

SAFE and Sound? Examining How the SAFE + Token Warrant Model Navigates Howey

By Dan Quatrella*

ABSTRACT

For many years, tensions have been rising between the cryptocurrency industry and the U.S. Securities and Exchange Commission (“SEC”) over the definition of a security and whether cryptocurrency tokens fall within that definition. No episode highlights this more than the enforcement actions brought against Telegram, Kik Interactive, and Ripple Labs. These projects made their best attempt to structure their early funding such that the cryptocurrency tokens they intended to launch would be shielded from both classification as a security and the corresponding requirements that would likely stifle their growth. The industry has concerns about the logistical consequences of SEC regulations on their early-stage products. Conversely, the SEC has an interest in regulating fraud in the new cryptocurrency sector. However, until Congress steps in and legislates, both sides are deadlocked; the SEC is trying to fit the “square peg” cryptocurrency into the “round hole” of the Securities Act of 1933.

An outgrowth of the SEC’s arguments in these cases has been a new structure for fundraising called the “SAFE + Token Warrant.” This Note will delve into: (1) explaining from first principles the value proposition of cryptocurrencies and decentralized computation networks to understand the goals of these protocols better; and (2) summarizing the back-and-forth between the industry and the SEC to clarify the industry’s attempts to navigate ambiguous regulatory frameworks. This background will provide the necessary context to analyze this current iterative attempt by the cryptocurrency industry to launch their novel products while navigating uncertainty in the securities laws. This Note will complete a comprehensive securities analysis of the SAFE + Token Warrant model and determine whether it accomplishes the startup’s goals in avoiding the classification of their tokens as securities. Finally, it will provide recommendations for resolving the present issues and present guidance on how cryptocurrency protocols can better mitigate regulatory risks during early-stage fundraising.

**J.D. expected May 2024, The George Washington University Law School; B.B.A in Finance and Real Estate, Villanova University, 2017. Special thanks to Walter Zalenski and Bryce Small for their advice and input during the preparation of this Note and to the members of The Business and Finance Law Review for their assistance with editing.*

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I. INTRODUCTION

Cryptocurrency is an emergent technology that has captured the attention of the masses in a short time.¹ Whether people view it as “electronic cash,” “digital gold,” a new conduit for art and finance,² or merely a “get rich quick” scheme³ there is no doubt it has significantly penetrated the mass social psyche. The cryptocurrency industry has largely been of public interest for its meteoric price appreciation and flashy headlines related to fraud or looming regulation.⁴ Nevertheless, despite the ripe potential for fraud and the turbulent volatility of this new asset class, one thing is certain: cryptocurrencies are not going anywhere.⁵

¹ See *Global Cryptocurrency Market Cap Charts*, COINGECKO, <https://www.coingecko.com/en/global-charts#:~:text=The%20global%20cryptocurrency%20market%20cap,a%20Bitcoin%20dominance%20of%2040.62%25> [https://perma.cc/6ADR-BQUV] (last visited Apr. 6, 2023) (highlighting the \$1.23 trillion overall cryptocurrency market capitalization (peaking at \$3 trillion in 2021) having grown from nothing since the 2009 Satoshi Whitepaper); see also Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* 1 (2008), <https://bitcoin.org/bitcoin.pdf> [https://perma.cc/BG2S-4VU2].

² See Michael Sonnenshein, *Is Cryptocurrency the Future of Finance? Here's What a New Study Shows*, WORLD ECON. F. (Nov. 11, 2022), <https://www.weforum.org/agenda/2022/11/cryptocurrency-us-midterms/#:~:text=This%20is%20how%20the%20top,Democrats%20and%2051%25%20of%20Republicans> [https://perma.cc/GMC7-3DKS]; Eyal Ben Dror, *How Web3 Internet Design Could Lead to a More Sustainable World*, WORLD ECON. F. (Oct. 17, 2017), <https://www.weforum.org/agenda/2022/10/how-web3-internet-design-could-lead-to-a-more-sustainable-world/> [https://perma.cc/D4ZN-S4FJ].

³ See *What To Know About Cryptocurrency and Scams*, FED. TRADE COMM'N CONSUMER ADVICE (May 2022), <https://consumer.ftc.gov/articles/what-know-about-cryptocurrency-and-scams> [https://perma.cc/RJ4T-HRH5].

⁴ See MacKenzie Sigalos, *Sam Bankman-Fried Pleads Not Guilty to Latest Round of Federal Fraud, Bribery Charges*, CNBC (Mar. 30, 2023), <https://www.cnbc.com/2023/03/30/sam-bankman-fried-pleads-not-guilty-to-latest-round-of-federal-fraud-charges.html> [https://perma.cc/AEK9-SC4G] (highlighting a recent case brought for crypto fraud); see also James Fanelli & Jiyoung Sohn, *U.S., South Korea Vie Over Extradition of Crypto Fugitive Do Kwon*, WALL ST. J. (Mar. 30, 2023), <https://www.wsj.com/articles/u-s-south-korea-vie-over-extradition-of-crypto-fugitive-do-kwon-738923fc> [https://perma.cc/4B5Y-X9ST] (highlighting another example of crypto fraud making headlines); Paul Grewal, *We Asked the SEC for Reasonable Crypto Rules for Americans. We Got Legal Threats Instead*, COINBASE (Mar. 22, 2023), <https://www.coinbase.com/blog/we-asked-the-sec-for-reasonable-crypto-rules-for-americans-we-got-legal> [https://perma.cc/T7DR-K9S7] (“This misunderstanding of crypto products, assets and services is another example of the need for comprehensive crypto regulation in the U.S.”).

⁵ See Guy Swann, *Bitcoin Is Here To Stay And Bitcoiners Aren't Going Anywhere*, BITCOIN MAG. (Oct. 28, 2022), <https://bitcoinmagazine.com/culture/bitcoin-and-bitcoiners-are-here-to-stay>

Volatility in the markets and the penchant for “rug pulls”⁶ have correctly drawn the attention of government regulators in financial markets.⁷ Unfortunately, with that attention has come a jurisdictional turf war between several United States (“U.S.”) agencies under whose purview cryptocurrency regulation falls,⁸ which has left the entire industry in a state of regulatory flux.⁹ Notably, there has been rising tensions between the broader cryptocurrency industry and the U.S. Securities and Exchange Commission (“SEC”).¹⁰ The SEC’s involvement in regulating the

[<https://perma.cc/Y3JE-NQVY>]; see also Maxim Galash, *Web3 is Not Dead. Here’s What the Crypto Space will Look Like in 2030*, FORTUNE (June 7, 2022), <https://fortune.com/2022/06/07/web3-crypto-crash-tech-finance-price-future-outlook-coinchange-maxim-galash/> [<https://perma.cc/KYH7-P4HP>]; David Rubenstein, *Crypto Is Not Going Away*, BLOOMBERG (Sept. 29, 2022), <https://www.bloomberg.com/news/videos/2022-09-29/david-rubenstein-crypto-is-not-going-away-video> [<https://perma.cc/44QK-56H2>]; Press Release, U.S. Dep’t of Just., Attorney General William P. Barr Announces Publication of Cryptocurrency Enforcement Framework (Oct. 8, 2020), <https://www.justice.gov/opa/pr/attorney-general-william-p-barr-announces-publication-cryptocurrency-enforcement-framework> [<https://perma.cc/6JAD-GUX4>] (“Cryptocurrency is a technology that could fundamentally transform how human beings interact, and how we organize society.”).

⁶ See *Rug Pull*, BINANCE ACAD. <https://academy.binance.com/en/glossary/rug-pull> [<https://perma.cc/AM9F-AHBW>] (last visited Apr. 6, 2023).

⁷ See *Fact Sheet: White House Releases First-Ever Comprehensive Framework for Responsible Development of Digital Assets*, THE WHITE HOUSE (Sept. 16, 2022), <https://www.whitehouse.gov/briefing-room/statements-releases/2022/09/16/fact-sheet-white-house-releases-first-ever-comprehensive-framework-for-responsible-development-of-digital-assets/> [<https://perma.cc/K75H-HDEM>].

⁸ See Casey Wagner, *Hester Pierce: There’s a Jurisdiction Battle Over Crypto Regulation*, BLOCKWORKS (Nov. 4, 2021), <https://blockworks.co/news/hester-pierce-theres-a-jurisdiction-battle-over-crypto-regulation> [<https://perma.cc/C2HD-NK86>].

⁹ See Mengqi Sun, *Regulatory Uncertainty Is a Barrier for Wider Bitcoin Adoption*, WALL ST. J. (Apr. 6, 2022), <https://www.wsj.com/articles/regulatory-uncertainty-is-a-barrier-for-wider-bitcoin-adoption-11649289387> [<https://perma.cc/TQ9C-S29C>].

¹⁰ See Matt Levine, *Crypto Wants Some SEC Rules*, BLOOMBERG (Sept. 13, 2022), <https://www.bloomberg.com/opinion/articles/2022-09-13/crypto-wants-some-sec-rules?leadSource=verify%20wall> [<https://perma.cc/2SD2-EG4P>]; see also *SEC Chair Stands Firm: ‘Vast Majority’ of Cryptocurrency Tokens are Securities*, BAKERHOSTETLER (Sept. 9, 2022), <https://www.bakerlaw.com/alerts/sec-chair-stands-firm-vast-majority-cryptocurrency-tokens-securities> [<https://perma.cc/U896-G62E>]; Press Release, U.S. Sec. and Exch. Comm’n, SEC Announces Enforcement Results for FY22 (Nov. 15, 2022), <https://www.sec.gov/news/press-release/2022-206> [<https://perma.cc/JQZ7-FT8T>].

industry dates back to as early as 2013,¹¹ but the agency has ramped up its prosecutorial pace within the past year launching a series of enforcement actions against various players within the industry.¹² In particular, the SEC has primarily focused its attention on the various forms of fundraising efforts by the industry.¹³

II. BACKGROUND

a. What are Cryptocurrencies?

i. What is Blockchain Technology?

Cryptocurrencies are one component of blockchain technology, and so to understand them at a fundamental level, one must begin with blockchains. Blockchain technology, at its most rudimentary level, is a digital ledger designed to record and store data.¹⁴ However, unlike traditional ledgers, most blockchains are not maintained by any centralized entity such as a bank or corporation.¹⁵ Instead, the ledger is copied and distributed across a network of users who are coordinating its maintenance.¹⁶ Incoming data, such as transactions between users, is batched into “blocks” and, once verified by a consensus of network operators, is linked to a “chain” of all the previously verified blocks (hence, the term “blockchain”).¹⁷

¹¹ See Courtney Degen, *SEC Ramped Up Cryptocurrency Enforcement in 2022, Report Shows*, PENSIONS & INVS., (Jan. 18, 2023), [https://www.pionline.com/cryptocurrency/sec-ramped-cryptocurrency-enforcement-2022-report-shows#:~:text=The%20SEC%20issued%20its%20first,issued%20127%20actions%20since%20then_\[https://perma.cc/QS9F-RVPL\]](https://www.pionline.com/cryptocurrency/sec-ramped-cryptocurrency-enforcement-2022-report-shows#:~:text=The%20SEC%20issued%20its%20first,issued%20127%20actions%20since%20then_[https://perma.cc/QS9F-RVPL]).

¹² See *id.*

¹³ See *id.*

¹⁴ See Annika Feign, *What is Blockchain Technology?*, COINDESK (July 22, 2021; 9:52 AM), <https://www.coindesk.com/learn/what-is-blockchain-technology/> [https://perma.cc/6KLB-599Q].

¹⁵ See *A Beginner's Guide to the Different Types of Blockchain Networks*, COINTELEGRAPH <https://cointelegraph.com/blockchain-for-beginners/a-beginners-guide-to-the-different-types-of-blockchain-networks> [https://perma.cc/HRY4-GPMB] (last visited Jan. 28, 2023) (explaining that there are private, permissioned blockchains controlled and maintained by a centralized authority; this Note will focus solely on public, permissionless, open-source blockchains).

¹⁶ See Cryptopedia Staff, *What is Blockchain? The Tech Behind Crypto Explained*, GEMINI (Oct. 2, 2023) <https://www.gemini.com/cryptopedia/blockchain-technology-explained> [https://perma.cc/C8DH-XZ5C].

¹⁷ See *id.*

Blockchain technology's critical innovation is using cryptography instead of a trusted central authority to verify that counterparties in a peer-to-peer transaction have the value they claim to possess.¹⁸ This cryptographical confirmation, combined with open-source code and a fully transparent ledger, is how public blockchains like Bitcoin and Ethereum have risen to prominence over the past decade.¹⁹ By eliminating the need for an institutional third party in a transaction, blockchains increase the speed of settlement, reduce costs, and remove any potential for fraud committed by trusted intermediaries.²⁰

One of the most prominent blockchain applications used today are smart contracts.²¹ The public blockchain Ethereum's major innovation was the addition of "smart contract" programmability, which allows developers to create code-based "automatically self-executing" contracts that settle on the Ethereum blockchain.²² Smart contracts on Ethereum are, "trustless, autonomous, decentralized, and transparent; they are irreversible and unmodifiable once deployed," removing any need for a third-party intermediary.²³ Ethereum's native cryptocurrency, Ether ("ETH"), can be used as a transfer of monetary value from one person to another, but ETH itself is primarily used to pay for the execution of smart contracts in the form of "gas fees."²⁴ Smart contracts have opened the floodgates of developers pouring into the blockchain industry who are using the technology to develop

¹⁸ For a comprehensive look into how blockchains operate to facilitate a transfer of value, see Andreas M. Antonopoulos, *Mastering Bitcoin*, GITHUB, https://github.com/bitcoinbook/bitcoinbook/blob/develop/ch01_intro.adoc [<https://perma.cc/EAN2-9G4S>] (last visited Oct. 25, 2021); see also Adam Hayes, *Blockchain Facts: What Is It, How It Works, and How It Can Be Used*, INVESTOPEDIA (Sept. 27, 2022), <https://www.investopedia.com/terms/b/blockchain.asp> [<https://perma.cc/T89X-5LEH>]; Cryptopedia Staff, *How Does Bitcoin Work?*, GEMINI (Oct. 16, 2023), <https://www.gemini.com/cryptopedia/what-is-bitcoin-and-how-does-it-work> [<https://perma.cc/6DXK-Y54N>].

¹⁹ See Cryptopedia Staff, *supra* note 16.

²⁰ See *id.*

²¹ *24 Top Enterprise Blockchain Applications*, CASPER <https://casper.network/en-us/web3/blockchain/applications/> [<https://perma.cc/2FAC-T8GU>] (last visited Jan. 26, 2024).

²² See Cryptopedia Staff, *How Are Bitcoin and Ethereum Different?*, GEMINI (Nov. 16, 2023), <https://www.gemini.com/cryptopedia/ethereum-vs-bitcoin-blockchain-differences> [<https://perma.cc/ZEJ8-RKDM>].

²³ See Cryptopedia Staff, *What are Smart Contracts?*, GEMINI (June 28, 2022), <https://www.gemini.com/cryptopedia/crypto-smart-contracts-explained> [<https://perma.cc/88V8-TSEX>].

²⁴ See *Gas and Fees*, ETHEREUM (Aug. 15, 2023), <https://ethereum.org/en/developers/docs/gas/> [<https://perma.cc/4NRN-TF2E>].

decentralized applications (“dApps”), which bundle smart contracts together to create protocols that offer functional services.²⁵ So far, there have been many dApps developed that offer financial services (such as DeFi)²⁶ or gaming services (such as GameFi)²⁷ and there is an expectation that they will work their way into other areas, such as real estate and the practice of law.²⁸

ii. Minimally Extractive Coordinators and Cryptocurrency’s Utility

By leveraging Smart Contract technology, dApps “encode the rules of engagement that coordinate the exchange of a service between a global supplier and global consumer.”²⁹ These encoded rules are simply “systems of logic that coordinate exchange between suppliers [businesses] and consumers of a service,” but they “are *not* businesses themselves.”³⁰ dApps are generally “coordinators of exchange” and are designed to be “minimally extractive” as opposed to businesses which are valued based on their profit generation.³¹

This concept of dApps as Minimally Extractive Coordinators (“MECs”) crystallizes the primary value proposition unlocked by blockchains and cryptocurrency.³² MECs are similar to service providers in the ilk of Uber or Amazon.³³ However, unlike those centralized entities that own and operate the “facilitation mechanism” with the incentive to monetize monopoly network

²⁵ See Cryptopedia Staff, *Real-World Use Cases for Smart Contracts and dApps*, GEMINI (Dec. 23, 2021), <https://www.gemini.com/cryptopedia/smart-contract-examples-smart-contract-use-cases> [<https://perma.cc/B6Z6-FY2H>].

²⁶ See *id.* (“DeFi dApps provide parallel services to the banking and financial services industry — like lending, borrowing, trading, and a host of other financial services — along with entirely new types of products and decentralized business models that can offer considerable benefit and utility for users.”).

²⁷ See *id.* (“Because NFTs are unique and can be designed to retain value beyond the game in which they originated, blockchain-built games and dApps have the potential to expand gaming economies, establish new gaming categories, and fuel development of new games.”).

²⁸ See *id.*

²⁹ See Chris Burniske, *Protocols as Minimally Extractive Coordinators*, PLACEHOLDER (Oct. 6, 2019), <https://www.placeholder.vc/blog/2019/10/6/protocols-as-minimally-extractive-coordinators> [<https://perma.cc/33VX-U3R3>].

³⁰ See *id.*

³¹ See *id.*

³² @Crypto__Oracle & @ChainLinkGod, *The Purpose and Value of Cryptocurrency*, SMARTCONTENT (Feb. 16, 2021), <https://smartcontentpublication.medium.com/the-purpose-and-value-of-cryptocurrency-and-tokens-4ad9db9fac7b> [<https://perma.cc/EU2Q-GNK5>].

³³ *Id.*

effects for profit maximization,³⁴ MECs participate in a decentralized network “that automatically matches supply with demand based on preset parameters that all parties can verify, but no one can tamper with.”³⁵ MECs operate similarly to the market for block space on the blockchain that Bitcoin operates, with users participating in an auction finding an equilibrium via supply and demand factors.³⁶ At bottom, MEC protocols remove the forms of rent extraction and pernicious abuse of monopoly power inherent in centralized entities, providing superior service to the end consumer and ultimately unlocking more value.³⁷

MECs possess a compelling value proposition but do present interesting challenges. Without a rent-seeking mechanism, there is a financial incentivization problem when launching these protocols, which has come to be known as the “chicken and the egg” problem.³⁸ Essentially, consumers will not pay for a product/service that does not exist (or is insecure), and suppliers will not operate a network without paying customers.³⁹ In order to jumpstart the creation of a product that can begin to attract consumers, a financial subsidy is required.⁴⁰ However, suppose the dApp relies on outside capital to grow. In that case, it becomes subject to the same profit incentives present within centralized operators due to the burden of paying off debts or needing to drive value to equity holders.⁴¹

To solve this problem, MECs leverage cryptocurrencies native to their protocol designed as a “required component for network usage and security.”⁴² Instead of raising capital from outside sources, the protocol subsidizes the “supply side of the MEC ecosystem in a debt-free manner before the demand side exists” by designating itself an allocation of the native cryptocurrency at launch.⁴³ Then, by requiring payment for the use of the network in the network’s native cryptocurrency, the value of the cryptocurrency

³⁴ *Id.* (“[T]he business, which serves as a facilitator, [has] the power to act in their own self-interests, such as raising costs when they establish a monopoly, censoring transactions to favor a particular party, or selling users’ data discretely to turn an additional profit.”).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* (detailing how and why MECs are able to provide a product that is better for the end consumer than their centralized counterparts).

³⁸ *The Purpose and Value of Cryptocurrency*, *supra* note 32.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

is tied directly to the network's demand from consumers.⁴⁴ If the service and network is valuable, demand should appear. As demand for the network increases, the value of the cryptocurrency will also increase by leveraging the supply and demand factors of an open market.⁴⁵ As a result, the subsidy allocation dedicated to funding the growth of the MEC increases, allowing for more spending on further improvements to the network.⁴⁶ Effectively, this subsidy allocation ties the value of the cryptocurrency to the “value the network provides to users.”⁴⁷

Critically, “the only way for those newly minted tokens to actually work in support of the network’s growth and security is for them to have financial value on the open market.”⁴⁸ Cryptocurrencies allow MECs to be minimally extractive, as the properly deployed tokens can generate significant network effects without taking on any debt.⁴⁹ This empowers networks to bootstrap themselves to the point of self-sustainability, allowing them to remain focused on service as opposed to appealing to special interests.⁵⁰

iii. The Tensions Between dApps and the Securities Regulations

This realization reveals the fundamental tension between a properly functioning dApp and securities laws, should these cryptocurrencies be classified as such. Typically, a company filing for an initial public offering has steady revenue and a balance sheet that can absorb the added costs related to registration with the

⁴⁴ *The Purpose and Value of Cryptocurrency*, *supra* note 32 (some examples of decentralized networks stimulating demand for native tokens include “payments for all network services made exclusively in native token” and “cashflow through dividends and burns” done in conjunction with staking, and on-chain governance).

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ See *The Purpose and Value of Cryptocurrency*, *supra* note 32; see also @Crypto___Oracle & @ChainLinkGod, *How dApp Value Capture will Distribute Across Decentralized Infrastructure*, SMARTCONTENT (June 21, 2021), <https://smartcontentpublication.medium.com/how-dapp-value-capture-will-distribute-across-decentralized-infrastructure-f7cebcbf5d3> [<https://perma.cc/R79F-6PGG>] (“Each decentralized network with a token will perform better than those without tokens, simply because they can bootstrap adoption without taking on debt. They can also cultivate excitement and notoriety by having communities that want to benefit from the project’s potential success financially.”).

SEC.⁵¹ On the other hand, to create a properly functioning MEC, the native cryptocurrency must be launched early in the lifecycle of the protocol.⁵² It also must be available on secondary markets so prospective users of the dApp can purchase it within the protocol.⁵³ The costs associated with registering and maintaining good status with the SEC are prohibitive for any day-one business aiming to show product market fit, especially in an industry receiving as much scrutiny as cryptocurrency.⁵⁴ If the protocol must front these substantial costs, it may never get off the ground or be worthwhile, given the risk of the dApp product or service failure.

Additionally, there are logistical concerns regarding filing disclosures designed to balance information asymmetries in public equity markets applied to a decentralized entity.⁵⁵ Questions such as: “who is supposed to be the agent for a decentralized protocol?” and “if these cryptocurrencies are securities, are the groups that help to facilitate the secondary markets (including decentralized exchange protocols (“DEX”)) necessary for powering these networks’ illegal securities exchanges?” arise.⁵⁶ Assuming they are

⁵¹ See Joanna Glasner, *The Case for Going Public Too Early*, CRUNCHBASE NEWS (July 5, 2022), <https://news.crunchbase.com/public/ipo-spac-going-public-timing/#:~:text=Historical%20trends%20around%20IPO%20timing&text=From%201980%20to%202021%2C%20the,University%20of%20Florida%20finance%20professor> [<https://perma.cc/G2JJ-CMFM>] (“[T]he median age of a technology company going public was eight years, per research from Jay Ritter, a University of Florida finance professor. In three of the past four calendar years, meanwhile, the median age was 12 years.”).

⁵² @Crypto___Oracle & @ChainLinkGod, *supra* note 32.

⁵³ *Id.*

⁵⁴ See Caleb Christensen, *The Costs of Going Public*, IPOHUB (Mar. 27, 2018), <https://www.ipohub.org/costs-going-public/> [<https://perma.cc/U6P9-3ARV>]; see also Rodrigo Seira et al., *Due to SEC Inaction, Registration is Not a Viable Path for Crypto Projects*, PARADIGM (Mar. 23, 2023), <https://policy.paradigm.xyz/writing/secs-path-to-registration-part-i> [<https://perma.cc/7AA3-T5BF>] (detailing the challenges that cryptocurrency startups would face in attempts to register with the SEC).

⁵⁵ See Miles Jennings, *Principles & Models of Web3 Decentralization*, ANDREESSEN HOROWITZ https://a16z.com/wp-content/uploads/2022/04/principles-and-models-of-decentralization_miles-jennings_a16zcrypto.pdf [<https://perma.cc/3YMU-UUXM>] (last visited Feb. 13, 2024) (“[I]f an enterprise is so decentralized that it operates without a central controlling entity or management team, it would be difficult (or impossible) to establish an issuer or registrant for purposes of SEC filings and registration, making the application of securities laws impractical. Although such decentralization might not be possible for most businesses, it is not only possible for many web3 systems, but also essential to their function.”).

⁵⁶ See Press Release, U.S. Sec. and Exch. Comm’n, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (Mar. 7, 2018), <https://www.sec.gov/news/public-statement/enforcement-tm-statement->

considered securities, it would undoubtedly hinder the effectiveness of getting the protocol off the ground.⁵⁷ As a result of these burdensome implications, the industry has gone to great lengths to avoid having their cryptocurrencies classified as securities.⁵⁸ This objective, combined with a lack of clarity from regulators,⁵⁹ is the driving factor behind rising tensions with the SEC.

b. The SAFE + Token Warrant

The cryptocurrency industry has experimented with a variety of unique capital raising structures to avoid the previously explained pitfalls that are attached to security classification of cryptocurrency tokens.⁶⁰ The most popularly deployed of these structures as of today is the SAFE + Token Warrant.⁶¹ A Token Warrant, also

potentially-unlawful-online-platforms-trading [<https://perma.cc/82Z9-VH8M>] (“If a platform offers trading of digital assets that are securities and operates as an “exchange,” as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration.”); *see also* Helen Partz, *SEC Reportedly Investigates Decentralized Exchange Uniswap*, COINTELEGRAPH (Sept. 3, 2021), <https://cointelegraph.com/news/sec-reportedly-investigates-decentralized-exchange-uniswap> [<https://perma.cc/JNW6-C9XA>].

⁵⁷ *See* Robert Stevens, *Securities vs. Commodities: Why It Matters For Crypto*, COINDESK (Jan. 23, 2024), <https://www.coindesk.com/learn/securities-vs-commodities-why-it-matters-for-crypto/> [<https://perma.cc/76ZE-C5CG>].

⁵⁸ *See, e.g.*, Juan Batiz-Benet et al., *The SAFT Project: Toward a Compliant Token Sale Framework*, at *1 THE SAFT PROJECT (Oct. 2, 2017), <https://saftproject.com/static/SAFT-Project-Whitepaper.pdf> [<https://perma.cc/M7CD-QR42>]. (highlighting the lengths to which industry players went to avoid security classification under *Howey*).

⁵⁹ *See* James Taylor, *Lacking Regulatory Clarity: The Single Biggest Obstacle To Institutional Crypto Adoption in U.S.*, NASDAQ (Apr. 26, 2022), <https://www.nasdaq.com/articles/lacking-regulatory-clarity%3A-the-single-biggest-obstacle-to-institutional-crypto-adoption> [<https://perma.cc/4X8B-WBRV>].

⁶⁰ Darko Stefanoski et al., *Tokenization of Assets: Decentralized Finance (DeFi)*, 1 ERNST & YOUNG 10-25 (2020).

⁶¹ *See* Ricah Bhagat, *Panoptic Raises \$4.5 Million In a Seed Funding Round*, THE CRYPTO TIMES (Dec. 6, 2022; 7:38 AM), <https://www.cryptotimes.io/panoptic-raises-4-5-million-in-a-seed-funding-round/> [<https://perma.cc/ZEQ2-8Q7P>]; *see also* Bradley Nelson, *An Aptos-Based Multi-Sig Wallet Secures \$5 Million in Funding*, TOKENHELL (Jan. 7, 2023), <https://tokenhell.com/an-aptos-based-multi-sig-wallet-secures-5-million-in-funding/> [<https://perma.cc/GFL2-5SAU>]; Michael Abadha, *UK Blockchain Sharding Startup Calimero Raises \$8.5 Million*, INVESTINGCUBE (Jan. 23, 2023), <https://www.investingcube.com/uk-blockchain-sharding-startup-calimero-raises-8-5-million/> [<https://perma.cc/Y2PC-ZQU9>]; Kurt Ebenzer, *OpenAI Founder to Raise Funding with Cryptocurrency Project Worldcoin*, OUR BITCOIN NEWS (Feb. 10, 2023), <https://ourbitcoinnews.com/openai-founder-to-raise-funding-with-cryptocurrency-project-worldcoin/> [<https://perma.cc/U8V4-TYKF>].

known as a token side letter,⁶² is an agreement between investors and an “overarching corporation” that initially develops a protocol whereby investors are given the option to purchase tokens at a discount before a specified expiration⁶³ that is “commensurate with the equity ownership percentage” of the investor.⁶⁴ Token Warrants are typically part of an agreement in which a startup signs a SAFE or other regular convertible instrument in addition to the Token Warrants.⁶⁵ Critically, “the Token Warrant conveys a right to acquire or buy future tokens but not a commitment to do so” and they do not become a substitute for shares in the corporation or LLC.⁶⁶ To provide an example, Maple Finance allocated 26% of their native cryptocurrency token “MPL” to “seed investors.”⁶⁷ Based on this, a seed investor with a 10% equity stake in the overarching corporation who began Maple Finance’s development will have a warrant granting them the option to purchase up to 2.6% of the cryptocurrency token supply at an agreed upon price and, presumably, before an agreed upon expiration date.⁶⁸ The remaining tokens would be allocated between a variety of uses including public allocation, the development team, the protocol treasury, and for providing liquidity.⁶⁹

⁶² See *Token Warrants – How Can You Use Them for Crypto Fundraising?*, EQVISTA <https://eqvista.com/company-valuation/valuation-crypto-assets/token-warrants/> [<https://perma.cc/X9ZK-DVX4>] (last visited Apr. 6, 2023) (“While not identical, properly worded token side letters and warrants are meant to accomplish the same result.”).

⁶³ See *What Is a Token Warrant? A Fundraising Guide for Web3 Startups*, PULLEY (May 5, 2023), <https://pulley.com/guides/token-warrant> [<https://perma.cc/2BSM-NXUG>] (“A token warrant is a derivative that allows the warrant holder to purchase tokens in the issuing company at a specified price on or before a specified expiration date.”).

⁶⁴ Steve Glaveski, *SAFTs & Token Warrants – What They Are and How They Work*, MEDIUM (May 24, 2022), <https://glaveski.medium.com/safts-token-warrants-what-they-are-and-how-they-work-9be323e0afed> [<https://perma.cc/9WA8-M938>].

⁶⁵ See *Token Warrants*, *supra* note 62. Other examples of a regular convertible instrument include a Convertible Note and an Advanced Subscription Agreement.

⁶⁶ *Id.*

⁶⁷ See *Maple*, COLLECTIVESHIFT, <https://collectiveshift.io/mpl/> [<https://perma.cc/CL5H-HV4C>] (last visited Apr. 6, 2023); see also Glaveski, *supra* note 64.

⁶⁸ See Glaveski, *supra* note 64; *What is a Token Warrant?*, *supra* note 63.

⁶⁹ Public Allocations are commonly referred to as an “airdrop.” See Andrey Sergeenkov, *What is a Crypto Airdrop?*, COINDESK (Jan. 19, 2022), <https://www.coindesk.com/learn/what-is-a-crypto-airdrop/> [<https://perma.cc/B67H-9F4Q>]; see also Cryptopedia Staff, *What are Liquidity Pools?*, GEMINI (Nov. 16, 2023), <https://www.gemini.com/cryptopedia/what-is-a-liquidity-pool-crypto-market-liquidity> [<https://perma.cc/E7SN-33QM>].

To be sure, there are a variety of potential benefits for both investors and founders in the Token Warrant structure, including flexibility and control.⁷⁰ That being said, “the chief reason for the shift away from pure token sales is the menace of U.S. regulation and prevailing uncertainty around what type of token might qualify as a security.”⁷¹ The industry’s intention is that by structuring the offering as a SAFE + Token Warrant the initial developers can raise the money they need while shielding their cryptocurrency from being classified as a security as defined by U.S. securities laws and regulations.⁷²

The Securities Act of 1933 (“1933 Act”) defines a security as, “any note, stock, . . . *investment contract*, . . . any put, call, straddle, option, or privilege on any security . . . or, in general, any interest or instrument commonly known as a “security”, . . . or warrant or right to subscribe to or purchase, any of the foregoing.”⁷³ The term “investment contract,” acting as a catch-all within the statutory definition, is the key language relevant to whether or not cryptocurrencies are within the jurisdiction of the SEC. This catch-all has been how the SEC attempts to capture various cryptocurrencies under its jurisdiction for enforcement actions.⁷⁴ More specifically, the SAFE + Token Warrant is designed to fail the *Howey* test which was set out by the Supreme Court in the landmark case *Securities & Exchange Commission v. W.J. Howey Company* as the bona fide test for defining an investment contract.⁷⁵

⁷⁰ See Nestor Dubnevych, *Choosing a Web3 Fundraising Document in 2023: A Playbook for Founders*, LEGALNODES (Jan. 26, 2024), <https://legalnodes.com/article/web3-investment-documents> [https://perma.cc/FF29-J59R]; see also Ryan Weeks, *Why Equity Plus Token Warrants is the New Go-To Formula for Crypto VCs*, THE BLOCK (Sept. 21, 2022), <https://www.theblock.co/post/171609/why-equity-plus-token-warrants-is-the-new-go-to-formula-for-crypto-vc> [https://perma.cc/9G88-HDF8].

⁷¹ Weeks, *supra* note 70 (“If a token is used for fundraising purposes, it may fail the Howey Test — U.S. regulators’ method of determining what constitutes a security.”).

⁷² See *id.*

⁷³ Securities Act of 1933, 15 U.S.C. § 77b(2)(a)(1); see also Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (“The term “security” means any note, stock, . . . *investment contract*, . . . any put, call, straddle, option, or privilege on any security, . . . or in general, any instrument commonly known as a “security” . . . or warrant or right to subscribe to or purchase, any of the foregoing.”) (emphasis added).

⁷⁴ See Sam Reynolds, *Coinbase Says SEC is Attempting to “Redefine Definition of Investment Contract”*, COINDESK (Oct. 25, 2023), <https://www.coindesk.com/policy/2023/10/25/coinbase-says-sec-is-attempting-to-redefine-definition-of-an-investment-contract/> [https://perma.cc/9YUP-P3NE].

⁷⁵ See *Glaveski, supra* note 64; *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946).

III. ISSUE

The issue that this Note analyzes is whether the “SAFE + Token Warrant” capital raising structure fails the *Howey* test and successfully prevents cryptocurrencies from being classified as securities.

IV. RELEVANT SECURITIES LAW

c. Controlling Securities Law: The *Howey* Test

The Supreme Court defined “investment contract” in *Howey*, in which the SEC alleged that Howey sold unregistered securities when he offered subdivided parcels of a citrus grove combined with a separate contract for the full servicing of those parcels to investors.⁷⁶ The Court agreed, defining an investment contract in the context of the 1933 Act as “a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party.”⁷⁷ The Court emphasized the “economic reality” of the interest opting for a definition that “embodies a flexible, rather than static principle . . . capable of adaption to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”⁷⁸ Ultimately, because the investors that Howey contracted with had “no desire to occupy the land or to develop it themselves” and were “attracted solely by the prospects of a return on their investment” the criteria necessary to be an investment contract were satisfied.⁷⁹

Howey established a four-part test that courts and regulators look to when determining whether an interest is an investment contract.⁸⁰ To be considered an investment contract the interest must include: (1) an investment; (2) in a common enterprise; (3) with an

⁷⁶ *W.J. Howey Co.*, 328 U.S. at 293.

⁷⁷ *Id.* at 299-300.

⁷⁸ *Id.* at 298-99.

⁷⁹ *Id.* at 300.

⁸⁰ *See id.*

expectation of profits; (4) derived from the efforts of others.⁸¹ Subsequent cases have helped to clarify this test.⁸²

1. Investment of Money

Fairly straightforward, the first prong of *Howey* asks whether the purchasers of the interest made an “investment of money.”⁸³ Although “money” is commonly thought of as some form of currency it can be any sort of consideration offered.⁸⁴

2. Common Enterprise

To be an “investment contract” for purposes of the 1933 Act, the investor must be making their investment into a “common enterprise.”⁸⁵ The Supreme Court has never clearly defined the term, which has led to variation amongst the circuits.⁸⁶ Courts have found a showing of a common enterprise either through “horizontal commonality” or “vertical commonality.”⁸⁷ Horizontal commonality is generally defined as “the tying of each individual investor’s fortunes to the fortunes of the other investors by a pooling of assets” where “each investor depend[s] upon the profitability of the enterprise as a whole.”⁸⁸ On the other hand, vertical commonality “focuses on the relationship between the promoter and the body of investors.”⁸⁹ Circuits deploying the vertical commonality test are further split looking either for “broad vertical commonality” or “strict vertical commonality.”⁹⁰ Broad vertical commonality is focused on the link between the investors fortune to the promoters’ efforts.⁹¹ Strict vertical commonality “requires that

⁸¹ *See id.*; *see also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (“investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others”).

⁸² *See, e.g.*, S.E.C. v. Edwards, 540 U.S. 389, 392, 395 (2004); *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990).

⁸³ *W.J. Howey Co.*, 328 U.S. at 301.

⁸⁴ *See* S.E.C. v. SG Ltd., 265 F.3d 42, 47 (1st Cir. 2001) (citing *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 561 (1979)).

⁸⁵ *W.J. Howey Co.*, 328 U.S. at 298-99.

⁸⁶ *See* *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994) (citing *Hart v. Pulte Homes of Mich. Corp.*, 735 F.2d 1001, 1004 (6th Cir. 1984)); *Salcer v. Merrill Lynch*, 682 F.2d 459, 460 (3d Cir. 1982) (investment must be “part of a pooled group of funds”); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276 (7th Cir.) (success or failure of other contracts must have a “direct impact on the profitability of plaintiffs’ contract”).

⁸⁷ *Revak*, 18 F.3d at 87.

⁸⁸ *Id.*

⁸⁹ *Id.* at 88.

⁹⁰ *Id.*

⁹¹ *See id.*

the fortunes of the investors be tied to the fortunes of the promoter.”⁹²

3. Expectation of Profit

To be an “investment contract” for purposes of the 1933 Act, the investor must have an expectation of profits. “By profits the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors’ funds.”⁹³ Importantly, *Howey* stressed that the investor must be “‘attracted solely by the prospects of a return’ on his investment.”⁹⁴ Therefore, “when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.”⁹⁵

4. Efforts of Others

To be an investment contract for purposes of the 1933 Act, *Howey* tells us that an expectation of profits must be “solely” based on the efforts of others.⁹⁶ As the Supreme Court has held that the definition of investment contract should be flexible and construed broadly to cover various schemes, courts have not read the word “solely” to be a literal restriction where all profits must be derived from the efforts of others.⁹⁷ Instead, Courts ask “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”⁹⁸

⁹² *Id.* (quoting *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978)).

⁹³ *United Hous. Found., Inc.*, 421 U.S. at 852; *see also Edwards*, 540 U.S. at 394 (“We used ‘profits’ in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of investments.”).

⁹⁴ *United Hous. Found., Inc.*, 421 U.S. at 852 (quoting *W.J. Howey Co.*, 328 U.S. at 293).

⁹⁵ *United Hous. Found., Inc.*, 421 U.S. at 852-53 (“What distinguishes a security transaction — and what is absent here — is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or . . . for personal use.”); *see also Landreth Timber Co. v. Landreth*, 471 U.S. 681, 689 (1985) (“Applying the *Howey* test, we concluded that the instruments likewise were not ‘securities’ by virtue of being ‘investment contracts’ because the economic realities of the transaction showed that the purchasers had parted with their money not for the purpose of reaping profits from the efforts of others, but for the purpose of purchasing a commodity for personal consumption.”).

⁹⁶ *W.J. Howey Co.*, 328 U.S. at 298.

⁹⁷ *See S.E.C. v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

⁹⁸ *Id.*

i. Bitcoin is Not a Security; Initial Coin Offerings are Securities

Applying the *Howey* framework to cryptocurrencies leads to varying results. For example, Bitcoin likely fails the *Howey* test and would therefore not be a security.⁹⁹ While purchasers of Bitcoin are investing money, meeting the first prong of *Howey*, there is no “common enterprise” because there is no issuer of Bitcoin and purchaser funds are inherently not pooled as each user maintains full custody of their bitcoin.¹⁰⁰ Additionally, any investor purchasing bitcoin may expect future profits, but these profits cannot be said to have been derived from the efforts of others, as there is no promoter whose “essential managerial efforts” lead to increasing Bitcoin’s value.¹⁰¹

Former SEC Chair Clayton and current Chair Gensler have both agreed with this line of reasoning, publicly stating that they do not consider Bitcoin a security.¹⁰² On the other hand, Commissioner Clayton was clear in 2018 before the U.S. Senate when he said “every [Initial Coin Offering] I’ve seen is a security.”¹⁰³ This is

⁹⁹ See Glenn Williams, *Bitcoin, Ether Fall Outside Howey Test Criteria*, COINDESK (June 21, 2023, 3:15 PM), <https://www.coindesk.com/markets/2023/06/21/bitcoin-ether-fall-outside-howey-test-criteria/> [<https://perma.cc/3PUQ-FAQ6>].

¹⁰⁰ See *W.J. Howey Co.*, 328 U.S. at 298-99; *Bitcoin*, BITCOIN.IT (last visited Apr. 6, 2023), <https://en.bitcoin.it/wiki/Bitcoin> [<https://perma.cc/42FR-P7X7>] (“Bitcoin has no central issuer; instead, the peer-to-peer network regulates bitcoins, transactions and issuance according to consensus in network software. These transactions are verified by network nodes through the use of cryptography and recorded in a public distributed ledger called a blockchain.”).

¹⁰¹ See *Glenn W. Turner Enters., Inc.*, 474 F.2d at 482; Andrew Bloomenthal, *What Determines Bitcoin’s Price?*, INVESTOPEDIA, <https://www.investopedia.com/tech/what-determines-value-1-bitcoin/> [<https://perma.cc/49KY-22EJ>] (last visited May 11, 2023) (“Bitcoin acts as more of a commodity being used to store value, so the following factors influence its price: the supply of Bitcoin and the market’s demand for it, the cost of producing a bitcoin through the mining process, the number of competing cryptocurrencies, regulations governing its sale and use, media and news.”).

¹⁰² See Neeraj Agrawal, *SEC Chairman Clayton: Bitcoin is Not a Security.*, COIN CENTER (Apr. 27, 2018), <https://www.coincenter.org/sec-chairman-clayton-bitcoin-is-not-a-security/> [<https://perma.cc/3ZBV-GQJ7>]; Andre Beganski, *SEC Chair Gensler Again Says Bitcoin is Not a Security. What About Ethereum?*, DECRYPT (June 27, 2022), <https://decrypt.co/103926/sec-chair-gensler-bitcoin-not-security-what-about-ethereum> [<https://perma.cc/K2R5-A4ER>].

¹⁰³ See Stan Higgins, *SEC Chief Clayton: ‘Every ICO I’ve Seen Is a Security’*, COINDESK (Sept. 13, 2021, 3:32 AM), <https://www.coindesk.com/markets/2018/02/06/sec-chief-clayton-every-ico-ive-seen-is-a-security/> [<https://perma.cc/SH37-U9R5>]; see also Stan Higgins, *SEC: US Securities Laws ‘May Apply’ to Token Sales*, COINDESK (Sept. 13, 2021,

likely due to key factual distinctions between the Bitcoin network and Initial Coin Offerings (“ICOs”). Early stage blockchain developers may use ICOs as a fundraising mechanism, where the blockchain’s cryptocurrency is “pre-mined” and sold to the public directly in exchange for capital (generally BTC or ETH) that will be used to seed further development of their protocol.¹⁰⁴ The purchasers invest BTC or ETH in exchange for the new tokens.¹⁰⁵ Horizontal commonality exists by a pooling of investor funds, while vertical commonality is present when the promoter and investor fortunes become aligned with the success of the developing blockchain product.¹⁰⁶ There is also an expectation of profit “derived from the efforts of others” as the prospective investors are exchanging their BTC or ETH for the new cryptocurrency with the expectation that further development by the startup will increase the value of the cryptocurrency.¹⁰⁷ Given ICOs’ clear nature as investment contracts under *Howey*, combined with the naked hawkishness from the SEC at the time,¹⁰⁸ the industry birthed a new evolution of cryptocurrency offerings: the SAFT.¹⁰⁹

b. The Simple Agreement for Future Tokens

The Simple Agreement for Future Tokens (“SAFT”) is an instrument designed by the firm Cooley LLP in an attempt to facilitate the fundraising efforts of blockchain protocols without classifying the tokens as securities.¹¹⁰ The SAFT itself is an investment contract sold exclusively to accredited investors.¹¹¹

2:46 AM), <https://www.coindesk.com/markets/2017/07/25/sec-us-securities-laws-may-apply-to-token-sales/> [perma.cc/9387-59QH] (showing that there was SEC scrutiny of ICOs as early as 2017); Nikhilesh De, *SEC Chairman Gensler Agrees with Predecessor: ‘Every ICO Is a Security’*, COINDESK (Sept. 14, 2021, 9:34 AM), <https://www.coindesk.com/markets/2021/08/03/sec-chairman-gensler-agrees-with-predecessor-every-ico-is-a-security/> [perma.cc/9M9C-XNPB].

¹⁰⁴ See Annika Feign, *What Is an ICO?*, COINDESK (Dec. 11, 2022, 2:32 PM) <https://www.coindesk.com/learn/what-is-an-ico/> [https://perma.cc/SW5R-Z9DW]; see also *The Purpose and Value of Cryptocurrency and Tokens*, *supra* note 32 (discussing the ideal fundraising event for an MEC).

¹⁰⁵ Feign, *supra* note 104.

¹⁰⁶ See *Revak*, 18 F.3d at 87.

¹⁰⁷ See Feign, *supra* note 104 (“Ethereum’s ICO was one of the first real success stories using this relatively new type of fundraising mechanism, raising \$15.5 million in 2014. Fifty million ether tokens (ETH) were sold at \$0.311 each, and on May 12, 2021, it hit an all-time high of \$4,382.73, offering investors a 1,408,903% return on investment.”).

¹⁰⁸ See Agrawal, *supra* note 102.

¹⁰⁹ See Batiz-Benet, *supra* note 58, at *1.

¹¹⁰ *Id.*

¹¹¹ *Id.*

These investors purchase the SAFT in exchange for an interest in the functional utility tokens which will be created, launched, and delivered to them in the future.¹¹² In the SAFT whitepaper, it is presumed that these tokens, at the time of delivery, are not investment contracts and thus not securities.¹¹³ Therefore, at the time of delivery to SAFT purchasers, the tokens can be sold without having to register them as securities with the SEC.¹¹⁴

The SAFT whitepaper explains its reasoning by distinguishing two potential types of purchasers of cryptocurrencies on the secondary markets.¹¹⁵ The first is a purchaser who buys the tokens to use them, where “consumptive desires predominate their profit seeking motives.”¹¹⁶ The whitepaper cites to cases such as *United Housings Foundation, Landreth*, and *S.E.C. v. SG Ltd.*, to show that the courts have many times “distinguished between the acquiring [of] an interest for personal use or consumption versus [the] acquiring [of] an interest in a profit-making venture.”¹¹⁷ For example, in *United Housing Foundation*, the purchasers of stock in the housing co-op intended to live in the co-op when they purchased the stock.¹¹⁸ Therefore, if a secondary purchaser has consumptive intent, the SAFT purchasers selling to them would not be selling an investment contract at that time.¹¹⁹

The second type of purchaser is one who does buy the tokens with an expectation of profit.¹²⁰ Here, the argument is that a functional utility token has evolved past the stage where any profits made by selling them comes from the “efforts of others.”¹²¹ Citing cases such as *Noa v. Key Futures* and *S.E.C. v. Belmont Reid*, the SAFT whitepaper points out that courts have held that gold and silver futures contracts were not investment contracts because the

¹¹² *Id.*

¹¹³ *Id.* (“Unlike a pre-functional token, though, whose market value is determined predominantly by the efforts of the sellers in imbuing the tokens with functionality, a genuinely functional token’s value is determined by a variety of market factors, the aggregate impact of which likely predominates the ‘efforts of others.’ Sellers of already functional tokens have likely already expended the ‘essential’ managerial efforts that might otherwise satisfy the Howey test.”).

¹¹⁴ *Id.* at *15-16.

¹¹⁵ Batiz-Benet, *supra* note 58, at *9.

¹¹⁶ *Id.*

¹¹⁷ *Id.* at *8, n.32. *United Hous. Found.*, 421 U.S. at 858; *Landreth*, 471 U.S. at 689; *SG Ltd.*, 265 F.3d at 53.

¹¹⁸ See *United Hous. Found.*, 421 U.S. at 842.

¹¹⁹ See Batiz-Benet, *supra* note 58, at *9.

¹²⁰ *Id.*

¹²¹ *Id.* (distinguishing “expectation of profit” prong from “efforts of others prong;” arguing that sloppy analysis often collapses these two prongs into one).

“profits to the investor depended primarily upon the fluctuations of the silver market, not the *managerial efforts* of Key Futures [and Belmont Reid].”¹²² Further distinguishing cryptocurrencies from gold and silver, the paper acknowledges that developers may continue to provide improvements to the network which may increase the value of already functional-utility tokens, but that because developers have relinquished control of the “monetary policy” functions of the network, supply and demand are the main drivers of token price appreciation.¹²³ Thus, these developer efforts no longer become “essential” to any investor’s realization of profit, failing the “efforts of others” prong of *Howey*.¹²⁴

In 2018, the SEC Director of the Division of Corporation Finance Bill Hinman, gave a speech addressing whether “a digital asset that was originally offered in a securities offering [will] ever be later sold in a manner that does not constitute an offering of a security . . .”¹²⁵ In short he answered affirmatively to the arguments put forward by the SAFT whitepaper about functional utility tokens.¹²⁶ In Hinman’s eyes, the cryptocurrency itself is merely computer code, and its status as an investment contract (and thus a security) is wholly dependent upon the way in which it is sold.¹²⁷ Critically, Hinman parroted the exact same logic employed in the SAFT whitepaper, acknowledging that there are cases where cryptocurrencies no longer rely on “essential managerial or entrepreneurial efforts” of developers and that as the network grows, the ability to even identify an issuer or promoter makes disclosures meaningless.¹²⁸ This acknowledgment gave many industry players

¹²² *Id.* (emphasis added); *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980); *S.E.C. v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986).

¹²³ See Batiz-Benet, *supra* note 58, at *9.

¹²⁴ *Id.* at *10 (“Thus, an already-functional utility token is less likely to be a security for two independent grounds. First, it is more likely that purchasers have bought them to use them (since, unlike pre-functional utility tokens, they can be used immediately to satisfy imminent needs). Second, purchasers who buy them with an eye toward profit upon resale can expect those profits to be determined by a variety of market factors that predominate the efforts of the seller in updating the token’s functionality.”).

¹²⁵ See William Hinman, Director, Division of Corporation Finance, S.E.C., Digital Asset Transactions: When *Howey* Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018) (transcript available at <https://www.sec.gov/news/speech/speech-hinman-061418> [<https://perma.cc/H98L-NL48>]).

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* (“If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract.”).

the confidence to utilize the SAFT with the expectation that they would be safe from any securities laws.¹²⁹ That was, until the SEC brought an enforcement action against Telegram.¹³⁰

c. S.E.C. v. Telegram

In 2018, utilizing a SAFT structure, Telegram raised \$1.7 billion dollars from a group of accredited investors in exchange for a “Grams Purchase Agreement” which promised the delivery of 2.9 billion cryptocurrency tokens (to be called “Grams”).¹³¹ The plan was for Grams to be developed and integrated into the pre-existing Telegram app as the native currency via a Telegram Open Network (“TON”) blockchain.¹³² At the time of delivery it was assumed the market price for Grams would far exceed the agreed upon purchase price in the Gram Purchase Agreement generating substantial profits for the investors.¹³³

The SEC sought to enjoin Telegram, alleging that the accredited investors were simply acting as underwriters for Telegram in a distribution of unregistered securities (the Grams) to the public markets.¹³⁴ The court agreed with the SEC’s argument that while the Grams themselves may be “little more than alphanumeric cryptographic sequence[s],” the *Howey* test applies to “contracts, transactions or schemes.”¹³⁵ Here, the SAFT and subsequent resale into secondary markets all fall under the same “scheme” and therefore the appropriate time to evaluate this scheme is when “the scheme’s participants first had a meeting of the minds . . . rather than [at] the date of delivery.”¹³⁶ Critically, the *Telegram*

¹²⁹ See Stu Alderoty, *The Speech that Muddied the Crypto Waters*, FORTUNE (June 13, 2022, 6:33 AM), <https://fortune.com/2022/06/13/hinman-speech-sec-ripple-crypto-waters-xrp-eth-regulation-stu-alderoty/> [<https://perma.cc/VSN3-PCX5>] (“[T]he market took Hinman’s speech to heart. For Ripple, Hinman’s speech affirmed the conclusion that XRP – a cryptocurrency that exists on an open, permissionless, decentralized blockchain ledger – was a commodity and/or a virtual currency. Certainly not a security.”).

¹³⁰ See *S.E.C. v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352 (S.D.N.Y. 2020).

¹³¹ *Id.* at 358.

¹³² *Id.* at 360.

¹³³ *Id.* at 372.

¹³⁴ *Id.* at 358; see also *Ackerberg v. Johnson*, 892 F.2d 1328, 1336 (8th Cir. 1989) (stating that an individual is not an underwriter if: (1) the individual purchased the securities for the purpose of holding them as an investment, and (2) the individual does not resell the securities as a distribution for the issuer. Distribution is defined as a public offering. Courts will consider the purchase to be made with an eye towards investment if the individual holds it for at least two years without trying to sell the securities).

¹³⁵ See *Telegram Grp. Inc.*, 448 F. Supp. 3d at 379.

¹³⁶ *Id.* at 379.

court changed the paradigm of how to analyze these cryptocurrencies under *Howey*.¹³⁷ Instead of looking at it from the perspective of the various prospective purchasers—separating out accredited investors purchasing Gram Purchase Agreements and subsequent secondary market purchasers of Grams into two separate analyses—the *Telegram* court focused on the “economic realities” and intentions of the issuer (in this case, Telegram) when the “scheme” started.¹³⁸ Therefore, the court proceeded to analyze the Grams themselves under *Howey* as if they had been sold to the purchasers in 2018 at the time the Gram Purchase Agreements were formed instead of from the perspective of public market investors purchasing them from the accredited investors.¹³⁹

In doing so, the court stated that this should be a fact-based inquiry, noting that in Telegram’s public marketing the goal was to establish Grams as a “mass market cryptocurrency.”¹⁴⁰ To achieve those ends Telegram aggressively marketed Grams as an investment opportunity to the public, sought out venture capital investors, and set up incentive structures such that SAFT purchasers would quickly resell their Grams into the open market for a quick profit.¹⁴¹ Further, the investors agreed to different lock up periods for certain discounts on their purchase price.¹⁴² Telegram also made it clear that they would “be the guiding force behind the TON blockchain” during the “post-launch period.”¹⁴³ This combination of facts showed:

[A] substantial likelihood of success in proving that the initial purchasers purchased Grams in the 2018 sales with an expectation of profit in the resale of those Grams to the public via the TON blockchain, which would be developed by Telegram and the success of which would be implicitly guaranteed post-launch by Telegram.¹⁴⁴

The presence of the lockup periods, in the court’s opinion, made it conclusive that once those periods ended the initial purchasers would then sell those Grams into the public market.¹⁴⁵ Thus, the Grams Purchase Agreement “scheme,” which Grams were a part of, was an investment contract that did not end until the initial

¹³⁷ *Id.* at 358.

¹³⁸ *Id.* at 365.

¹³⁹ *Id.* at 368.

¹⁴⁰ *Id.* at 379-80.

¹⁴¹ *Telegram Grp. Inc.*, 448 F. Supp. 3d at 372-73, 380

¹⁴² *Id.* at 372.

¹⁴³ *Id.* at 358.

¹⁴⁴ *Id.* at 371.

¹⁴⁵ *Id.* at 367.

purchasers sold their Grams into the public markets via the TON blockchain for a profit.¹⁴⁶ Therefore, the court held that these Gram Purchase Agreement purchasers would have acted as underwriters of unregistered securities when selling the Grams into the secondary market.¹⁴⁷

This analysis by the *Telegram* court was surprising to the cryptocurrency industry, given that *Howey* is a facts and circumstances based test and the court chose to focus its analysis only on the facts of the initial purchasers, ignoring the facts and circumstances of the subsequent public market purchasers.¹⁴⁸ This same line of reasoning was used successfully by the SEC against another cryptocurrency in *S.E.C. v. Kik Interactive*¹⁴⁹ and is currently being deployed by the SEC against Ripple Lab,¹⁵⁰ in which the SEC is arguing that the XRP token embodies the facts, circumstances, expectations, etc., of the investment contract and, therefore, is a security.¹⁵¹ While there is hope within the industry that the Ripple case will at the very least bring some much needed

¹⁴⁶ *Id.*

¹⁴⁷ *Telegram Grp. Inc.*, 448 F. Supp. 3d at 380-81 (calling the SAFT scheme a “disguised public distribution.” “The Grams would not and were not intended to come to rest with the Initial Purchasers but instead were intended to move with the Initial Purchasers to the general public.”).

¹⁴⁸ See *SEC v. Telegram: Key Takeaways and Implications*, COOLEY (May 7, 2020), <https://www.cooley.com/news/insight/2020/2020-05-07-sec-v-telegram-key-takeaways-implications> [<https://perma.cc/7VNV-H44W>] (providing a detailed analysis of the implications of the Telegram case as well as a response to some of the arguments raised, which is outside the scope of this Note).

¹⁴⁹ 492 F. Supp. 3d 169, 181-82 (S.D.N.Y. 2020).

¹⁵⁰ See Gabriel Shapiro, *How SEC v. Ripple Stems from an Age-Old Philosophical Debate*, LEXNODE SUBSTACK (May 10, 2021), <https://lexnode.substack.com/p/how-sec-vs-ripple-stems-from-an-age> [<https://perma.cc/PH4Q-VC8V>] (“[T]he security in this case is not simply the [XRP], which is little more than alphanumeric cryptographic sequence,’ [but rather] it is all the facts and circumstances surrounding the digital asset and the manner in which it is offered and sold (including the entirety of the representations Ripple made and purchasers’ resulting expectations) that made the offers and sales of XRP the offers and sales of an investment contract. The XRP traded, even in the secondary market, is the embodiment of those facts, circumstances, promises, and expectations, and today represents that investment contract.”). As of April 2023, when this paper was authored, critical developments in securities law regarding cryptocurrency were yet to unfold, notably in *S.E.C. v. Ripple* and *S.E.C. v. Terraform*.

¹⁵¹ John E. Deaton, *An Open Letter to the Members of the House Financial Services Committee and of the U.S. Securities and Exchange Commission*, CRYPTO LAW (July 12, 2022), <https://www.crypto-law.us/an-open-letter-to-the-members-of-the-house-financial-services-committee-and-of-the-u-s-securities-and-exchange-commission/> [<https://perma.cc/LD7P-A4S8>].

legal clarity,¹⁵² projects in the meantime have had to adapt to this line of reasoning put forth by the SEC and accepted by the court in *Telegram*.¹⁵³

At bottom, the SAFT model has been handicapped from achieving its goal of shielding the cryptocurrency itself from being classified security. Cooley LLP, in response to the *Telegram* ruling, released a list of recommendations for how to proceed as an industry.¹⁵⁴ Among those suggestions were to, “differentiate and disaggregate the ‘scheme’” by restricting the early purchaser’s transferability of assets post-launch until, “additional decentralization and/or additional functionality and further market liquidity not linked to early purchasers’ resales has been established.”¹⁵⁵ Additionally, Cooley LLP noted that if the SAFT purchase agreement contemplated “unrestricted distributions” there

¹⁵² See Dave Michaels, *Ripple’s Legal Brawl with SEC Could Help Settle When Cryptocurrencies are Securities*, WALL ST. J. (Feb. 2, 2022), <https://www.wsj.com/articles/crypto-industry-hopes-looming-legal-brawl-will-thwart-secs-regulation-push-11643724002> [<https://perma.cc/B9HZ-NZKC>].

¹⁵³ See Stuart D. Levi et al., *Two Sides of the Same Coin: Analyzing the Recent Ripple and Terraform Decisions*, REUTERS (Aug. 31, 2023), <https://www.reuters.com/legal/legalindustry/two-sides-same-coin-analyzing-recent-ripple-terraform-decisions-2023-08-31/> [<https://perma.cc/PQQ5-ZBFD>]; see also Alex Drylewski et al., *Ripple Effects: Developments Following Groundbreaking Decision in SEC v. Ripple Labs*, REUTERS LEGAL NEWS (Dec. 5, 2023), <https://www.reuters.com/legal/legalindustry/ripple-effects-developments-following-groundbreaking-decision-sec-v-ripple-labs-2023-12-05/> [<https://perma.cc/RLL9-TDYM>]. As of April 2023, when this paper was authored, critical developments in securities law regarding cryptocurrency were yet to unfold, notably in *S.E.C. v. Ripple* and *S.E.C. v. Terraform*. In *Ripple*, the court emphasized a facts-and-circumstances approach, distinguishing between institutional sales, secondary “programmatically” sales, and employee sales. Institutional buyers were thought to expect profits from Ripple’s efforts, a rationale not applicable to programmatic sales due to anonymity on secondary platforms. According to the judge in *Ripple*, secondary purchasers of XRP had no reason to expect their proceeds would be used to generate profits by Ripple on their behalf. In contrast, *Terraform*’s ruling rejected this distinction, suggesting that Terraform’s public statements and marketing campaigns created an expectation of profit across all types of sales, including an expectation of profit in any unsophisticated retail purchasers on the secondary market. These rulings highlight the legal ambiguity around secondary market transactions in cryptocurrencies depending on the specific facts and circumstances of each cryptocurrency. There is still no consensus with ongoing cases like *S.E.C. v. Coinbase* and *S.E.C. v. Binance*. These cases, rooted in unique circumstances, suggest that a definitive legal stance will only emerge once higher courts, such as the Second Circuit, weigh in, shaping the future of cryptocurrency regulation, but importantly emphasize that these analyses are grounded in the facts and circumstances.

¹⁵⁴ See *SEC v. Telegram: Key Takeaways and Implications*, *supra* note 148.

¹⁵⁵ See *id.*

would be a significant increase in the risk of purchasers being classified as underwriters in the scheme going forward.¹⁵⁶ Key to Cooley's recommended steps to protect against this new line of reasoning was to ensure the protocol achieved, "decentralization; functionality; equal market risk among initial purchasers; the issuer and purchasers at launch; liquidity; and distributions other than as a result of initial purchaser resale."¹⁵⁷

V. ANALYSIS

d. The Safe + Token Warrant Offering Under *Howey*

i. The Scheme

As noted above, a SAFT is a transaction involving the exchange of seed capital for a promise to deliver cryptocurrency tokens to be developed in the future.¹⁵⁸ On the other hand, the SAFE + Token Warrant structure involves a transaction where seed capital is exchanged for equity in the corporate entity which will develop the protocol in its early stages (the SAFE), plus a separate agreement whereby the investor has a right, but not an obligation, to purchase tokens in the future (Token Warrants).¹⁵⁹ In *Telegram*, the SEC's argument and the court's holding stood on the foundational notion that the "Gram Purchase Agreement" (the SAFT) was a "scheme" whereby Telegram would receive capital in exchange for a promise to deliver cryptocurrency and that "scheme" did not end until the investors realized their profits by distributing those tokens into the public markets.¹⁶⁰ The court rationalized this holding by pointing to efforts made by Telegram to market Grams as a high upside investment while creating an incentive structure in the Gram Purchase Agreements such that no reasonable investor would do anything other than immediately sell the Grams as soon as the lock-up ended to (realize their profits).¹⁶¹ Notably, the investor sale of Grams into the secondary market would also generate a liquidity for the overall market of Grams because it would coincide with the launch of Grams to the public.¹⁶² Thus, the Grams "embodied" the facts, circumstances, and realities of the overall scheme and were also securities.¹⁶³ As such, the court analyzed the Grams under

¹⁵⁶ *See id.*

¹⁵⁷ *See id.*

¹⁵⁸ Batiz-Benet, *supra* note 58.

¹⁵⁹ *See What Is a Token Warrant?*, *supra* note 63.

¹⁶⁰ *Telegram Grp. Inc.*, 448 F. Supp. 3d at 367.

¹⁶¹ *Id.* at 380.

¹⁶² *See id.* at 361.

¹⁶³ *See* Deaton, *supra* note 151.

Howey at the time of the purchase of the Gram Purchase Agreements, which inherently blocks any inclusion of the facts around consumptive intent and sufficient decentralization which negates any expectation of profits derived from the efforts of others as anticipated by the SAFT issuers.¹⁶⁴

The SAFE + Token Warrant model presents an entirely new set of facts and circumstances, forming a structure improbable to be susceptible to the same analysis employed by the SEC and the court in *Telegram*.¹⁶⁵ In *Telegram*, the court noted that the Gram Purchase Agreement “scheme” was not fully executed until Telegram delivered on its promise to send tokens to the purchasers of the agreements, who subsequently harvested profits by selling into the secondary public market.¹⁶⁶ In the case of a SAFE + Token Warrant model, the seed capital is exchanged for equity in the corporate entity.¹⁶⁷ As such, the purchasers of the SAFE + Token Warrants reasonably expect that the capital provided will likely return profits in the form of the increased value of the equity in the entity.

Token Warrants are a separate interest offered in conjunction with this equity.¹⁶⁸ If the purchasers wish to exercise their right to buy tokens from the Token Warrants signed in addition to the SAFE, they would have to purchase those tokens at that time.¹⁶⁹ In doing so, the investors will provide new capital to the now sufficiently decentralized protocol in exchange for the tokens.¹⁷⁰ This reveals several vital facts distinct from the SAFT analysis supporting the *Telegram* court’s finding. First, as mentioned, at the time of the initial transaction, the investor is not relying on the delivery of tokens in the future from the startup to make a profit on their investment.¹⁷¹ Second, if the investor decided to exercise their option to buy tokens in the future, it would have to provide new capital as an investment of money in exchange for those tokens—a

¹⁶⁴ See *Telegram Grp. Inc.*, 448 F. Supp. 3d at 367.

¹⁶⁵ See *SEC v. Telegram: Key Takeaways and Implications*, *supra* note 148. Importantly, the recent holdings in *Ripple* and *Terraform*, while non-binding precedent, which came down after this Note was authored in April 2023, continue to bolster the notion that the analysis needs to be a fact and circumstances-based analysis. This plays into those favoring attempts to use a SAFE + Token Warrant offering to distinguish from an ICO or SAFT offering.

¹⁶⁶ See *Telegram Grp. Inc.*, 448 F. Supp. 3d at 367.

¹⁶⁷ See *Token Warrants – How Can You Use Them for Crypto Fundraising?*, *supra* note 62.

¹⁶⁸ See *id.*

¹⁶⁹ See *What Is a Token Warrant? A Fundraising Guide for Web3 Startups*, *supra* note 63.

¹⁷⁰ See *id.*

¹⁷¹ Weeks, *supra* note 70.

wholly new and separate transaction and with it, a new set of facts and circumstances.¹⁷²

Additionally, unlike in *Telegram*, when these warrants are exercised here, there is likely to already be a liquid market for these tokens.¹⁷³ As such, the investors are likely not being relied upon to create liquidity in the secondary market. In other words, the facts and circumstances of the transactions are much less intertwined and have a distinct set of expectations and understandings given the length of time between them. These factors should sufficiently separate the two transactions, requiring two separate *Howey* analyses instead of being swept together as one “scheme.” As a result, courts should use two separate analyses: (1) the purchase of the SAFE and (2) the call on the Token Warrants.

ii. The SAFE

The SAFE is an investment contract under *Howey* and would not be disputed otherwise.¹⁷⁴ The seed investors provide capital to the corporate entity in exchange for equity in that entity with the expectation that the value of that equity will grow once the entity puts the capital to use in developing the blockchain protocol.¹⁷⁵ This checks the four boxes of *Howey*: (1) an investment of money (the seed capital); (2) in a common enterprise (pooling of all seed investors’ funds in the corporate entity); (3) with an expectation of profits (increased value of equity in the entity); and (4) derived from the efforts of others (the entity develops and launches the blockchain protocol).¹⁷⁶ However, just as was the case for the SAFT, purchasers of the SAFE are accredited investors relying on the exemption outlined in Rule 506(c) of Regulation D of the Securities Act.¹⁷⁷

¹⁷² Robin Ji, *Crypto Fundraising with Token Side Letters or Token Warrants*, LIQUIFI (Feb. 17, 2022), <https://www.liquifi.finance/post/crypto-web3-fundraising-with-token-side-letters-or-token-warrants> [<https://perma.cc/G25L-4BPE>].

¹⁷³ Sergeenkov, *supra* note 69; *see generally* *What are Liquidity Pools?*, *supra* note 69.

¹⁷⁴ *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding*, INVESTOR.GOV (May 9, 2017), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-52> [<https://perma.cc/8TY8-LACQ>].

¹⁷⁵ Batiz-Benet, *supra* note 58.

¹⁷⁶ *W.J. Howey Co.*, 328 U.S. at 298-99.

¹⁷⁷ Batiz-Benet, *supra* note 58; 15 U.S.C. § 77d.

iii. The Token Warrants

Looking at the general facts and circumstances surrounding a call on a Token Warrant under *Howey*, one will likely find that the warrants are not investment contracts. As mentioned, the investor who exercises his right to purchase the cryptocurrency tokens must invest new capital in exchange, which satisfies the “investment of money” prong.¹⁷⁸ This money would then be pooled with any other money raised by the protocol, which shows horizontal commonality and, therefore, a common enterprise.¹⁷⁹ Some buyers in this market may have consumptive intent, looking to purchase these tokens to use within the protocol, and that may also be true for the investor regarding a portion of the tokens purchased. However, it would be fair to reason the investor is generally seeking profits when exercising their warrant. Consequently, the first three prongs of *Howey* would likely be found to have been met by a court.

However, at this time, the blockchain protocol should be sufficiently decentralized such that any profits made on the subsequent resale of these tokens are no longer derived from the efforts of others. Just like Bitcoin no longer relies on the essential managerial efforts of any entity,¹⁸⁰ the protocol at this stage should be to the point where the community of miners, node operators, validators, and users are all operating as a self-sustaining decentralized network.¹⁸¹ Presumably, and ideally, the protocol is at the stage where the startup has even ceded control over the monetary policy of the network to the larger community, as recommended by Cooley LLP.¹⁸² At this stage in the life of the protocol, any price appreciation reflects the supply and demand balance within the secondary market for the native cryptocurrency.¹⁸³ As such, any profits derived from this appreciation would not result from the “efforts of others.” This line of reasoning is the same employed by the SAFT whitepaper, which cites cases like *Key Futures* and *Belmont Reid*, where the courts held that futures contracts for gold and silver did not rely on the efforts of others for profit because profits were determined by “fluctuations in the market” as opposed to the “managerial efforts” of either entity.¹⁸⁴

¹⁷⁸ *Id.*

¹⁷⁹ *Revak*, 18 F.3d at 87-88.

¹⁸⁰ See Bloomenthal, *supra* note 101.

¹⁸¹ See *The Purpose and Value of Cryptocurrency and Tokens*, *supra* note 32.

¹⁸² Batiz-Benet, *supra* note 58.

¹⁸³ *Id.*

¹⁸⁴ *Id.* Additionally, this Note will not address the concept of an “Active Participant” put forth by the SEC under non-binding “agency guidance” and not affirmed by any courts to this date as it is outside its scope. For more

e. Issues with the SAFE + Token Warrant

Although the SAFE + Token Warrant mitigates the most glaring regulatory risks associated with the SAFT, it is not conclusive whether it will ultimately stand up to full scrutiny such that it successfully protects the cryptocurrency token from security classification. First, there is a question of whether the pre-negotiated price discount is enough for a court to find an expectation of profit derived from the efforts of others. Second, a court may still find the “economic realities” of the transaction are such that the cryptocurrency is part of the investment contract.

i. Token Warrant Price Discounts and the Efforts of Others

First, courts may take issue with the set of circumstances surrounding the negotiated discount investors receive when calling their option to buy cryptocurrency via the Token Warrants. That is because this fact is (1) material in the investor’s expectation of profit; and (2) was negotiated at the time of the original agreement.¹⁸⁵ Consequently, without the discount negotiated at the time of the signing of the Token Warrant, there might be no profit to be made on the sale of the cryptocurrency.¹⁸⁶ In other words, the investor relies on the agreement made at the time of signing the SAFE + Token Warrant to realize any expected profits on the subsequent exercising of said warrants and the resale into public markets. In the case of a cryptocurrency where the value has appreciated substantially due to decentralized market forces, the investor may attempt to highlight that as the primary driver of any potential profits. However, even in this case, there would still be a portion of any realized profits which are directly a consequence of the specified discount agreed upon in the Token Warrant at the time of signing the SAFE + Token Warrant.¹⁸⁷

information on the Active Participant concept and how it may counter the argument put forth regarding the “efforts of others” prong, see *Framework for “Investment Contract” Analysis of Digital Assets*, SEC. & EXCH. COMM’N, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn15 [https://perma.cc/GV4B-JRM7] (last visited Mar. 8, 2023) (notably, the SEC has attempted to expand the notion of “others” beyond a promoter and sponsor to include any third party who contributes to the decentralized network).

¹⁸⁵ Mark Anson, *Initial Coin Offerings: Economic Reality or Virtual Economics?*, 21 J. PRIV. EQUITY 41, 46 (2018).

¹⁸⁶ *Id.*

¹⁸⁷ See *Token Warrants – How Can You Use Them for Crypto Fundraising?*, *supra* note 62.

The legal implications here are twofold. First, the SEC could use this argument to blur the lines between the facts and circumstances of the SAFE and the subsequent future calling on the Token Warrants. If successful, this would place the startup and investors in the same place as Telegram, and in the position where the purchasers of Gram Purchase Agreements stood, which is to say the tokens might be evaluated under *Howey* from the time of purchase of the SAFE + Token Warrant.¹⁸⁸ Second, supposing that the prior argument is not accepted, the SEC could still argue that the “efforts of others” prong is satisfied because the expected profits are directly linked to the specified discount agreed upon before the protocol launched. As a result of making this connection, any profits derived from the discount would result from the efforts made by the startup entity in developing and launching the protocol before they stepped back from their central role in the network.¹⁸⁹ Therefore, a risk is present that courts may reason that those expected profits (the discount) were derived from, at least in part, the efforts of others.

ii. Substance Over Form and the “Economic Realities” of the SAFE + Token Warrant

Even more pressing is how courts will interpret the “economic realities” of the SAFE + Token Warrant model. As the *Telegram* court noted, “in the analysis of purported investment contracts, ‘form should be disregarded for substance and the emphasis should be on the economic reality.’”¹⁹⁰ *Howey* emphasized this notion so that the test was “flexible” and “capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”¹⁹¹ As this analysis has shown, in the case of SAFE + Token Warrant, there is no doubt that the “form” advances the startup’s goals in shielding their cryptocurrency token from a similar fate to what Telegram faced. However, the “substance” of the economic realities surrounding the SAFE + Token Warrant is less clear.

¹⁸⁸ See *Telegram Grp. Inc.*, 448 F. Supp. 3d at 379.

¹⁸⁹ See *id.* (holding that investment in Telegram relied on efforts of others because in order “to realize a return on their investment, the Initial Purchasers were entirely reliant on Telegram’s efforts to develop, launch, and provide ongoing support for the TON Blockchain and Grams”).

¹⁹⁰ *Id.* at 365 (quoting *Tcherepin v. Knight* 389 U.S. 332, 336 (1967)); see also *United Hous. Found., Inc.*, 421 U.S. at 848 (quoting *Tcherepin*, 389 U.S. at 336).

¹⁹¹ *W.J. Howey Co.*, 328 U.S. at 299.

First, there is the issue of whether the substance has changed enough to distinguish from the holding of *Telegram* if everyone who possesses a Token Warrant exercises it. This could be construed as optionality in form only, where the economic reality is that every investor will exercise the Token Warrant and subsequently resell into the public markets. Taking the Maple Finance facts as an example, if every seed investor exercised their options, this would cause a 26% block of total supply to be issued into the markets.¹⁹² So even though the startup did not promise or guarantee the tokens as *Telegram* did in selling Gram Purchase Agreements, if every investor is effectively guaranteed to exercise their warrants, it could be construed as practically the same. This would potentially leave the startup open to the same weakness as the *Telegram*'s SAFT.

Second, and potentially compounding the first, is that once a protocol is sufficiently decentralized and the native cryptocurrency is imbued with functionality, the value accrual of the protocol should imbue into the cryptocurrency.¹⁹³ At that point, there is a question about the value of any equity the investors own in the entity that initially raised the money to bootstrap the project. In other words, if all value generated by the protocol is accruing to the native cryptocurrency, then does that necessarily render the initial purchaser's equity investment in the startup entity worthless? Furthermore, if so, is there any option other than to call on the warrants to realize a profit on their investment? If the answers to the first question is 'yes,' and the answer to the second is 'no,' then the equity is essentially worthless, and, leaves no choice but to exercise the warrants to buy the native cryptocurrency, courts will likely find that the economic reality is such that an investor only has reasonable expectation of profits in the SAFE + Token Warrant model via the exercising of token warrants and subsequent sale of cryptocurrency into the public markets. However, even if all value accrues to the cryptocurrency, the investors may be able to argue that their equity in the original entity retains its value and potential for profit because that startup entity holds a block of cryptocurrency as well. Therefore, their equity is merely a right to a portion of the value of said cryptocurrency. On its face, this argument does seem to respond to whether the investor's only route to profits is exercising their warrant(s).

f. Recommendations

In launching a decentralized protocol and raising money from accredited investors, the SAFE + Token Warrant model seems

¹⁹² Glaveski *supra* note 64.

¹⁹³ See *The Purpose and Value of Cryptocurrency and Tokens*, *supra* note 32.

preferable to the SAFT model if the goal is to avoid being classified as a security in the U.S. However, the startup should consider the following actions before allowing the initial investors to exercise their warrants. To further mitigate risk, it would be advisable to launch the protocol and collect fees in a non-native cryptocurrency (such as ETH) at first to determine whether the protocol exhibits product market fit. Once it is established that there is a use for this product, only then should the protocol switch from a non-native mechanism towards a native cryptocurrency. This will allow the protocol to grow and gain a base of users and contributors to further decentralize before launching a token and running into any potential regulatory risk related to securities laws.

After launching the native cryptocurrency as the value capture mechanism, issuing these tokens at no cost to the community of users established as a liquidity generation event is advisable.¹⁹⁴ This should cause a public secondary market to form, allowing the “virtuous cycle of growth”¹⁹⁵ to begin. Finally, the startup should begin to cede control over the protocol to the larger community allowing for a democratic process by which “monetary policy” can be determined.¹⁹⁶ At this point, there should be a sufficiently decentralized protocol where secondary market purchasers are partly consumptive.¹⁹⁷ The supply and demand factors will take over in dictating the price of the cryptocurrency.¹⁹⁸ Only at this point would it be advisable to allow seed capital investors to call on their token warrants if mitigating regulatory risk is a priority.

VI. CONCLUSION

Cryptocurrency is a revolutionary technological advance that could change how capital organizes itself. As the industry continues to age, there are growing pains as bad actors within the space will take advantage of its chaotic nature. Ultimately, there needs to be a clear and concise regulatory framework to implement necessary safeguards while clarifying and establishing regulatory stability for future capital investment. As it stands today, jurisdictional turf wars between agencies have harmed industry participants and likely postponed the ability for capital allocators to take a strong look at startups in the industry. This lack of clarity has

¹⁹⁴ See Sergeenkov, *supra* note 69; see also *SEC v. Telegram: Key Takeaways and Implications*, *supra* note 148.

¹⁹⁵ See *The Purpose and Value of Cryptocurrency and Tokens*, *supra* note 32.

¹⁹⁶ Batiz-Benet, *supra* note 58, at *20.

¹⁹⁷ *Id.* at *7.

¹⁹⁸ *Id.* at *9.

caused tension between the industry and the SEC as participants attempt to avoid requirements designed for legacy forms of capital formation, which provide no value to the consumer in this context and only stifles innovations. To this end, the newest fundraising model, the SAFE + Token Warrant, has evolved by attempting to mitigate existing regulatory risks imposed by the SEC's use of *Howey* against cryptocurrency protocols. Although the structure appears to be the most well-equipped iterative attempt yet by the industry to weave around these legal frameworks, whether it effectively accomplishes that goal is decidedly unclear.

Additionally, the tradeoffs made in attempting to comply within the existing securities law framework effectively shackles the technology from functioning as it was intended. Startups must go to traditional forms of legacy fundraising instead of initially launching as a genuinely decentralized cryptocurrency offering to avoid the costs associated with disclosures for traditional securities. Ultimately, these regulatory roadblocks have the practical effect of taking the massive financial opportunity out of the hands of early community members and instead gift it to accredited venture capitalists. This goes against the very ethos of the decentralized blockchain network, which is to create products and services which eliminate as much rent-seeking behavior as possible so that consumers may retain as much value as possible.