clients, such as Microsoft's Outlook or Apple's Mail programs.[63] As mentioned above, the use of the email protocol is free and widely accessible.[64] Email as a protocol is interoperable, allowing users a variety of providers and clients to select from while still using the same email

51 NAKAMOTO, *supra* note 30, at 3–4; DE FILIPPI & WRIGHT, *supra* note 16, at 23–25.

52 DE FILIPPI & WRIGHT, *supra* note 16, at 24.

53 *Id.*

54 *Id.*

55 NAKAMOTO, *supra* note 30, at 1.

56 DE FILIPPI & WRIGHT, *supra* note 16, at 20–21.

57 *Id.* at 20.

58 *Id.* at 21.

59 *Id.*

60 *Id.* at 20–21.

61 *Id.* at 21.

62 *Id.*

63 *Id.*

64 *Id.*

protocol that all other users enjoy regardless of their underlying provider and client.[65]

Like email users, Bitcoin participants interact with others through an account address.[66] Where email users send and receive email through their email addresses, Bitcoin participants can execute transactions to send or receive Bitcoin to or from other addresses.[67] The client that Bitcoin participants use to interact with the Bitcoin network—analogously to how email users access email through email clients like Outlook—is a "wallet."[68] While blockchain's initial application implicated the financial industry directly as a digital currency, its success encouraged technologists to consider blockchain applications outside of just digital currencies; many of its most recent advancements have expanded to hosting distributed applications, business structures, and more.[69]

c. Ethereum

Bitcoin, like the noncash payment systems before it, came with its limitations.[70] These limitations encouraged developers to imagine and launch new blockchain applications, including "on-blockchain digital assets," representing custom currencies and financial instruments, ownership rights for physical property, nonfungible assets such as intellectual property rights, blockchain-based decentralized autonomous organizations, and complex decentralized applications.[71] Ethereum enables all of these and more, but its most relevant application here is its use as a medium to deploy, host, and maintain dapps.[72]

In 2013, Vitalik Buterin proposed the Ethereum protocol in the *Ethereum Whitepaper*.[73] Ethereum launched in 2015, and, like Bitcoin,

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65 *Id.*

66 *Id.*

67 *Id.*

68 *Id.*

69 *Id.* at 27; *see, e.g.*, Larissa Lee, *New Kids on the Blockchain: How Bitcoin's Technology Could Reinvent the Stock Market*, 12 HASTINGS BUS. L.J. 81 (2016) (hypothesizing blockchain solutions covering transactions to intangible property rights).

70 DE FILIPPI & WRIGHT, *supra* note 16, at 27 (describing Bitcoin's limitations such as the slowness of the network in requiring ten minutes to validate transactions, lack of governance, and difficulty in improving the protocol).

71 Ethereum is a blockchain protocol similar to Bitcoin. Ethereum's focus is on building decentralized applications. VITALIK BUTERIN, ETHEREUM WHITEPAPER (2021), https://ethereum.org/en/whitepaper [https://perma.cc/4DWL-62N8]; DE FILIPPI & WRIGHT, *supra* note 16, at 27.

72 BUTERIN, *supra* note 71; DE FILIPPI & WRIGHT, *supra* note 16, at 27–28.

73 BUTERIN, *supra* note 71.

it is a free and open-source protocol.[74] It implemented another digital currency, called ether or "ETH,"[75] that incentivized participants in a similar mining or proof-of-work consensus-building system.[76] However, the Ethereum blockchain is faster, a new block being generated roughly once every twelve seconds as opposed to Bitcoin's ten minutes.[77] Ethereum also implemented a programming language, which allows programmers to write and deploy code to the Ethereum blockchain in the form of smart contracts.[78] Decentralized applications, called "dapps," are web services or protocols that enable people to interact with smart contracts.[79] Just as transactions stored on the blockchain are decentralized and highly resilient, applications deployed on the blockchain are also decentralized and highly resilient.[80]

Smart contracts can be conceptualized by returning to the email protocol.[81] To send and receive emails, users possess an account that has a unique email address; in Ethereum, users and smart contracts each possess accounts with unique addresses to enable them to send and receive tokens.[82] A smart contract executes its code when it receives a transaction with some inputs, whether from a user or another smart contract—similar to if a program or task was set to execute whenever an email address receives an email based on the email's contents.[83] A traditional analogy for smart contracts compares them to a vending machine: by entering funds into a vending machine and selecting an option, the user receives her product.[84] Through these mechanisms, a dapp enables users to interact with smart contracts to form a decentralized exchange: the user sends some amount of ETH into the decentralized exchange's dapp account and, in exchange, receives some other digital currency she requests.[85]

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74 DE FILIPPI & WRIGHT, *supra* note 16, at 27–28.

75 *See generally Welcome to Ethereum*, ETHEREUM, https://ethereum.org/en [https://perma.cc/FE7U-RBKU].

76 DE FILIPPI & WRIGHT, *supra* note 16, at 28.

77 *Id.*

78 BUTERIN, *supra* note 71; DE FILIPPI & WRIGHT, *supra* note 16, at 28.

79 *Decentralized Applications (dapps): Ethereum-Powered Tools and Services*, ETHEREUM (Dec. 22, 2021) [hereinafter *Decentralized Applications*], https://ethereum.org/en/dapps [https://perma.cc/9AZG-8T2D]; *Introduction to dapps*, ETHEREUM (Dec. 22, 2021), https://ethereum.org/en/developers/docs/dapps [https://perma.cc/5M2R-L2JZ].

80 *Decentralized Applications*, *supra* note 79.

81 *See supra* notes 57–69 and accompanying text.

82 DE FILIPPI & WRIGHT, *supra* note 16, at 20–21, 28.

83 *Id.* at 28–29.

84 *Decentralized Applications*, *supra* note 79.

85 *See, e.g.*, discussion on Uniswap *infra* Section I.A.3.d.

Bitcoin, Ethereum, and blockchain all present significant advancements in decentralized technology.[86] Decentralized technology presents substantial regulatory challenges.[87] Experts have compared the decentralization resulting from blockchain's adoption to that experienced at the advent of the internet.[88] Just as the internet decentralized businesses and presented significant regulatory challenges, blockchain has and will continue to challenge traditional regulatory structures.[89] As Wright and De Filippi explain, regulatory bodies often rely on a centralized authority to levy regulations.[90] Decentralized technology, thus, is inherently challenging to regulate.[91] States and regulatory bodies, including the SEC, have been working to regulate blockchain advancements such as smart contracts, addressing capital-raising enterprises or states enacting legislation to give smart contracts legal enforceability.[92]

2. Token Types

Blockchain transactions represent the transfer of digital assets referred to as tokens.[93] Jonathan Rohr and Aaron Wright articulate several token classifications.[94] The first classification distinguishes the

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86 Aaron Wright & Primavera De Filippi, Decentralized Blockchain Technology and the Rise of Lex Cryptographia 2, 17 (July 25, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2580664 (last visited Jan. 3, 2022); Kevin Werbach, *Trust, but Verify: Why the Blockchain Needs the Law*, 33 BERKELEY TECH. L.J. 487 (2018); Gerald Spindler, *Fintech, Digitalization, and the Law Applicable to Proprietary Effects of Transactions in Securities (Tokens): A European Perspective*, 24 UNIF. L. REV. 724, 725–26 (2019).

87 *See* Wright & De Filippi, *supra* note 86, at 17, 19–20.

88 *Id.* at 2–3.

89 *Id.* at 2.

90 *Id.* at 18.

91 *Id.* at 3–4. Wright and De Filippi discuss some of the peculiar difficulties governments face in regulating blockchain-based organizations. *Id.* at 19–24. "[T]he transnational, encrypted, and decentralized nature of blockchain-based applications . . . . along with the pseudonymity provided by the blockchain, may make it increasingly difficult for law enforcement agencies to identify and prosecute the users of these emergent technologies." *Id.* at 56.

92 *See, e.g.*, Alexis Collomb, Primavera De Filippi & Klara Sok, *Blockchain Technology and Financial Regulation: A Risk-Based Approach to the Regulation of ICOs*, 10 EUR. J. RISK REG. 263, 264 (2019) (examining both U.S. and European regulations of ICOs); Craig A. de Ridder, Mercedes K. Tunstall & Nathalie Prescott, *Recognition of Smart Contracts in the United States*, 29 INTELL. PROP. & TECH. L.J. 17, 17 (2017) (overviewing the efforts of enterprising states in providing formal legal recognition to smart contracts); *see also* Erika J. Nash, *Blockchain & Smart Contract Technology: Alternative Incentives for Legal Contract Innovation*, 2019 BYU L. REV. 799 (analyzing the smart contract).

93 DE FILIPPI & WRIGHT, *supra* note 16, at 4.

94 Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, 70 HASTINGS L.J. 463, 470, 474–77 (2019).

asset as either a "protocol token" or an "application token."[95] Protocol tokens represent the core assets of their protocol.[96] For example, this Note has already discussed two popular protocol tokens: Bitcoin is the protocol token, or digital currency, for its underlying Bitcoin protocol, and Ether is the protocol token for the Ethereum protocol.[97]

In contrast, application tokens are organized around online services and projects.[98] Application tokens run on the protocols that underlie protocol tokens, most commonly on the Ethereum protocol specifically.[99] Someone seeking to create an application token deploys a smart contract program that handles how the new application token is minted and issued and records who owns the token.[100] While application tokens are often created for narrower purposes than protocol tokens, they can still imbue their holder with rights and privileges that were not previously possible.[101]

Rohr and Wright divide application tokens into "investment token" and "utility token" subtypes.[102] An investment token gives its holder an economic right to share profits generated by some project or organization.[103] The SEC has spent significant efforts on enforcement actions involving digital assets that operate as investment tokens.[104] For many entrepreneurs, cryptocurrencies represented a unique opportunity to crowdfund from a much broader audience than traditional project funding sources.[105] Initial coin offerings (ICOs), or token sales, began to flood the market starting in 2013 as entrepreneurs

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95 *Id.* at 470, 474.

96 *Id.* at 470–72.

97 These protocol tokens are the original blockchain-based digital assets. They incentivize participation in the blockchain for transacting parties and miners. *Id.*

98 *Id.* at 474 n.52 ("Another way to characterize these tokens is as 'sub-currencies' for individual applications or organizations or 'app coins.'").

99 *Id.* at 474 ("[T]hey are generally created by deploying a smart contract program on the Ethereum network . . . . By using a smart contract . . . developers can set up and generate their own cryptographically secured tokens, which can be assigned various economic, voting, participation, consumptive, or utilization rights.").

100 *Id.* ("Indeed, the Ethereum developer community has created a standardized smart contract, known as the ERC20 token standard, which makes it possible for anyone to issue a token using less than 100 lines of smart contract code.").

101 *Id.* at 475.

102 *Id.* at 475–77.

103 *Id.* at 476.

104 *See, e.g.*, SEC v. Shavers, No. 13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013); Erik T. Voorhees, Securities Act Release No. 9592, 109 SEC Docket 3, 2014 WL 2465620 (June 3, 2014).

105 Philipp Hacker, *Corporate Governance for Complex Cryptocurrencies? A Framework for Stability and Decision Making in Blockchain-Based Organizations*, *in* REGULATING BLOCKCHAIN. TECHNO-SOCIAL AND LEGAL CHALLENGES 140 (Philipp Hacker, Ioannis Lianos, Georgios Dimitropoulous & Stefan Eich eds., 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2998830 (last visited Jan. 27, 2022).

began imagining new methods of raising capital.[106] Many of these were scams, fraudulent, or just never ended up manifesting into value.[107] Regulatory agencies immediately began working on clarifying the law surrounding ICOs.[108]

In contrast to investment tokens, a utility token gives its holder a right to access some service or participate in an organization.[109] The investment and utility classifications are not mutually exclusive, and many tokens possess both investment and utility characteristics.[110] For example, the token may give the user the right to access a service while also permitting them to profit from the same service.[111]

Governance tokens are a subset of utility tokens.[112] Governance tokens grant their holder a utility in the form of the right to participate in the organization's governance decisions.[113] The token holder manages the token in the same manner that she does her other digital assets such as Ethereum or Bitcoin (protocol tokens).[114] However, she uses her governance token to vote on governance decisions presented to her organization.[115] Governance token holders establish communities where they debate, propose, and vote on changes in their underlying protocol or organization.[116] While a token holder may have acquired their governance token by purchasing it, users may also be awarded governance tokens based on their participation in or use of the organization's services or protocol.[117] Like a managing member of a

106 Collomb, De Filippi & Sok, *supra* note 92, at 264 (examining both U.S. and European sales, tracking legal development, and proposing a method of regulation).

107 As Collomb, De Filippi, and Sok compare risks of ICOs to those of traditional IPOs, "a study prepared by ICO advisory firm Satis Group revealed that 'more than 80 percent of initial coin offerings conducted in 2017 were identified as scams,' though they 'received very little funding when compared with the industry as a whole.'" *Id.* at 294 (quoting Ana Alexandre, *New Study Says 80 Percent of ICOs Conducted in 2017 Were Scams*, COINTELEGRAPH (July 13, 2018), https://cointelegraph.com/news/new-study-says-80-percent-of-icos-conducted-in-2017-were-scams [https://perma.cc/Y7X3-UUF6]).

108 For a discussion of the different policy objectives underlying regulation, see *id.* at 271–76.

109 Rohr & Wright, *supra* note 94, at 475.

110 Tokens used by The DAO possessed both investment and utility characteristics. *See* discussion *infra* Section II.A.

111 *See, e.g.*, Rohr & Wright, *supra* note 94, at 476.

112 *See The Different Types of Cryptocurrency Tokens Explained*, MAKERDAO: MAKER BLOG (Feb. 11, 2020), https://blog.makerdao.com/the-different-types-of-cryptocurrency-tokens-explained [https://perma.cc/AJH7-PT3M].

113 Rohr & Wright, *supra* note 94, at 475.

114 *Id.* at 474.

115 Ali Abugheida, *Budding Decentralized Finance Industry Comes with Risks*, LAW360 (Aug. 21, 2020, 6:06 PM), https://www.law360.com/articles/1300085/budding-decentralized-finance-industry-comes-with-risks (last visited Sept. 29, 2021).

116 *Id.*

117 *Id.*

limited liability corporation has a say over her company's direction, a governance token holder becomes like a managing member of a decentralized autonomous organization (DAO).[118]

3. Governance Token Case Studies

Governance tokens are increasingly common within decentralized finance (DeFi).[119] DeFi is a term referring to alternative financial systems launched on the Ethereum protocol.[120] It encompasses applications that enable digital-asset holders to leverage their tokens to achieve just about any economic utility that a traditional financial institution can typically perform, including lending, borrowing, interest yielding, and exchanging.[121]

Ethereum's application-focused design has enabled creators to dive into additional financial applications beyond capital raising[122] and into applications that are increasingly less finance-centric.[123] For example, entrepreneurs are revolutionizing traditional business structures by forming DAOs.[124] A DAO is a digital organization deployed on blockchain smart contracts.[125] These organizations can coordinate disparate groups of people to operate much like a

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118 *See* Adam Bavosa, *Building a Governance Interface*, MEDIUM: COMPOUND FIN. (Apr. 22, 2020), https://medium.com/compound-finance/building-a-governance-interface-474fc271588c [https://perma.cc/XP6J-N46A].

119 Coelho-Prabhu, *supra* note 21.

120 Abugheida, *supra* note 115.

121 *Id.*; *see, e.g.*, Leeor Shimron, *DeFi Yield Farmers and Crypto Investors Are Raking in 100%+ Annualized Yields*, FORBES (June 22, 2020, 8:50 AM), https://www.forbes.com/sites/leeorshimron/2020/06/22/defi-yield-farmers-and-crypto-investors-are-raking-in-100-annualized-yields [https://perma.cc/56JP-67UE].

122 *See, e.g.*, *What Is the LAO?*, LAO (Mar. 9, 2021, 5:55 PM), https://docs.thelao.io [https://perma.cc/SV7U-NXZZ] (venture capital fund DAO deployed as an application running on Ethereum); MAKERDAO, *supra* note 15, at 4–6 (proposing DeFi protocol that mints digital assets and manages loans).

123 For a guide with examples of Ethereum-based assets moving beyond traditional financial tools from collectibles to property-right-bestowing tokens, see Bennett Garner, *What Are NFTs? Non-Fungible Tokens, Explained*, COINCENTRAL (Feb. 20, 2021), https://coincentral.com/nfts-non-fungible-tokens [https://perma.cc/8F8D-8K35].

124 *See generally* DE FILIPPI & WRIGHT, *supra* note 16, at 131–33.

125 This makes DAOs decentralized applications, or "dapps." *See supra* Section I.A.1.c. For a deeper discussion of DAOs and dapps, their originals, and how the terms are related, see, for example, Gavin Yue, *What's the Difference Between DApp, iDApp and DAO? And Why They Are the Future of Blockchain?*, MEDIUM: START IT UP (June 5, 2018), https://medium.com/swlh/whats-the-difference-between-dapp-idapp-and-dao-and-why-they-are-the-future-of-blockchain-52758f50474e (last visited Jan. 4, 2022).

corporation of loosely coupled managers.[126] A DAO can make governance decisions based on an algorithm, or it may allow its participants to vote on the outcome of governance proposals, effectively decentralizing governance democratically among its participants.[127] One way to achieve such a governance mechanism is through the use of a governance token.[128] DAOs manage many DeFi protocols today.[129]

A second use for governance tokens exists in segmenting organizational governance decisions.[130] Corporations are legally obligated to act as fiduciaries to their stakeholders and are required to act in the company's best financial interest.[131] In contrast, governance tokens and the general movement of decentralizing governance offer mechanisms by which an organization can part from the limits of traditional business structures by segmenting governance decisions to invested communities. This potentially optimizes the balance of interests between traditional business organizations and the communities that an organization serves.[132] Several protocol-based organizations have begun eschewing traditional centralized-governance structures in favor of decentralized governance, which is made possible by governance tokens.[133] This Section examines four governance token

126 *See Organization*, LAO (Apr. 22, 2020, 2:25 PM), https://docs.thelao.io/organization.html [https://perma.cc/87U8-9PZ9].

127 Vitalik Buterin, *DAOs, DACs, DAs and More: An Incomplete Terminology Guide*, ETHEREUM FOUND. BLOG (May 6, 2014), https://blog.ethereum.org/2014/05/06/daos-dacs-das-and-more-an-incomplete-terminology-guide [https://perma.cc/8NN9-UFXY] (exploring various forms of decentralized autonomous entities made possible by blockchain technology); *see also* Ying-Ying Hsieh, Jean-Philippe Vergne, Philip Anderson, Karim Lakhani & Markus Reitzig, *Bitcoin and the Rise of Decentralized Autonomous Organizations*, 7 J. ORG. DESIGN, no. 14, 2018.

128 *See* Bavosa, *supra* note 118.

129 *See, e.g.*, *infra* Sections I.A.3.b–I.A.3.d.

130 *See* David B. Guenther, *The Strange Case of the Missing Doctrine and the "Odd Exercise" of* Ebay: *Why Exactly Must Corporations Maximize Profits to Shareholders?*, 12 VA. L. & BUS. REV. 427 (2018) (examining why for-profit corporations have a duty to shareholders to maximize profits).

131 *See id.*

132 "By using blockchain-based autonomous code, organizations can divide duties and deploy smart contract code that bars any organizational transaction from happening without the express approval of multiple parties." DE FILIPPI & WRIGHT, *supra* note 16, at 135. Implementing and administering routine operations and control mechanisms such as stakeholder voting through a blockchain can promote transparency and precision and allow for such procedures to be streamlined and automated. *Id.* at 133–34.

133 Coelho-Prabhu, *supra* note 21 ("Across the DeFi ecosystem, we're also seeing a move towards decentralizing governance and decision-making. Despite the word 'decentralized' in DeFi, many projects today have master keys for the developers to shut down or disable dapps. This was done to allow for easy upgrades and provide an emergency shutoff valve in case of buggy code. However, as the code becomes more battle-tested, we expect developers will give up these

case studies: The DAO and the DAO Token, MakerDAO and the MKR token, Compound and the COMP token, and Uniswap and the UNI token.

a. The DAO

The DAO was a digital organization embodied in computer code executed on the Ethereum blockchain.[134] Its purpose was to coordinate crowdfunding to raise funds to grow companies in the crypto space.[135] Interested parties would invest by purchasing DAO Tokens in exchange for Ether.[136] DAO Tokens (1) represented an entitlement to future proceeds on the organization's investments, allowing the holder to share in The DAO's anticipated earnings; and (2) entitled the token holder to vote on contract proposals, including investment proposals submitted to The DAO.[137] However, many of The DAO's assets were stolen before its launch.[138] The Ethereum community was able to recover the losses, but The DAO shuttered shortly afterward.[139]

b. MakerDAO and MKR

MakerDAO is an open-source management DAO that governs the Maker Protocol.[140] The Maker Protocol is a DeFi protocol in which users deposit digital assets as collateral and, in return, are loaned newly minted Dai.[141] A holder's share of governance tokens establishes voting rights, which, in MakerDAO, are reflected by an Ethereum-compliant token named MKR.[142] MakerDAO has a variety of voting mechanisms handled via smart contracts on the Ethereum blockchain.[143] Anyone,

backdoor switches. The DeFi community is experimenting with ways to allow stakeholders to vote on decisions, including through the use of blockchain-based Decentralized Autonomous Organizations (DAOs).").

134 Christoph Jentzsch, *The History of the DAO and Lessons Learned*, MEDIUM: SLOCK.IT BLOG (Aug. 24, 2016), https://blog.slock.it/the-history-of-the-dao-and-lessons-learned-d06740f8cfa5 [https://perma.cc/G8Z6-TKKT].

135 *Id.*

136 *Id.*

137 *Id.*

138 *Id.*

139 *Id.*; Usman W. Chohan, The Decentralized Autonomous Organization and Governance Issues 1–2 (Dec. 4, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3082055 (last visited Jan. 4, 2022).

140 MAKERDAO, *supra* note 15, at 1–2.

141 Dai is a digital asset and therefore is used and maintained by Dai holders, much like Ethereum, Bitcoin, and governance tokens such as MKR. *Id.* at 5.

142 *Id.* at 1–2.

143 *What Is MKR?*, MAKERDAO: MAKER BLOG (Sept. 10, 2015), https://blog.makerdao.com/what-is-mkr [https://perma.cc/F3GV-AHQ3].

even nontoken holders, may submit proposals.[144] A proposal contract is programmed to execute sometime following its approval and could, among other responsibilities, accept a new collateral type, vote to ratify risk parameters or interest rates, trigger an emergency shutdown, allocate funds for infrastructure needs, or upgrade the system.[145]

c. Compound and COMP

Compound is a protocol that establishes money markets for users to supply or borrow digital assets.[146] Compound unveiled COMP to start decentralizing the Compound protocol.[147] Compound's leadership retained some protections in launching the COMP token, including the ability to suspend the governance system and a mandatory two-day timelock on approved decisions.[148] COMP token holders can propose and vote on changes to the protocol and delegate their votes to others.[149] Compound's founders expressly wrote that COMP was not meant for fundraising or as an investment opportunity.[150] Furthermore, until Compound could fully decentralize, COMP would not be available to the public, limiting access to the token until the COMP token was tested and a community ideally developed.[151]

d. Uniswap and UNI

Uniswap is a decentralized exchange for crypto assets.[152] Crypto users can become liquidity providers by depositing two types of Ethereum-compliant[153] tokens to Uniswap's liquidity pools.[154] When a user seeks to trade one crypto asset for another, her trade utilizes the liquidity provider's pool, generating a cut for both the liquidity provider and Uniswap.[155] On September 16, 2020, Uniswap introduced its governance token, UNI, to decentralize the Uniswap protocol's

144 MAKERDAO, *supra* note 15, at 13.

145 *Id.* at 13–14.

146 ROBERT LESHNER & GEOFFREY HAYES, COMPOUND: THE MONEY MARKET PROTOCOL 2–3 (2019), https://compound.finance/documents/Compound.Whitepaper.pdf [https://perma.cc/YU39-ASNJ].

147 Leshner, *supra* note 23.

148 *Id.*

149 *Id.*

150 *Id.*

151 *Id.*

152 *Uniswap Protocol*, UNISWAP, https://uniswap.org [https://perma.cc/Z9ZQ-TL8F].

153 *ERC-20 Token Standard*, *supra* note 14.

154 *How Uniswap Works*, *supra* note 4.

155 *Id.*

governance.[156] The first fifteen percent of UNI tokens were made available to historical users and liquidity providers.[157] UNI was earned not in exchange for purchases, but in exchange for providing liquidity to Uniswap's liquidity pools, and in proportion to the amount of liquidity provided.[158] Uniswap announced that UNI holders would immediately have ownership of Uniswap's governance, the community treasury, and various governance parameters.[159]

B. *The Securities and Exchange Commission*

The Securities Act of 1933 and the Securities Exchange Act of 1934 authorize the SEC to regulate securities and security exchanges.[160] The SEC may make, amend, and rescind rules and regulations of securities and security exchanges.[161] All securities offered and sold must be registered with the SEC or must qualify under an exemption.[162] Registered securities have to comply with the SEC's rules and regulations.[163] To enforce its authority, the SEC may bring enforcement actions, seek cease and desist orders, impose fines, investigate violations, perform compliance examinations, publish reports, and more.[164] When the SEC attempts to enforce its authority, the enforcement subject may argue that their financial instrument is not a security, requiring the SEC to demonstrate that it has regulatory jurisdiction because the instrument is a security.[165]

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156 *Introducing UNI*, *supra* note 4 ("UNI officially enshrines Uniswap as publicly-owned and self-sustainable infrastructure while continuing to carefully protect its indestructible and autonomous qualities.").

157 *Id.*

158 *Id.*

159 *Id.*

160 15 U.S.C. §§ 77b, 78d.

161 *Id.* § 77s.

162 *See id.* §§ 77d–77e.

163 *E.g.*, *id.* § 78*l* (outlining registration requirements for securities); *id.* § 77e (outlining prohibitions relating to securities in interstate commerce).

164 *Id.* §§ 77t, 77v, 78u, 78aa.

165 *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (holding that units of a citrus grove and a contract to cultivate them were investment contracts and thus subject to securities regulations).

1. The *Howey* Test: Identifying Securities

Section 2(a)(1) of the Securities Act provides that a security includes investment contracts.[166] However, the term investment contract is not defined in the Securities Act and is left to the courts' interpretation.[167] In 1946, the Supreme Court articulated a test defining investment contracts in *SEC v. W.J. Howey Co*.[168]

In *Howey*, a Florida corporation, the Howey Company, sold land sales contracts for strips of farmland to purchasers who had no professional knowledge or experience in agriculture.[169] These contracts conveyed the land to the purchaser but retained a leasehold interest for Howey-in-the-Hills Service, Inc.[170] The agreement promised the purchasers substantial profits and granted the company complete discretion and authority over cultivating, harvesting, and marketing the crops.[171] The Howey Company sought to advertise to prospective purchasers via mail, and the SEC filed for an injunction to stop the practice.[172]

To define an investment contract's elements, the Court found no definition in the Securities Act or legislative reports and looked to state "blue sky"[173] laws.[174] The Court held that an investment contract is a contract, transaction, or scheme in which: (1) a person invests money; (2) in a common enterprise; (3) and is led to expect profits; (4) from the efforts of another.[175] To capture the statutory purpose of the Securities Act, the *Howey* test is flexible.[176] Therefore, it determines investment contracts by examining case by case the substance rather than the form of the contract, transaction, or scheme.[177]

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166 § 77b(a)(1).

167 *Howey*, 328 U.S. at 298.

168 328 U.S. 293.

169 *Id.* at 295–96.

170 *Id.*

171 *Id.* at 296.

172 *Id.* at 294, 296–97.

173 Predecessors to federal securities laws, "blue sky" laws were state laws enacted prior to the federal Securities Act that targeted speculative schemes "to put a stop to the sale of shares in visionary oil wells, nonexistent gold mines, and other 'get-rich-quick' schemes calculated to despoil credulous individuals of their savings." State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920).

174 *Howey*, 328 U.S. at 298.

175 *Id.* at 298–99; *see* Section 21(a) SEC Report on The DAO, *supra* note 18, at 11.

176 *Howey*, 328 U.S. at 298–99.

177 *Id.* at 298 ("Form was disregarded for substance and emphasis was placed upon economic reality.").

The Court applied the *Howey* test to the Howey Company's operation and found that it had been offering investment contracts.[178] The Howey Company provided investors the opportunity to contribute money and share its citrus fruit business's profits.[179] The investors provided no equipment, labor, or experience to the enterprise.[180] The investors were attracted to the investment by the prospect of earning a profit from the Howey Company's efforts.[181] As a result, the Supreme Court found that the Howey Company's arrangement involved investment contracts and, therefore, was within the Securities Act's scope.[182]

2. SEC Applies *Howey* to The DAO

The DAO was the first major experiment in decentralized governance.[183] Despite The DAO having shuttered, the SEC published a nonbinding opinion analyzing whether its underlying digital asset, the DAO Token, was a security.[184] The SEC applied the *Howey* test and concluded that DAO Tokens were securities.[185]

The first requirement is an investment of money, and it need not take the form of cash.[186] DAO Tokens were received in exchange for a payment in Ether, and such a contribution of value can create an investment contract.[187] In token sales, transactions entirely in digital assets still satisfy an investment of money.[188] The *Howey* test disregards

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178 *Id.* at 299 ("The transactions in this case clearly involve investment contracts as so defined.").

179 *Id.* at 299–300.

180 *Id.*

181 *Id.* at 300.

182 *Id.* ("[A]ll the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts . . . .").

183 *See supra* Section I.A.3.a.

184 *See generally* Section 21(a) SEC Report on The DAO, *supra* note 18, at 11.

185 *Id.* (citing 15 U.S.C. §§ 77b–77c).

186 *Id.*

187 *See* SEC v. Shavers, No. 13-CV-416, 2014 WL 4652121, at *8 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin meets the first prong of *Howey*).

188 Section 21(a) SEC Report on The DAO, *supra* note 18, at 2 ("This Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, 'smart contracts,'

the transaction's form in favor of the transaction's substance and economic reality.[189] Hence, for an investment contract analysis, Bitcoin counts as money.[190] Since 2013, the SEC has issued a panoply of SEC actions based on investments made via Bitcoin.[191] Investments made with digital assets such as Bitcoin create investment contracts under the *Howey* test.[192]

Second, *Howey* looks to whether the investment is in a common enterprise.[193] The SEC determined that investors who purchased DAO Tokens invested in a common enterprise—The DAO.[194] The SEC's treatment of this prong was brief, stating simply that this element was fulfilled without going into detail.[195]

Third, the *Howey* test looks to whether the investor had a reasonable expectation of profits.[196] The SEC determined that this requirement is satisfied because The DAO's developing organization, Slock.it, and its cofounders spent considerable efforts advertising The DAO, including producing promotional materials and publishing blog posts.[197] The SEC then determined that "a reasonable investor would have been motivated, at least in part, by the prospect of profits" from The DAO.[198]

The *Howey* test's final element requires that the investment's expected profits are derived from others' efforts.[199] While the

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or computer code, does not remove conduct from the purview of the U.S. federal securities laws."); *see also* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) ("[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a "security."'"); Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) ("Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called.").

189 SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

190 SEC v. Shavers, No. 13-CV-416, 2013 WL 4028182, at *1–2 (E.D. Tex. Aug. 6, 2013) (rejecting an argument that subject "investments are not securities because Bitcoin is not money, and is not part of anything regulated by the United States" because "it can also be exchanged for conventional currencies, such as the U.S. dollar" and that "[t]herefore, Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money").

191 *See, e.g.*, Erik T. Voorhees, Securities Act Release No. 9592, 109 SEC Docket 3, 2014 WL 2465620 (June 3, 2014).

192 *Shavers*, 2013 WL 4028182, at *1–2.

193 Section 21(a) SEC Report on The DAO, *supra* note 18, at 11.

194 *Id.*

195 *Id.*

196 *Id.*

197 *Id.* at 11–12.

198 *Id.* at 12.

199 *Id.*

managerial efforts of Slock.it's cofounders and The DAO's curators were significant in deriving profits, DAO Token holders possessed voting rights.[200] The DAO's token holders may have been deriving profit from their own efforts—potentially obviating the final element of the *Howey* test—in the form of voting for funding proposals, which would require research and due diligence.[201] In the end, the SEC determined that the efforts of Slock.it, its cofounders, and The DAO's curators were essential to the enterprise and outweighed the limited voting rights possessed by DAO Token holders.[202]

II. ANALYSIS

A. *Applying* Howey *to Governance Tokens*

The *Howey* test then provides that an investment contract is (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the entrepreneurial or managerial efforts of others.[203] In this Section, the *Howey* test is applied to several governance token case studies.

1. An Investment of Money

Case law has established that the investment of cryptocurrencies satisfies the "investment of money" requirement.[204] However, many of the governance tokens issued today are not exchanged for an investment of money.[205] For example, interested parties accrue the COMP governance token as they use the Compound protocol.[206] Thus, the token is accrued not for money, but for the use of the protocol,

200 *Id.*

201 *Id.*

202 *Id.* at 14 ("The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders' ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.").

203 *Id.* at 11.

204 "The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration." SEC, FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS 2 (2019), https://www.sec.gov/files/dlt-framework.pdf [https://perma.cc/TFP8-JHJY].

205 *See, e.g.*, *Introducing UNI*, *supra* note 4.

206 Bavosa, *supra* note 118.

almost like a loyalty or rewards program.[207] This loyalty program then enables the loyal token holder to guide her protocol by voting to adjust the interest rate model or add support for a new asset.[208]

However, several arguments could be raised that COMP token holders acquired their tokens through the investment of money regardless of how directly they acquired them. First, while the governance token is received in exchange for the Compound protocol, Compound is a financial protocol, and use of the protocol requires an investment of money within the scope of *Howey*.[209] Placing digital assets into the Compound protocol to receive compounding interest necessarily begins with investing money.[210] A user seeking to take a loan through the Compound protocol must first deposit digital assets to serve as collateral, which likewise entails transferring money.[211] Second, any use of the Compound protocol, including the claiming, transfer, and use of COMP tokens, requires the user to pay Ethereum's gas fees.[212] To the SEC, the placement of assets and gas fees may equate to an investment of money to satisfy the first element of a *Howey* analysis.[213] Finally, the COMP governance tokens are Ethereum compliant and thus freely transferrable assets.[214] This allows them to be sold and purchased on secondary markets and traded in exchange for digital assets.[215] The token has a market value and can be procured by parties that have never used the Compound protocol.

2. In a Common Enterprise

The second element of the *Howey* test requires that the investment was made in a common enterprise.[216] The SEC has stated that in evaluating digital assets, a common enterprise typically exists.[217] A

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207 *Id.*

208 *Governance*, COMPOUND, https://compound.finance/docs/governance [https://perma.cc/ATV8-58EK].

209 *See* Bavosa, *supra* note 118 ("To receive COMP, use the Compound protocol on Ethereum . . . .").

210 *See id.*

211 *See id.*

212 DE FILIPPI & WRIGHT, *supra* note 16, at 29.

213 The SEC has been clear that the transfer of digital assets can constitute the investment of money, and the gas fee associated with the transaction—while not directly in exchange for the investment contract—is the first node in a chain reaction that ends with the governance token eventually being issued. *See* Section 21(a) SEC Report on The DAO, *supra* note 18, at 11.

214 *ERC-20 Token Standard*, *supra* note 14.

215 For a decentralized exchange, see *Uniswap Protocol*, *supra* note 152.

216 SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

217 SEC, *supra* note 204, at 2.

common enterprise exists where there is horizontal commonality and sometimes where there is vertical commonality.[218] Horizontal commonality is where each individual investor's fortunes are tied together with the success of the overall venture—investors' fortunes rise and fall together with those of the common enterprise.[219] Horizontal commonality requires the investors to pool their assets, which are often combined with the pro-rata distribution of profits.[220]

Circuits diverge on whether and in what circumstances vertical commonalities are sufficient to satisfy *Howey*'s common enterprise requirement.[221] Vertical commonalities focus on the relationship between the promoter and the enterprise's investors. In contrast with horizontal commonalities, investors' fortunes in vertical commonalities may rise and fall separately.[222] Vertical commonality has two forms: broad vertical commonality and strict vertical commonality.[223] In broad vertical commonality, the fortunes of the investors are not linked to the fortunes of the promoter, but rather to the promoter's *efforts*.[224] In strict vertical commonality, the fortunes of the investors are directly linked to the promoter's *fortunes*.[225] Circuits are more likely to find that strict vertical commonalities are consistent with *Howey*'s common enterprise requirement than they are with broad vertical commonalities.[226]

One argument that technologists may raise—which will likely fail—is that DeFi protocols and DAOs are fundamentally of such an incomparably different nature to traditional enterprises that they are

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218 *E.g.*, Revak v. SEC Realty Corp., 18 F.3d 81, 87–88 (2d Cir. 1994); Hart v. Pulte Homes of Mich. Corp., 735 F.2d 1001, 1004 (6th Cir. 1984).

219 *Revak*, 18 F.3d at 87; *Hart*, 735 F.2d at 1004.

220 *Revak*, 18 F.3d at 87; *Hart*, 735 F.2d at 1004.

221 *Revak*, 18 F.3d at 87.

222 *Id.*

223 *Id.*

224 *Id.* at 87–88; Long v. Shultz Cattle Co., 881 F.2d 129, 140–41 (5th Cir. 1989).

225 *Revak*, 18 F.3d at 88; Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978).

226 The Fifth and Eleventh Circuits have held that *Howey*'s common enterprise requirement may be satisfied by broad vertical commonalities. SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974). The Ninth Circuit has held that strict vertical commonalities may demonstrate a common enterprise. SEC v. Eurobond Exch., Ltd., 13 F.3d 1334, 1339 (9th Cir. 1994). The Second Circuit has explicitly held that broad vertical commonalities do not satisfy *Howey*'s common enterprises requirement but has not decided whether strict vertical commonalities satisfy *Howey*'s common enterprise requirement. *Revak*, 18 F.3d at 88; SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169, 178 n.5 (S.D.N.Y. 2020) ("The Second Circuit has expressly rejected broad vertical commonality, which only requires the fortunes of the investors to be linked to the efforts of the promoter. The Second Circuit has not yet decided whether strict vertical commonality, which requires that the fortunes of the investor be tied to the fortunes of the promoter, can satisfy the 'common enterprise' element of the *Howey* test." (citing *Revak*, 18 F.3d at 87–88)).

not in a common enterprise as has traditionally been defined.[227] These arguments will likely fail as courts applying the *Howey* test focus on the substance underlying the circumstances.[228] But DeFi protocols and DAOs still use tokens as a means of collectively pooling assets, tying the investor's fortunes to the protocol promoter's fortunes, thereby creating a horizontal commonality and satisfying the common enterprise requirement.[229] Thus, an investment in a blockchain-based organization can create an investment contract regardless of novelty in the organization's structure.[230]

3. With a Reasonable Expectation of Profits

The third element, requiring a reasonable expectation of profits, is a fact-dependent inquiry.[231] Courts look beyond the formal terms of the parties' agreement to find whether a reasonable expectation of profits was created.[232] A reasonable expectation of profits may be created by promotional materials, advertising, or other communications from the

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227 Indeed, DeFi protocols may look as different from modern software-based companies as modern software companies looked to traditional brick-and-mortar business. DeFi protocols are just an application, not an organization. The members of a DAO, in contrast to corporate stakeholders, tend to be comprised of loosely coupled disparate groups of people in a trustless system. *See, e.g.*, *supra* Section I.A.3.

228 SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) ("Form [is] disregarded for substance and emphasis [is] placed upon economic reality.").

229 *E.g.*, *Kik Interactive Inc.*, 492 F. Supp. 3d at 179; Balestra v. ATBCOIN LLC, 380 F. Supp. 3d 340, 354 (S.D.N.Y. 2019).

230 *See* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) ("[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a "security."'"); Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) ("Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called."). *See generally* Section 21(a) SEC Report on The DAO, *supra* note 18, at 2 ("This Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, 'smart contracts,' or computer code, does not remove conduct from the purview of the U.S. federal securities laws.").

231 *See Howey*, 328 U.S. at 298.

232 *E.g.*, United States v. Leonard, 529 F.3d 83, 85, 90 (2d Cir. 2008) (finding that the court "can (and should)" look beyond the terms of the investment contract and that, notwithstanding the language of the contract in question suggesting otherwise, there was sufficient evidence to support that defendants created a reasonable expectation of passive profits to support a securities fraud conviction arising from violations of the Securities Exchange Act of 1934).

organization's developer or leadership.[233] Therefore, a governance token's promotional advertising circumstances are essential: where the issuing company has issued promotional materials promoting its service and suggesting that the governance token will appreciate in value, a finding of a reasonable expectation of profits becomes more likely.[234]

4. To Be Derived from the Entrepreneurial or Managerial Efforts of Others

Because a governance token holder has the power to influence governance decisions within her organization, the final part of the *Howey* test is complicated by her own managerial efforts such as due diligence and voting.[235] The SEC's report concerning The DAO leaves open many questions as to how the last factor of the *Howey* analysis will apply in governance token regulation moving forward: For example, how much and what kind of involvement should a governance token holder have—and, in contrast, what kind of involvement should DAO creators avoid—so that the holder's profits are not derived from others' managerial efforts?[236] Indeed, a DAO decentralized governance model can result in too many proposals for the average token holder to keep herself informed—certainly, these systems must allow for governance tokens to be delegated to a third party who would be responsible for voting on the holder's behalf.[237] Services are emerging to fit this very need, as are protocol politicians—individuals in a protocol's community who research proposals and communicate

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233 "The Court will consider instruments to be 'securities' on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction." *Reves*, 494 U.S. at 66–67. For example, for The DAO, the SEC was particularly concerned with Slock.it's representations made surrounding The DAO. Section 21(a) SEC Report on The DAO, *supra* note 18, at 11–12.

234 *See* Section 21(a) SEC Report on The DAO, *supra* note 18, at 11.

235 *Id.* at 12–15.

236 *See id.* at 11–12.

237 Holders of COMP tokens in their Ethereum wallets may delegate their voting rights either to themselves, or to any other Ethereum addresses . . . . The recipients of delegated voting rights, known as delegates, whether they be the COMP holders themselves or another address, may propose, vote on, and execute proposals to modify the protocol.

Bavosa, *supra* note 118; *see also Governance Overview*, COMPOUND, https://compound.finance/governance [https://perma.cc/57EU-32E2].

recommendations to the community.[238] While this solves an essential need in decentralizing governance in these organizations, it separates the token holder from the organization and suggests that token holders derive profits from others' managerial efforts.[239]

B. *Governance Tokens and Regulatory Frameworks*

In 2019, the SEC published its "Framework for 'Investment Contract' Analysis of Digital Assets."[240] The framework provides an analytical tool to help digital asset issuers determine whether their digital asset falls under securities laws.[241] The SEC's guidance provides that digital asset regimes typically satisfy the investment of money and common enterprise requirements of an investment contract, the first two *Howey* prongs.[242] The main issue in analyzing a digital asset stems from whether the digital asset holder has a reasonable expectation of profits derived from the efforts of others.[243] The framework's listed characteristics suggestive of securities include an issuer whose ongoing presence and work is central to the maintenance of the network or digital asset;[244] a digital asset that grants its holder income or profits of the enterprise such as pro-rata rights;[245] a digital asset that is expected to accrue in value and may be listed on a secondary market or is expected to be;[246] a digital asset that is offered broadly to potential purchasers in contrast with being offered to prospective or actual users;[247] an issuer that uses the digital asset to raise funds that it

238 *See, e.g.*, *The Front Page of the Ownership Economy*, BOARDROOM, https://www.boardroom.info [https://perma.cc/W5L2-C9XV]. For a first-party service developed to solve this problem, see *Uniswap Governance*, UNISWAP, https://gov.uniswap.org [https://perma.cc/3HNM-J3AR].

239 Section 21(a) SEC Report on The DAO, *supra* note 18, at 14 ("The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because . . . DAO Token holders' ability to vote for contracts was a largely perfunctory one . . . .").

240 SEC, *supra* note 204; *see also* Statement, Bill Hinman, Dir. of Div. of Corp. Fin., & Valerie Szczepanik, Senior Advisor for Digit. Assets and Innovation, Statement on "Framework for 'Investment Contract' Analysis of Digital Assets" (Apr. 3, 2019), https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets [https://perma.cc/7TQG-W4UM].

241 Statement, Bill Hinman & Valerie Szczepanik, *supra* note 240.

242 SEC, *supra* note 204, at 2.

243 *Id.*

244 *Id.* at 3–4.

245 *Id.* at 6.

246 *Id.*

247 *Id.*

continues to expend on the network or digital asset;[248] and a digital asset that upon issuance is ready to be used for its intended utility.[249]

Recall that an application token is a digital asset and that application tokens include investment token and utility token subtypes.[250] Investment tokens, much like investment contracts, are meant to give its holders an economic right to share in the profits generated by a project or organization.[251] In contrast, a utility token, the superset of a governance token, finds its purpose in granting the holder a right to access some service or participation in an organization.[252] Governance tokens are meant to grant their holder a utility in the form of the right to participate in the network's governance decisions and, by themselves, do not reflect on the holder's economic rights.[253] The characteristics outlined in the SEC's framework implicate the digital asset as a provisioner of economic rights; utility rights are less affected.[254] These characteristics bear primarily on a digital asset's qualities as an investment token and not as a utility or governance token.[255]

This conclusion under the SEC investment token framework is consistent with the Swiss Financial Market Supervisory Authority's (FINMA) framework.[256] FINMA's framework explicitly excludes utility tokens from securities if the token's sole purpose is to confer digital access rights to an application or service—such as governance rights—and if the utility token can actually be used when the security inquiry is performed.[257] However, if a utility token has an investment purpose, the digital asset will be treated as a security.[258] Likewise, the Monetary Authority of Singapore has published guidance that digital assets are

248 *Id.* at 7.

249 *Id.* at 9.

250 *See supra* Section I.A.2; Rohr & Wright, *supra* note 94, at 476.

251 Rohr & Wright, *supra* note 94, at 476.

252 *Id.* at 475.

253 *Id.*

254 SEC, *supra* note 204, at 2; *see supra* Section I.A.2.

255 *See supra* Section I.A.2.

256 *See generally* FINMA, GUIDELINES FOR ENQUIRIES REGARDING THE REGULATORY FRAMEWORK FOR INITIAL COIN OFFERINGS (ICOS) (2018), https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/1bewilligung/fintech/wegleitung-ico.pdf?la=en [https://perma.cc/7ZUQ-LV77].

257 *Id.* at 5.

258 *Id.*

not subject to securities laws where they provide rights of access with limited accompanying economic rights.[259]

C. *Distinguishing from The DAO*

While the SEC determined in its nonbinding 2017 report that The DAO's underlying token, the DAO Token, constituted a security despite its characteristics as a governance token, the SEC's determination is not applicable to all instances of governance tokens.[260] The DAO's token had governance token characteristics in that it permitted its holder to vote on proposals such as into which projects to invest.[261] But it also had investment token characteristics in that it entitled its holder to earnings on those investments.[262] DAO Tokens shared qualities of investment and governance tokens, making it a hybrid token.[263] The DAO Token's characteristics as an investment token and not as a governance token motivated the SEC's decision.[264]

For example, the investment of money was the exchange of a cryptocurrency, Ether, for DAO Tokens.[265] This structure is common to investment tokens, especially in application token sales or ICOs—investment tokens are issued in exchange for investments in the form of digital assets.[266] In contrast, governance tokens may be given in exchange for the use of the protocol.[267] Second, the reasonable expectation of profit in The DAO reflected a fundamental interest specific to the investment token—the Slock.it cofounders spent considerable efforts promoting the token for its use as a capital-raising tool.[268] The DAO was dependent on the capital-raising effect of DAO Tokens: to invest in other projects, it had to raise capital through its value proposition.[269] Finally, the SEC found that the final *Howey* element was satisfied because the profit was not sufficiently derived from the token holder's work but rather from The DAO's organizers'

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259 MONETARY AUTHORITY OF SINGAPORE, A GUIDE TO DIGITAL TOKEN OFFERINGS 10–15 (2020), https://www.mas.gov.sg/-/media/MAS/Sectors/Guidance/Guide-to-Digital-Token-Offerings-26-May-2020.pdf [https://perma.cc/Z3KJ-D89R].

260 *See* Section 21(a) SEC Report on The DAO, *supra* note 18, at 12.

261 *Id.* at 4.

262 *Id.*

263 *See id.* at 3–4.

264 *Id.* at 11–15.

265 *Id.* at 11.

266 *See* DE FILIPPI & WRIGHT, *supra* note 16, at 101; Rohr & Wright, *supra* note 94, at 478–79.

267 *See, e.g.*, Bavosa, *supra* note 118.

268 Section 21(a) SEC Report on The DAO, *supra* note 18, at 4–5.

269 *Id.*

managerial efforts, Slock.it, Slock.it's cofounders, and The DAO's curators.[270] Slock.it and its cofounders opted not to launch The DAO fully decentralized but gradually.[271] While this may have been responsible, the SEC saw the cofounders' retention cut against a token holder's argument that their efforts were an influential factor in deriving profits from their investment.[272] The more control the cofounders were able to leverage, the less work the token holders would legitimately put into deriving profits on their investments.[273] Participants' trustless nature was also an issue for the SEC; the participants did not know each other and did not communicate meaningfully for votes.[274]

The elements of DAO Tokens that drew the SEC's focus in its report were its qualities as an investment token, the features necessary for its use in raising, deploying, and distributing capital.[275] DAO Tokens were obtained in exchange for an investment and, most notably, they were obtained with the intent that there would be a return on its investment.[276] The asset's characteristics as a governance token raised a meaningful argument that the *Howey* analysis's last element was not satisfied because the token holder participated in deriving profit by voting for proposals.[277] Unfortunately, the level of control that token holders possessed was not enough, but more recent governance tokens grant even greater control to token holders.[278]

A governance token issuer may reasonably look at the SEC's report on The DAO and mistake it for meaning that all governance tokens are securities. But as discussed above, not all governance tokens are

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270 *Id.* at 12.

271 *Id.*

272 *Id.*

273 *Id.* at 14 ("The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders' ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.").

274 *Id.* at 11–15.

275 *Id.* at 12.

276 *Id.* at 15.

277 *Id.*

278 *Id.* at 12 ("The DAO's investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO's Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO's investors."); *see, e.g.*, *Introducing UNI*, *supra* at 4 ("Uniswap governance will be live from day one, although control over the treasury will be delayed until October 17 2020 12:00am UTC. Control over the Uniswap fee switch is subject to a 180 day time lockdelay. These grace periods provide the Uniswap community enough time to familiarize itself with the governance system, bring in a diverse and high-quality set of protocol delegates, and begin discussions and communications around potential governance proposals.").

securities.[279] The DAO's SEC report based its decision on the nongovernance token features of the DAO Token.[280] This Note will proceed by articulating a framework to help practitioners design and issue governance tokens that are not securities and assist courts in differentiating governance tokens from investment tokens.

III. PROPOSAL

Not all governance tokens are securities.[281] But some are, and how will a governance token issuer know when their governance token is a security? What features should a court or the SEC examine to differentiate a governance token from an investment token? Whether a governance token is a security is a fact-heavy inquiry, turning on case-by-case evaluations of the totality of the circumstances ranging from the token's functionality to the underlying organization's control and marketing.[282] This Note proposes a four-factor framework that, when satisfied, minimizes the likelihood that a governance token is a security. This framework does not replace the *Howey* test. Instead, in fulfilling this framework, a governance token will be less likely to satisfy the *Howey* test. A governance token is less like a security where: (1) the token's issuance resembles loyalty rewards; (2) the token is not issued for capital raising or fee splitting; (3) marketing or promotional materials do not suggest monetary value behind the token; and (4) governance rights are substantially decentralized, with minimal control retained by individual private parties as opposed to token holders.

A. *Governance Tokens Provisioned as Loyalty Programs*

The first factor in the framework is that the token is used as a loyalty or reward system rather than an exchange of money.[283] The more internally the token is kept and maintained, the better.[284] Many

279 *See* discussion *supra* Section II.A.

280 *See* discussion *supra* Section II.B.

281 *See* discussion *supra* Section II.A.

282 *See* discussion *supra* Section II.A.

283 Loyalty or "[r]eward programs allow customers to accumulate some form of points and use these points as a currency to buy other products, services, samples, or, in some cases, exchange them for cash." Natalie M. Banta, *Property Interests in Digital Assets: The Rise of Digital Feudalism*, 38 CARDOZO L. REV. 1099, 1120 (2017).

284 For example, some DAOs do not permit the free transfer of their governance token. Membership into these organizations is restricted to a specific procedure, so simply acquiring the token will not bestow membership status. *See, e.g.*, *Membership*, *supra* note 14.

governance tokens are Ethereum compliant, which jeopardizes their status as nonsecurities because they can be acquired for money on secondary exchanges and their value can appreciate.[285] It follows that if the digital asset has a value that can appreciate, then a reasonable expectation of increasing value could be established. In contrast, a governance token that is untransferable or otherwise not listable on a secondary exchange has a stronger claim against being found a security—in such a scenario, the asset does not have a secondary value for which a party could have a reasonable expectation of appreciating value.[286] A token that has the sole purpose of conveying governance rights—as opposed to possessing investment purposes—has the most substantial claim to avoiding classification as a security.[287] Indeed, the SEC's token framework provides that a purchaser can reasonably expect profits derived from others consistently with *Howey* by selling tokens on secondary markets for appreciating returns.[288] The digital asset's transferability on a secondary market, or the expectation that it will become tradeable, may suggest that an asset is a security.[289] At the least, this suggests that some restrictions on the transferability of a token would be recommended to limit exposure on edge cases where a digital asset is more suggestive of a security.[290]

Uniswap's UNI token, as initially announced in September 2020, is an example of a governance token that closely resembles a loyalty

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285 *See, e.g.*, *ERC-20 Token Standard*, *supra* note 14; Leshner, *supra* note 23.

286 *See, e.g.*, *Membership*, *supra* note 14 (restricting access to the LAO's governance mechanisms to preapproved members); Leshner, *supra* note 23 ("Until the decentralization process is complete, COMP will not be available to the public.").

287 The Supreme Court has noted that a contract that appreciates could be a security, but "when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply." United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975). The Court was referring specifically to an agreement for cooperative community property, which is secured so that the purchaser may "occupy the land or . . . develop it themselves." *Id.* Similarly, a token secured solely for the underlying governance right and not as an investment should keep a governance token from being classified as a security. *See* Reves v. Ernst & Young, 494 U.S. 56, 66 (1990) ("First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it.").

288 A purchaser may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market. When a promoter, sponsor, or other third party . . . provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts, then this prong of the test is met.

SEC, *supra* note 204, at 2–3.

289 *Id.* at 6.

290 Rohr & Wright, *supra* note 94, at 492–96 (analyzing the issue of hybrid (both investment and utility) tokens and the surrounding case law and concluding that transfer restrictions may be recommended to limit exposure).

program.[291] Uniswap awarded the first fifteen percent of UNI's tokens to liquidity providers and announced that sixty percent of UNI would go to Uniswap's community members over a four-year schedule.[292] UNI was not acquired directly in exchange for money in the form of cryptocurrency.[293] A governance token implemented as a similar loyalty program decentralizes governance to loyal members of the community and cuts against the first element of the *Howey* test in requiring an exchange of money.[294]

B. *Avoidance of Capital Raising*

The second factor in the framework is that the token is not used as a capital-raising or fee-splitting tool.[295] Here, timing is vital—an investment token sold earlier in the development of an application to fund development is more indicative of an investment.[296] The SEC's token framework recommends that any funds raised for the digital asset be limited to those required to establish a functional network or digital asset.[297] And the issuer should avoid spending funds from proceeds or operations to continue enhancing the functionality or value of the network or digital asset.[298] A DAO's organizers will have a stronger argument that their token is not a security where it is not used as a source for raising capital.[299] The DAO was first and foremost a venture

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291 *See Introducing UNI*, *supra* note 4.

292 *Id.*

293 *See id.* Remember, however, that because UNI is Ethereum compliant (ERC-20), the UNI token is freely tradeable and therefore may be listed on secondary exchanges, including Uniswap. *ERC-20 Token Standard*, *supra* note 14. This means that some individuals who hold UNI never provided liquidity to one of Uniswap's pools and need not have even used Uniswap before.

294 *See supra* Section II.A.1.

295 *See* SEC, *supra* note 204, at 7; Section 21(a) SEC Report on The DAO, *supra* note 18, at 5–6 (discussing The DAO's business model).

296 Rohr & Wright, *supra* note 94, at 501 ("Another potentially relevant consideration under the 'efforts of others' prong is the timing of those efforts in relation to the sale, and in this regard, tokens differ. Some tokens are sold prior to the commencement of the project and most of the efforts will occur post-sale. Others are sold when the project has been completed (or when it is close to completion), and in these situations, the relevant efforts will occur primarily prior to the sale."); Reves v. Ernst & Young, 494 U.S. 56, 66 (1990) ("First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments . . . the instrument is likely to be a 'security.'").

297 SEC, *supra* note 204, at 7.

298 *Id.*

299 The SEC opens its discussion in its report on The DAO by noting that "[t]he Commission is aware that virtual organizations and associated individuals and entities *increasingly* are using

capital fund.[300] Users provided the capital and would execute on their governance tokens to vote on governance decisions, such as in which projects to invest.[301] Holders of The DAO's governance token earned value based on the success of their token.[302] The DAO Token appears like an investment token in this regard.[303] A governance token with no capital-raising element will likely be free of the security aspects of investment tokens, and the appearance of an expected profit in a contract acquired in exchange for money becomes less clear.[304]

C. *Avoidance of Marketing that Creates a Reasonable Expectation of Profit*

The third feature in this framework is that marketing materials do not convey to users that the token will accrue interest, making them profitable.[305] While there is no requirement that the user's reasonable expectation of profit be established off of the organization's activities, its activities are substantial in setting reasonable expectations.[306] The SEC recommends avoiding marketing a digital asset, directly and

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distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital." Section 21(a) SEC Report on The DAO, *supra* note 18, at 10 (emphasis added); *see also id.* at 1–2 ("The Commission deems it appropriate and in the public interest to . . . advise those who would use a [DAO] . . . for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws."). The SEC Report on The DAO was a warning addressed to "virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities," leaving some latitude to organizations that seek to use tokens for purely non-capital-raising bases. *Id.* at 2.

300 Section 21(a) SEC Report on The DAO, *supra* note 18, at 5–6 ("The DAO would earn profits by funding projects that would provide DAO Token holders a return on investment.").

301 *Id.*

302 *Id.* at 6 ("The various promotional materials disseminated by Slock.it's co-founders touted that DAO Token holders would receive 'rewards,' which the White Paper defined as, 'any [ETH] received by a DAO [Entity] generated from projects the DAO [Entity] funded.'" (alterations in original) (citation omitted)).

303 *See* Rohr & Wright, *supra* note 94, at 476.

304 *See* Section 21(a) SEC Report on The DAO, *supra* note 18, at 11 (applying *Howey* and finding The DAO's tokens are securities in part because the pooling of capital satisfies the common enterprise requirements).

305 *See* SEC, *supra* note 204, at 7–8.

306 Recall the major failing of The DAO that led to the DAO Token being classified as a security. Its cofounders relied on the capital raising and made express statements concerning the purpose and end goal for DAO Tokens. Section 21(a) SEC Report on The DAO, *supra* note 18, at 5, 11–12; *see also* Bitcoin Inv. Tr., Exchange Act Release No. 78282, 114 SEC Docket 3237, 2016 WL 4363462, at *2 (July 11, 2016) ("BIT employed the following special selling efforts and methods to facilitate the offering of its shares.").

indirectly.[307] The public's perception of a governance token speaks to the issuer's and token receiver's purposes, and the issuer's advertising and representations set public perception.[308] Where a user may have had a reasonable expectation based on a third party, that reasonable expectation may be canceled out if due diligence would have shown the DAO's express statements that there was no such expectation or goal.[309] For example, expressly disclaiming it as an investment opportunity supports that the token is not an investment token or investment contract.[310]

D. *The Extent of Decentralization*

The last factor in this framework analyzes the extent to which the model adopted is substantially decentralized such that there is no special-manager class that retains significant control over the organization.[311] This factor is consistent with the SEC's framework for analyzing digital assets, which inquires into the level of control and any lead, central, or managerial role that the issuer retains, as well as whether the issuer continues to be important to the value of the digital asset or the success of the common enterprise.[312] Like many governance tokens, Uniswap's is awarded to those who use the underlying protocol.[313] While users of the platform stake money, the UNI token is awarded not in exchange for the money but as a reward or loyalty point.[314] Uniswap developers allocated forty percent of UNI's first issuance to team members, investors, and advisors,[315] but retained no

307 SEC, *supra* note 204, at 7–8.

308 *See* Reves v. Ernst & Young, 494 U.S. 56, 66 (1990) ("[W]e examine the reasonable expectations of the investing public: The Court will consider instruments to be 'securities' on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction.").

309 *Compare* Leshner, *supra* note 23 ("COMP empowers community governance—it isn't a fundraising device or investment opportunity."), *with* Section 21(a) SEC Report on The DAO, *supra* note 18, at 5–6, 12 (emphasizing The DAO's cofounders' promotions and representations).

310 *See, e.g.*, Leshner, *supra* note 23 ("COMP empowers community governance—*it isn't a fundraising device or investment opportunity*." (emphasis added)).

311 Section 21(a) SEC Report on The DAO, *supra* note 18, at 12–13 (finding the control retained by the founders significantly determinative for the final *Howey* factor).

312 SEC, *supra* note 204, at 4–5.

313 *Introducing UNI*, *supra* note 4.

314 *Id.*

315 The Uniswap team issued 60% of UNI's first issue to Uniswap community members. *Id.* And the team allocated 21.266% to team members and future employees, 18.044% to investors, and 0.69% to advisors. *Id.*

special control unique from community UNI holders who received the remaining sixty percent of issued tokens, and Uniswap immediately vested ownership rights among UNI holders.[316] Even more interesting, the first UNI token holders were not aware that they were accruing UNI tokens.[317] There is no reasonable expectation of deriving profits from others' managerial efforts in these circumstances on the part of the users who were granted this token for using Uniswap.[318] With regard to whether any party retains control such that the SEC would say that token holders benefit from the managerial efforts of others, the UNI token's analysis is more straightforward than The DAO's circumstances in that governance-right retention is significantly limited.[319]

CONCLUSION

Since its inception, blockchain has captured the creativity of a generation of entrepreneurs. Blockchain's novelty and its earliest adopters' innovative nature have made it a regulatory target and the subject of market speculation. Like other decentralized technologies, blockchain assets naturally defy regulatory authority.[320] DeFi and DAOs raise many novel legal issues: ICOs,[321] token sales,[322] and now governance tokens. The SEC has spent significant resources to clarify

316 *Id.* ("UNI holders *will have immediate ownership* of: Uniswap governance; UNI community treasury; The protocol fee switch . . . ." (emphasis added)).

317 Shaurya Malwa, *Uniswap Announces UNI Tokens, Airdrops Over $1,200 to Users*, BTC MANAGER (Sept. 17, 2020), https://btcmanager.com/uniswap-uni-tokens-1200-users [https://perma.cc/R2PJ-UBGN] ("Decentralized exchange Uniswap launched its native UNI tokens earlier today *in a surprise move*, with several crypto exchanges rushing to list the token and Ethereum network becoming congested to use." (emphasis added)).

318 Even if the first two elements of the *Howey* test are satisfied, the users were accruing the token before it was announced: "15% of UNI . . . can immediately be claimed by historical . . . users . . . based on a snapshot ending" roughly two weeks before the announcement. *Introducing UNI*, *supra* note 4. Because the token was retrospectively awarded, users did not know that they would be rewarded with the UNI token and therefore could not have manifested an expectation to profit from the token when they were using the Uniswap protocol.

319 *Id.* ("UNI holders are responsible for ensuring that governance decisions are made in compliance with applicable laws and regulations. . . . The community is encouraged to consult knowledgeable legal and regulatory professionals before implementing any specific proposal.").

320 *See* Wright & De Filippi, *supra* note 86.

321 Vlad Burilov, Utility Token Offerings and Crypto Exchange Listings: How Regulation Can Help? (Aug. 7, 2019) (unpublished manuscript), https://ssrn.com/abstract=3284049 [https://perma.cc/SC2A-J9DN]; Sabrina Howell, Marina Niessner & David Yermack, *Initial Coin Offerings: Financing Growth with Cryptocurrency Token Sales* (Eur. Corp. Governance Inst., Fin. Working Paper No. 564, 2019), https://ssrn.com/abstract=3201259 (last visited Jan. 27, 2022).

322 Collomb, De Filippi & Sok, *supra* note 92.

that investment tokens are securities—but not all governance tokens possess investment characteristics.[323] Thus, the question remains as to how protocols build and issue their governance tokens to determine whether they will fall under SEC regulatory guidance.[324]

The SEC has invested considerable resources in recent years to clarify the relationship between digital assets broadly and securities laws.[325] Yet, governance tokens have not explicitly been analyzed.[326] Indeed, many current governance tokens defy security classification[327] under the *Howey* test.[328] The four-factor framework proposed in this Note emphasizes the specific characteristics by which governance tokens may avoid security classification.[329] These factors include how the token resembles a loyalty rewards program, avoidance of capital raising, the use of marketing, and the extent to which the organization has decentralized governance.[330]

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323 *See* Section 21(a) SEC Report on The DAO, *supra* note 18, at 18 (citing several enforcement actions and investor alerts involving digital assets).

324 There has been some discussion on DAOs as corporate entities and how they come under the SEC, but not focusing on whether sole governance tokens are securities. *See* Kyung Taeck Minn, *Towards Enhanced Oversight of "Self-Governing" Decentralized Autonomous Organizations: Case Study of The DAO and Its Shortcomings*, 9 N.Y.U. J. INTELL. PROP. & ENT. L. 139 (2019); Laila Metjahic, *Deconstructing The DAO: The Need for Legal Recognition and the Application of Securities Laws to Decentralized Organizations*, 39 CARDOZO L. REV. 1533 (2018).

325 *See* Statement from Jay Clayton, Chairman, SEC, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 [https://perma.cc/ASC4-86FZ]; Investor Bulletin, SEC, Investor Bulletin: Initial Coin Offerings (July 25, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings [https://perma.cc/XXH2-D4MN].

326 *See supra* Section II.A. *See generally* SEC, *supra* note 204.

327 SEC, *supra* note 204.

328 *See* discussion *supra* Section II.A.

329 *See* discussion *supra* Part III.

330 *See* discussion *supra* Part III.