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INTRODUCTION

In the past decade, the emergence of blockchain technology and cryptocurrency has completely disrupted traditional capital markets, becoming a hot topic among regulators[1], legislators[2], financial professionals[3], and even celebrities.[4] Straying away from the conventional means of fundraising, digital asset transactions enable developers to raise capital online to fund a digital project, platform, or software through the distribution of tokens. Taking the place of initial public offerings ("IPOs"), emerging technology companies have opted out of pitching their ideas to venture capitalists and have increasingly looked to initial coin offerings ("ICOs") to finance the development of their networks. In turn, ICOs have come under siege by the Securities and Exchange Commission ("SEC") because these transactions often involve the distribution of security tokens. These tokens entitle their holders to certain rights and may thus qualify as "securities." Once these tokens are distributed, they may be resold on a secondary market to investors through a virtual currency exchange or an online platform. And since crypto markets are largely unregulated, many investors are scammed and defrauded in the process. Now, the SEC actively monitors digital asset transactions and has begun its crackdown on ICOs.

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[1] Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, U.S. SEC. & EXCH. COMM'N (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017- 12-11.

[2] *See* Kia Kokalitcheva, *Congress Holds First Hearing on Initial Coin Offerings,* AXIOS (Mar. 14, 2018), https://www.axios.com/crypto-ico-congress-1521059028-8807c852-22de-461a-8c9e- 8a8a9f85d452.html.

[3] *See Beyond the Hype: Blockchain Technology,* ADVISOR PERSPECTIVES (Mar. 28, 2019), https://www.advisorperspectives.com/podcasts/2019/03/28/beyond-the-hype-blockchain-technology.

[4] Ana Alexandre, *US SEC Charges Floyd Mayweather Jr and DJ Khaled for Unlawfully Promoting ICO,* COINTELEGRAPH (Nov. 29, 2018), https://cointelegraph.com/news/us-sec-charges-floyd-mayweather-jr-and-dj-khaled-for-unlawfully-promoting-ico.

To combat the slew of enforcement actions against ICO-conducting companies, developers are searching for a new way to comply with demanding federal securities laws. Thus, airdrops have entered the scene. These "free" token distributions are an imaginative attempt to further evade the securities regulations. But "free" does not mean free from regulatory compliance. Airdrops may qualify as securities offerings, even though the tokens are touted as "free," bearing strong similarity to "free-stock" offerings and other instances of "gifted" securities. Furthermore, regulators have addressed digital asset trading platforms, broker-dealers, and other cryptocurrency transactions to deter issuers from conducting offerings without meeting the requirements set in place by the existing regulatory framework. Labeling a securities offering as "free" does not exclude it from the purview of the securities laws—even if it makes assessing the transaction more difficult.

Although the "crypto craze" has slowed, billions of dollars are still being raised through digital asset transactions, leaving countless investors without any protection. Developers continue to craft new names and methods of conducting securities offerings to escape compliance. In response, regulators have imposed greater regulatory scrutiny, leaving little wiggle room for entrepreneurs and new innovations. Balancing the governments interests in protecting investors, fostering innovation and creating an efficient market remains challenging, and ultimately the existing framework might need to be supplemented.

This note aims to clarify and analyze the role of airdrops and the current state of the crypto market surrounding these transactions, with the goal of educating the legal community on concepts involving these security token offerings. Part I of this Note begins by giving a brief background on cryptocurrency and blockchain technology before discussing the categorization of coins and tokens. Next, Part I explains why developers use ICOs and how they are conducted. Part I concludes with information about airdrops, including what they are, why developers use them, and how they work.

Part II will give an overview on the SEC's developing jurisdiction over digital assets. Part II also defines the term "security token", explains the criteria under the *Howey* test, and describes the registration requirements that are pertinent to digital asset transactions. Lastly, Part II examines the regulatory landscape surrounding ICOs which has led to the emergence of airdrops.

Part III applies the *Howey* test to examine airdrops in the context of the federal securities laws. Part III then considers whether these token distributions need to comply with registration requirements by looking at prior SEC cases where companies "gifted" stocks. This Part will also explore how airdrops emulate "free stock" offerings that were halted by

the SEC, presenting four seminal cases that are analogous to "free" token offerings. Afterward, this Part describes the first cease and desist order that appears to address airdrops. Part III also clarifies regulators' positions based on their recent actions as well as past cases and discusses what might be in store for airdrops and the volatile crypto market. Part III concludes by proposing a potential alternative to a more stringent regulatory regime.

This Note concludes that airdrops might be "free," but they are not free from regulatory compliance. Regulators will continue to protect investors, even at the cost of inhibiting innovation. However, an alternative to strict regulation might afford better protection to investors.

II. UNDERSTANDING AIRDROPS

A. *Brief Background on Cryptocurrency*

To fully understand airdrops, it is important to first understand cryptocurrency, tokens and ICOs. A cryptocurrency is a digital currency which uses encryption algorithms and cryptographic techniques to regulate the generation of units of currency and verify the transfer of funds, operating independently from a central bank.[5] It functions as a virtual medium, but rather than holding on to a tangible piece of paper, cryptocurrency holders can exchange these virtual assets without having to rely on a financial institution to process each transaction.[6] These transactions are processed and completed via a peer-to-peer network through the use of blockchain technology and code.[7]

Blockchain serves as the foundation for cryptocurrencies,[8] and most notably bitcoin.[9] Originating in 2009, blockchain technology was first implemented by an anonymous author going by the pseudonym Satoshi Nakamoto.[10] Blockchain is:

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[5] Ameer Rosic, *What is Cryptocurrency? [Everything You Need To Know!],* BLOCKGEEKS (updated Sept. 13, 2018), https://blockgeeks.com/guides/what-is-cryptocurrency/.

[6] *Id*.

[7] *Id*.

[8] *See* Satoshi Nakamoto, *Bitcoin: A Peer-to-PeerElectronic Cash System,* BITCOIN (2008), https://bitcoin.org/bitcoin.pdf.

[9] BITCOIN, https://bitcoin.org/en/faq#general (last visited Feb. 8, 2020) ("Bitcoin is a consensus network that enables a new payment system and a completely digital money. It is the first decentralized peer-to-peer payment network that is powered by its users with no central authority or middlemen. From a user perspective, Bitcoin is pretty much like cash for the Internet.").

[10] Bernard Marr, *A Short History of Bitcoin and Crypto Currency Everyone Should Read,* FORBES (Dec. 6, 2017), https://www.forbes.com/sites/bernardmarr/2017/12/06/a-short-history-of-bitcoin-and-crypto-currency-everyone-should-read/#12f6a32d3f27.

> "[a] tamper-evident, shared digital ledger that records transactions in a public or private peer-to-peer network. Distributed to all member nodes in the network, the ledger permanently records, in a sequential chain of cryptographic hash-linked blocks, the history of asset exchanges that take place between the peers in the network. All the confirmed and validated transaction blocks are linked and chained from the beginning of the chain to the most current block, hence the name blockchain. The blockchain thus acts as a single source of truth, and members in a blockchain network can view only those transactions that are relevant to them."[11]

Blockchain therefore enables secure peer-to-peer transactions to take place without the use of a third-party intermediary, such as a bank.[12]

B. *Categorization of Crypto: Coins vs. Tokens*

Cryptocurrencies that have their own separate, standalone blockchain are referred to as coins while the term token can refer to any cryptocurrency that is built on top of an existing blockchain.[13] Thus, tokens require another platform to host them so that they may operate and exist.[14] While coins are used to store value and pay for services much in the same way you would use physical money, tokens instead represent digital assets with wider functionality.[15]

Tokens can represent almost any asset that is fungible and tradeable[16]—from commodities to voting rights.[17] Since tokens only require an existing platform, they are much easier to create than coins.[18] Moreover, creating your own token is practically effortless thanks to

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[11] Sloane Brakeville & Bhargav Perepa, *Blockchain Basics*, INT'L BUS. MACH. CORP. (IBM) (Mar. 18, 2018), https://developer.ibm.com/tutorials/cl-blockchain-basics-intro-bluemix-trs/.

[12] *See* Nakamoto, *supra* note 8.

[13] Delton Rhodes, *Crypto Coin vs. Token: Understanding the Difference,* COINCENTRAL (Aug. 10, 2018), https://coincentral.com/crypto-coin-vs-token-cryptocurrency/.

[14] *The Basics: Coin vs. Token. What is the Difference?*, CITOWISE (Jan. 22, 2018), https://blog.citowise.com/the-basics-coin-vs-token-what-is-the-difference-5cd270591538.

[15] *Token vs Coin—what's the difference?* CHRONO.TECH (Aug. 13, 2017), https://blog.chronobank.io/token-vs-coin-whats-the-difference-5ef7580d1199.

[16] Aziz, Master the Crypto Founder, *Coins, Tokens & Altcoins: What's the Difference?*, MASTERTHECRYPTO, https://masterthecrypto.com/differences-between-cryptocurrency-coins-and-tokens//(last visited Feb. 28, 2019).

[17] Ed Moffatt, *Blockchain Tokens, Simply Explained,* MEDIUM (Jan. 14, 2020) https://medium.com/@edmoffat/blockchain-tokens-simply-explained-d05d88688b65.

[18] *See* Aziz, *supra* note 16.

standard templates and smart contracts, which are self-executing, programmable computer codes.[19] These tokens may be created and distributed to the public through what is known as an initial coin offering ("ICO"), though this is an apparent misnomer.[20]

C. *Utility Tokens vs. Security Tokens*

The two most prevalent types of tokens issued through ICOs are utility tokens and security tokens.[21] The main difference between the two categories of tokens is their intended use and functionality.[22] Utility tokens are not issued in the form of an investment, whereas security tokens resemble traditional securities.[23] Utility tokens are user tokens that enable access to future products or services offered by a company.[24] Alternatively, security tokens are digital assets that derive their value from a tradeable asset and entitle their holders to certain ownership rights of the company.[25] The main difference between the two categories of tokens is that security tokens have to comply with federal securities laws while utility tokens do not.[26]

The SEC has primarily used the *Howey* test to classify the two types of tokens.[27] However, given the ability of both categories of tokens to earn profit and appreciate in value, it is difficult to clearly delineate the difference between the two.[28] Due to their similarities, utility token

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[19] *See* Aziz, *supra* note 16.

[20] *See* Arjun Kharpal, *Tokenization: The world of ICOs*, CNBC (Jul. 16, 2018), https://www.law.georgetown.edu/wp-content/uploads/2018/07/Rule-18-Handout-1.Secara-1.pdf (last updated Apr. 12, 2019) ("[T]he term ICO is actually a misnomer because it implies a similarity to an IPO. ICOs, or as we prefer to call them 'Token Generation Events' (TGEs), are fundamentally different than IPOs in that an IPO is conducted by a mature company with a live product and revenue, while a TGE represents the birth of a new currency which powers a network.").

[21] Katalyse, Io, *Security Tokens vs. Utility Tokens— How different are they?*, CRYPTODIGEST (Jul. 27, 2018), https://cryptodigestnews.com/security-tokens-vs-utility-tokens-how-different-are-they-8a439c73e616.

[22] *Id*.

[23] Tamer Sameeh, *ICO Basics- the difference between security tokens and utility tokens*, COINTELLIGENCE (Mar. 29, 2018), https://www.cointelligence.com/content/ico-basics-security-tokens-vs-utility-tokens/ ("To sum up security tokens entitle their holders with ownership rights, whereas utility tokens can be thought of as coupons that grant holders access to certain products or services.").

[24] *Id*.

[25] *Id*.

[26] *Complete Guide to Security Tokens: How they Work Explained Simply*, THE TOKENIST, https://thetokenist.io/security-tokens-explained/ (last visited Feb. 28, 2019).

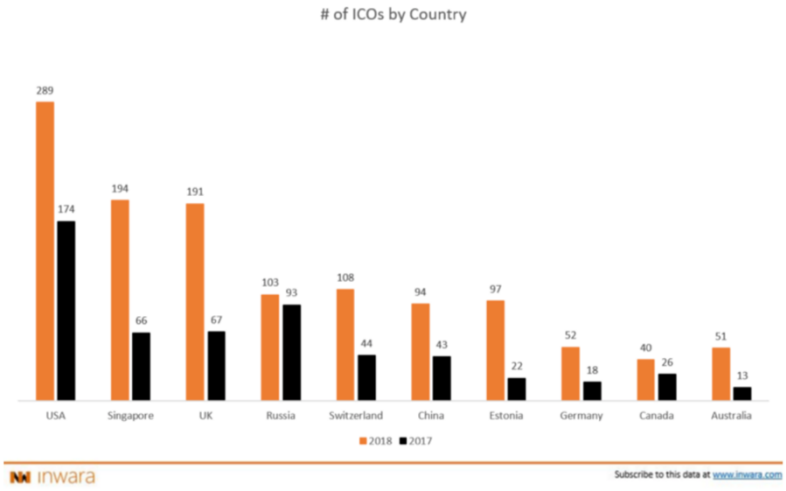
[27] *Id*.

[28] *Id*.

developers prefer to call ICOs involving these categories of tokens "token generation events."[29]

D. *What is an ICO?*

ICOs have become extremely popular in the last few years as a means of raising capital for virtual projects. According to the latest statistics, over $7 billion was raised via ICOs in the U.S. in 2018 alone.[30] In fact, the U.S. takes the lead when it comes to conducting ICOs, evidenced by the graph below: [31]



Despite a sharp increase in the amount of funds raised via ICOs from the prior year, the number of ICOs appears to be declining in 2019.[32] This significant pullback may be a result of companies choosing to fund their cryptocurrency projects through means compliant with the securities

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[29] Sameeh, *supra* note 23.
[30] *Funds Raised in 2018,* ICODATA.IO, https://www.icodata.io/stats/2018 (last visited Mar. 1, 2019).
[31] *ICO Funds and Trends Analysis 2018*, INWARA, https://www.inwara.com/report/annual-report-2018?utm_source=annualrepecryphub&utm_medium=annualrepecryphub&utm_campaign=annualrepecryphub (last visited Mar. 1, 2019).
[32] Ajit Tripathi, *RIP ICOs: 2019 Will Be the Year of Enterprise Blockchain Tokens*, COINDESK (Jan. 6, 2019), https://www.coindesk.com/r-i-p-icos-2019-will-be-the-year-of-enterprise-blockchain-tokens.

laws.[33] Yet despite the slowdown, some companies are still choosing to use ICOs to raise funds.[34] So, what exactly is an ICO?

> "An ICO is a fundraising event, effected using distributed ledger technology, in which a "token" or "coin" is offered to a participant in return for either cash (fiat currency) or cryptocurrency, such as Ether or Bitcoin. A token entitles its holders to various rights, which typically include the right to use a service to be developed and offered by the issuer. The proceeds of the token sale are used to fund a venture or a project undertaken by the ICO sponsors. Similar to equity securities, however, tokens sold in ICOs may also confer profit rights, may appreciate in value, and can be traded. ICO tokens do not represent an ownership interest in a venture."[35]

In 2013 the first ever ICO took place, opening the door to this alternative method of funding for emerging companies.[36] ICOs also bear similarities to traditional IPOs because investors can earn a return on their digital asset instrument—usually by selling their tokens on the secondary market once value is created and the digital project takes off.[37]

The ICO process typically begins when a development team announces an ICO through an online channel, such as a cryptocurrency website or forum.[38] This announcement will likely include access to the

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[33] Elizabeth Gail, *Muliti-Billion Dollar ICO Market Down to A Few Hundred Million,* COINCENTRAL (Sep. 13, 2018), https://coincentral.com/multibillion-dollar-ico-market-down/.

[34] *The ICO is Dead…Or Is It?,* INVEST IN BLOCKCHAIN (Dec. 12, 2018), https://www.investinblockchain.com/ico-is-dead/.

[35] David Felsenthal et al., *SEC Brings Enforcement Against Initial Coin Offering*, CLIFFORD CHANCE LLP (Oct. 2017), https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2017/10/sec-brings-first-enforcement-action-against-initial-coin-offering.pdf.

[36] Howard Marks, *The ICO is Dead. Long Live the ICO 2.0.,* HACKERNOON (Feb. 21, 2018) https://hackernoon.com/the-ico-is-dead-long-live-the-ico-2-0-7bb269987513 ("It turns out the first ever ICO was Mastercoin (now called Omni), which raised 5,000 Bitcoin at a total value of $500,000 in 2013. Mastercoin organized a foundation called the Mastercoin Foundation to receive the Bitcoin and manage the project.").

[37] William Hinman, Dir., SEC Div. of Corp. Fin., Remarks at the Yahoo Finance All Markets Summit: Crypto *Digital Asset Transactions: When Howey Met Gary (Plastic),* U.S. SEC. & EXCH. COMM'N (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418#_ftn3.

[38] Rocky Mui, *Initial Coin Offerings, Asking the Right Regulatory Questions*, CLIFFORD CHANCE LLP (May 2018), https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2018/05/initial-coin-offerings-asking-the-right-regulatory-questions.pdf.

project's website, which will feature "white paper," a crucial instrument of the ICO process.[39] The white paper will describe the project, key terms of the ICO, including subscription details, a timeline, the roadmap for the project, how the funds will be used and why the project is useful[40]—essentially all the information a prospective investor would need in deciding on whether they should invest in the project.[41] The white paper should provide key information to potential investors in a friendly manner[42] because, oftentimes, ICOs are held before the project is in a profit-generating state, meaning developers must focus on building confidence in their project so that they can receive necessary funding.[43] The development team also creates a webpage and a group chat to keep interested investors in the loop.[44] These webpages and group chats provide updates about development and important, upcoming dates.[45]

The development team will also provide a pre-sale, which is accessible for certain people who register for the "white list", prior to launching the ICO.[46] The pre-sale is held for a specified period of time, allowing those with access to exchange their coins[47] for the project's new tokens at a lower price.[48] Until the project is actually released, however, the tokens will have no use, and their value on secondary markets will be purely speculative.[49] Furthermore, if the project does not reach its funding goal, the funds contributed are returned and the token ceases to exist.[50] Following the pre-sale, an investor may participate in a public sale by transferring funds to the issuer in exchange for new tokens during the

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[39] *How to Launch an ICO, A Detailed Guide,* COINTELEGRAPH, https://cointelegraph.com/ico-101/how-to-launch-an-ico-a-detailed-guide#5-write-a-white-paper (last visited Mar. 2, 2019).

[40] Waves Lab, *How to write the white paper for an ICO project,* MEDIUM (Apr. 27, 2018), https://medium.com/waves-lab/how-to-write-the-white-paper-for-an-ico-project-2de3098c3407.

[41] *Id*.

[42] COINTELEGRAPH, *supra* note 39.

[43] *How to Develop a White Paper for ICO: Do's and Don'ts,* COINTELEGRAPH (Aug. 21, 2017), https://cointelegraph.com/news/how-to-develop-white-paper-for-ico-dos-and-donts.

[44] COINTELEGRAPH, *supra* note 39.

[45] *Id*.

[46] Phil Glazer, *Understanding Initial Coin Offerings (ICOs),* HACKERNOON (Jan. 28, 2018), https://hackernoon.com/evaluating-an-initial-coin-offering-ico-f9c24be0698b.

[47] *Id*. ("When the pre-sale or public sale period happens people will contribute funds by sending Bitcoin (BTC) or Ethereum (ETH) to a designated wallet address.").

[48] *Id*.

[49] *Id*.

[50] *Id*.

subscription process.[51] Unlike the pre-sale, the public sale is usually open longer and open to all investors.[52]

Despite the risk that projects may come up short, many ICOs do receive necessary funding to launch their platform.[53] For example, in June 2017 the EOS software developers[54] raised over $4.1 billion during the project's ICO alone.[55] However, even though a project may receive necessary funding through an ICO, there is no guarantee that the project will be successful following its launch.[56] In fact, a study suggests that more than half of ICO projects fail within four months of their token sales.[57]

Yet despite the high risk of failure, there are alluring "advantages" of ICOs that may outweigh their costs. ICOs enable entrepreneurs to raise funds rather quickly and easily.[58] Unlike conventional methods of fundraising, ICOs are largely unregulated.[59] Ideally, ICOs give entrepreneur-developers an idea of the price customers will pay for their product or service.[60] ICOs also allow for community building without geographic barriers, widespread exposure, and most importantly, low-cost fund raising.[61]

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[51] Mui, *supra* note 38.
[52] Glazer, *supra* note 46.
[53] *See* Jeffrey Tucker, *Despite What You Hear, The ICO is Not Over,* FORBES (Aug. 18, 2018), https://www.forbes.com/sites/jeffreytucker/2018/08/18/despite-what-you-hear-the-ico-is-not-rip/#84b0dc031921.
[54] EOS, ICOBENCH, https://icobench.com/ico/eos (last visited Mar. 2, 2019) ("EOS.IO is software that introduces a blockchain architecture designed to enable vertical and horizontal scaling of decentralized applications (the 'EOS.IO Software'). This is achieved through an operating system-like construct upon which applications can be built. The software provides accounts, authentication, databases, asynchronous communication and the scheduling of applications across multiple CPU cores and/or clusters. The resulting technology is a blockchain architecture that has the potential to scale to millions of transactions per second, eliminates user fees and allows for quick and easy deployment of decentralized applications.").
[55] *Id*.
[56] *See* Daniel Palmer, *More Than Half of ICOs Fail Within 4 Months, Study Suggests,* COINDESK (Jul. 10, 2018), https://www.coindesk.com/over-half-of-icos-fail-within-4-months-suggests-us-study.
[57] *Id*.
[58] Glazer, *supra* note 46.
[59] Theodore Schleifer, *Silicon Valley is obsessed with ICOs- here's why,* RECODE (Sept. 19, 2017 1:06 pm EDT), https://www.recode.net/2017/9/19/16243110/initial-coin-offering-ico-explained-what-is-money-bitcoin-digital-currency.
[60] Betsey Vereckey, *The pros and cons of ICOs for entrepreneurs,* MIT SLOAN SCHOOL OF MANAGEMENT (Apr. 12, 2018), https://mitsloan.mit.edu/ideas-made-to-matter/pros-and-cons-icos-entrepreneurs.
[61] *See id*.; *see also* Tucker, *supra* note 53.

However, regulators' crackdown has been the greatest pitfall of conducting an ICO.[62] Thus, some developers have replaced ICOs with airdrops.[63]

E. *Demystifying the Definition of an Airdrop: What is it and How Does it Work?*

In laymen's terms an airdrop is the practice through which developers of a new cryptocurrency-based project distribute "free" tokens to community members (also known as "users").[64] Why are developers giving away "free" tokens? An airdrop may be used as a marketing tool and a distribution mechanism.[65] With over 1,900 cryptocurrencies on the market today, it is vital for developers to effectively promote their new projects.[66] Rising competition in an already saturated marketplace has led to new techniques for raising awareness. Rather than using ICO advertising—which is now banned by many online platforms (including Facebook)[67]—crypto entrepreneurs are using airdrops as a marketing alternative.[68]

When done in a legitimate fashion, airdropping can be an effective marketing ploy to lift a new project off the ground.[69] Not only are airdrops used for "obscure" tokens, but they are also used for popular tokens as well. In May 2018, Tron Foundation completed an airdrop of $1.7 million worth of its TRX tokens to community members owning Ethereum.[70] Tron is far from obscure, and with a market cap of over $3.8 billion it is considered to be one of the most valuable "cryptocurrencies" on the market.[71]

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[62] *See* Vereckey, *supra* note 60.
[63] *See* Kai Sedgwick, *Six Alternatives to an Initial Coin Offering*, BITCOIN.COM (June 18, 2018), https://news.bitcoin.com/six-alternatives-to-an-initial-coin-offering/.
[64] *See* Jake Frankenfield, *Cryptocurrency Airdrop*, INVESTOPEDIA, https://www.investopedia.com/terms/a/airdrop-cryptocurrency.asp (last updated Nov. 12, 2019).
[65] Ian Lee, *What is a Cryptocurrency Airdrop and How Does it Differ from an ICO*?, COINGECKO (June 11, 2018), https://www.coingecko.com/buzz/what-is-a-cryptocurrency-airdrop-and-howdoes-it-differ-from-an-ico?locale=en.
[66] *Id*.
[67] Asha Barbaschow, *Facebook holds ICO ban but allows 'approved' cryptocurrency ads*, ZDNET (June 27, 2018) https://www.zdnet.com/article/facebook-holds-ico-ban-but-allows-approved-cryptocurrency-ads/.
[68] Lee, *supra* note 65.
[69] *Id*.
[70] *Id*.
[71] *Id*.

Obscure projects also might want to bolster community recognition by airdropping their tokens in an attempt to create "buzz."[72] Thus, developers rely on these distributions as well as users to create brand awareness and "buzz."[73]

While these airdropped tokens are touted as "free," they ultimately come at a price for recipients.[74] Developers anticipate that the airdrop recipient will perform actions that are beneficial to the project's development,[75] i.e., performing marketing services in exchange for receiving tokens.[76] Despite the notion of being "free"[77], airdrops often demand the performance of small tasks, including posting on social media forums, writing a blog post, or even connecting with a particular member of the blockchain project.[78] In effect, this serves as a "lead generation and referral campaign,"[79] shifting the promotional responsibility to the community members.[80] These free token offerings are also used as a way to reward early supporters who have already invested, giving them additional tokens.[81] Companies hope that these tactics will prompt early investors to hold on to their tokens. [82]

These massive token drops also function as a distribution device. [83] Airdrops can occur in tandem with an ICO, or after an ICO takes place, serving as a means to disseminate tokens to the community at large.[84] Once funds are raised for the project via token sales (ICO), developers may use a free token give away as a way to jump start long-term network growth.[85]

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[72] *See id*.
[73] *See generally* id.
[74] Rebecca G. DiStefano & Pallav Raghuvanshi, *Securities and Tax Law Effects of Token Airdrops*, GREENBERG TRAURIG (May 24, 2018), https://www.gtlaw.com/en/insights/2018/5/securities-and-tax-law-effects-of-token-airdrops.
[75] *Id*.
[76] *See id*.
[77] *Id*.
[78] Frankenfield, *supra* note 64.
[79] Lee, *supra* note 65.
[80] *See* Michael J. Casey, *Crypto Token Airdrops are A Marketing Ploy and that's OK,* COINDESK (Nov. 12, 2018), https://www.coindesk.com/crypto-token-airdrops-are-a-marketing-ploy-and-thats-ok.
[81] Sudhir Khatwani, *Airdrops in Cryptocurrenices*, COINSUTRA (last updated Aug. 11, 2019), https://coinsutra.com/what-is-airdrop/.
[82] *Id*.
[83] Lee, *supra* note 65.
[84] DiStefano & Raghuvanshi, *supra* note 75.
[85] *See* Shaurya Malwa, *All you need to know about Crypto Airdrops. AKA Free Money*, HACKERNOON (Mar. 1, 2018), https://hackernoon.com/all-you-need-to-know-about-crypto-airdrops-aka-free-money-243e60b22493; *see also* Esteban Casatano, *Why ICOs and airdrops don't work,* MEDIUM (Apr. 10, 2018),

Of course, the end goal is mass adoption of the token.[86] By rewarding users with these "freebies," project developers build a community for their token.[87] Even though the users are receiving relatively small amounts of tokens, the audience is usually sizeable.[88] This effectively creates a community of token holders and users.[89]

This so-called "community creation" leads to awareness and may also lead to a greater demand for the token.[90] This is because, inevitably, some of the users who receive the "free" tokens may do research and decide to acquire more of the tokens.[91] Users also tend to assign a greater value to a token they are holding than one they encounter on the open market.[92] Thus, this "endowment effect"[93] also leads to users building up the network and the community surrounding the token.[94] On the other hand, an advantage for users receiving "free" tokens is that they are able to "'test, trade, and transact unfamiliar crypto assets without having to mine or invest first."[95]

An airdrop can either be announced or unannounced prior to distribution.[96] In the case of an unannounced airdrop, users find themselves pleasantly surprised upon noticing new tokens in their digital

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https://medium.com/@estebancastano/solving-the-token-distribution-problem-c5ec3e37550.

[86] Evelyn Cheng, *Want free cryptocurrency? 'Airdrops' is coming,* CNBC (Mar. 12, 2018), https://www.cnbc.com/2018/03/12/want-free-cryptocurrency-airdrops-is-coming.html.

[87] Lee, *supra* note 65.

[88] *See* Kenny Li, *WTF is an Airdrop?* HACKERNOON (Feb. 27, 2018), https://hackernoon.com/all-you-need-to-know-about-crypto-airdrops-aka-free-money-243e60b22493.

[89] Lee, *supra* note 65.

[90] *Id*.

[91] *Id*.

[92] Akhilesh Ganti, *Endowment Effect*, INVESTOPEDIA, https://www.investopedia.com/terms/e/endowment-effect.asp (last updated Aug. 16, 2019) ("Studies have shown repeatedly that people will value something that they already own more than a similar item they do not own.").

[93] *Id*. ("[A] circumstance in which an individual places a higher value on an object that they already own than the value they would place on that same object if they did not own it.").

[94] Lee, *supra* note 65.

[95] Marie Huillet, *Blockchain.com Wallet Adds Stellar, Announces $125 Mln XLM Airdrop to 'Drive Adoption'*, COINTELEGRAPH (Nov. 6, 2018), https://cointelegraph.com/news/blockchaincom-wallet-adds-stellar-announces-125-mln-xlm-airdrop-to-drive-adoption.

[96] *Airdrop List,* ICO MARKS, https://icomarks.com/airdrops (last visited Jan. 5, 2019) (Displaying a list of active airdrops that a user may subscribe to and what requirements are needed to participate in each airdrop. The list also lets users know when the announced airdrops end.); Jack Filiba, *Airdrop*, COINSQUARE (Mar. 27, 2018), https://news.coinsquare.com/learn-coinsquare/airdrops-digital-currencies/.

wallets.[97] In some instances, the distribution is triggered when users hold certain cryptocurrencies or a specific number of crypto tokens in their wallet.[98] Developers may decide to distribute tokens after taking a "snapshot" of a block of particular cryptocurrency, entitling those holding the currency (as of the date of the snapshot) to "free" tokens.[99] In the case of announced airdrops, users can check websites that list scheduled airdrops and subscribe to the airdrops of their choice.[100]

Airdrops are appealing to developers as a low-cost marketing strategy, though many critics find these "free" distributions to be an utter waste of time.[101] Distributing too many tokens can create a surplus, diluting the token supply.[102] There is also no guarantee that the recipients of the tokens will hold on to them.[103] If enough of the recipients sell the token after receiving it, then its value will likely diminish.[104] A sufficient number of sales may lead to the token's demise.

Additionally, developers often set their expectations too high.[105] An increase in the token's usage does not necessarily occur simply because users hold onto airdropped tokens.[106] Nor does it mean that users view the tokens as anything other than spam.[107] Without sufficient incentives, token

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[97] *Cryptocurrency airdrop | What is a crypto airdrop?*, BEST BITCOIN ALTERNATIVE, https://bestbitcoinalternative.com/resources/cryptocurrency-airdrop/ (last visited Jan. 8, 2019).

[98] *See* Crypto Account Builders, *Beginners Guide to Crypto Airdrops: Free Coins & Tokens,* MEDIUM (Oct. 5, 2018) https://medium.com/@johnhinkle_80891/beginners-guide-to-crypto-airdrops-free-coins-tokens-643a7327709b.

[99] *See* Ermos Kyriakides, *All You Need to Know About Airdrops,* HACKERNOON (July 31, 2018), https://hackernoon.com/all-you-need-to-know-about-airdrops-98b1b5af7941.

[100] *See* AIRDROP ALERT.COM, https://airdropalert.com/about-us (last visited Jan. 24, 2020) ("AirdropAlert.com launched June 2017 to create awareness to the crypto community about the existence of airdrops. We believe majority of crypto fanatics are not aware of the concept of airdrops and how to claim it. We started an informational page where you can find data on when and where airdrops take place. We started as a team of 3 to collect data on airdrops and list them. With the rapid growth of airdrops, visitors and subscribers we quickly expended to a team of 15. Our goal is to provide information about legitimate ways to collect free cryptocurrency. Due to demand of ICOs we started the concept of Exclusive Airdrops that are hosted by us. We have hosted, promoted, marketed and distributed airdrops for over 30 ICOs.").

[101] Nathan Reiff, *Cryptocurrency Forks Vs. Airdrops: What's the Difference?*, INVESTOPEDIA, (July 3, 2018) https://www.investopedia.com/tech/cryptocurrency-forks-vs-airdrops-whats-difference/.

[102] *Id*.

[103] *See id*.

[104] *See* Casatano, *supra* note 86.

[105] *See id*.

[106] *Id*.

[107] *Id*.

holders will stray away from using the product and in turn the network will not grow.[108]

In fact, each holder is more apt to free ride on the growth of the network than to promote or use it themselves.[109] These speculative users might even have a negative impact on the network since there are only a finite number of tokens and they are holding on to them when other users would use them.[110] Thus, opponents to airdrops view the distributions as "flawed" because the recipients are motivated by the promise of "free" money with no real incentives to use the product, increase its utility, or grow the network. [111] However, for some companies the benefits overshadow the inconveniences of conducting a "free" token giveaway.

III. OVERVIEW OF THE SEC'S DEVELOPING JURISDICTION OVER DIGITAL ASSETS

Following the Great Crash of 1929, Congress created the SEC to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[112] This mission is based on the simple concept that "all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it."[113] To achieve this mission, the SEC requires full and fair disclosure so that investors may make use of this information for any transactions where they are buying, selling or holding a security.[114] Only through the flow of timely, comprehensive and accurate information can people make "sound investment decisions."[115]

For an investor to be afforded with protection from the SEC, a security must be involved.[116] Thus, determining the reach of the SEC's jurisdiction

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[108] *See* Alex Munkachy, *A Detailed Guide to Avoiding Airdrop and Bounty Scams,* COINIQ (Sept. 9, 2018), https://coiniq.com/airdrop-bounty-scams/.
[109] *See* Casatano, *supra* note 86.
[110] *See id*.
[111] *Id*.
[112] *About the SEC: What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/Article/whatwedo.html (last modified June 10, 2013).
[113] *Id*.
[114] *Id*.
[115] *Id*.
[116] Eva Su, *Digital Assets and SEC regulation,* CONG. RES. SERV. (Jan. 30, 2020), https://www.everycrsreport.com/files/20200130_R46208_8c73c5838d376d44e3d841ead7bb65df15744fb3.pdf ("Securities regulation generally applies to all securities, whether they are digital or traditional. The Securities and Exchange Commission (SEC) is the primary regulator overseeing securities offerings, sales, and investment activities. The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and

over cryptocurrency transactions is difficult.[117] Yet, the Commission is actively attempting to protect investors from the risks involved in digital asset transactions, announcing initiatives such as the creation of the Cyber Unit,[118] which is tasked with investigating digital misconduct and fraud to protect retail investors.[119]

In light of the recent craze in cryptocurrencies, the SEC has attempted to clarify its position regarding digital tokens, ICOs, and cryptocurrency itself. Released in July 2017, the Decentralized Autonomous Organization ("DAO") report marked the first instance where the SEC memorialized its position on the nature of digital tokens.[120] Today, digital assets can function as a medium of exchange, a unit of account, or store value.[121] Increasingly, however, these tokens are being used to represent other types of rights, like the right to participate in earning the developer's profits.[122] Depending on the situation, these other rights may cause the digital assets to be labeled as securities.[123]

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facilitate capital formation. The existing securities regulatory regime generally aligns with this mission, and the SEC's digital asset regulation generally follows the same regime.").

[117] Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, U.S. SEC. & EXCH. COMM'N (Dec. 11, 2011), https://www.sec.gov/news/public-statement/statement-clayton-2017- 12-11 ("It has been asserted that cryptocurrencies are not securities and that the offer and sale of cryptocurrencies are beyond the SEC's jurisdiction. Whether that assertion proves correct with respect to any digital asset that is labeled as a cryptocurrency will depend on the characteristics and use of that particular asset.").

[118] *SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors*, U.S. SEC. & EXCH. COMM'N (2017), https://www.sec.gov/news/press-release/2017-176 (last visited Mar. 2, 2019).

[119] Mitchell Moos, *SEC's New Cyber Unit Tasked with Blockchain Securities Fraud,* CRYPTOSLATE (Apr. 23, 2018), https://cryptoslate.com/secs-new-cyber-unit-tasked-with-blockchain-securities-fraud/ ("According to Stephanie Avakian, Co-Director of the SEC's Enforcement Division: 'Cyber-related threats and misconduct are among the greatest risks facing investors and the securities industry. The Cyber Unit will enhance our ability to detect and investigate cyber threats through increasing expertise in an area of critical national importance.'").

[120] *See Report of Investigation Pursuant to 21(a) of the Sec. & Exch. Act of 1934: The DAO*, Exchange Act Release No. 81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf [hereinafter *Report of Investigation*].

[121] Ximeng Tang, *Seventy Years after Howey: An Overview of the SEC's Developing Jurisdiction Over Digital Asset,* AMERICAN BAR ASSOCIATION: BUSINESS LAW TODAY (Oct. 12, 2018), https://businesslawtoday.org/2018/10/seventy-years-howey-overview-secs-developing-jurisdiction-digital-assets/.

[122] *Id.*

[123] *Id.*

A. *Categorizing Crypto – Different Tokens Means Different Treatment*

Because its jurisdiction is limited to "securities", the SEC provided its position on the cryptocurrencies it considers securities and which cryptocurrencies are not.[124] In doing so, the SEC broadly grouped these digital assets into three categories: currency, utility tokens, and security tokens.[125] SEC Chairman Jay Clayton has further clarified the agency's position with regard to the first category: "These are replacements for sovereign currencies, replace the dollar, the euro, the yen with bitcoin, [t]hat type of currency is not a security."[126] Since the SEC does not have jurisdiction over transactions in currencies or commodities the distinction between the categories is significant.[127] In contrast, Clayton addressed "token[s], or a digital asset[s] used in a fundraising process" as securities.[128] This helps to further distinguish the two tokens since utility tokens are not created for fundraising or investment purposes.[129]

Establishing jurisdiction over the two categories of tokens is trickier, especially after the release of the DAO Report.[130] The DAO Report warned issuers of potential liability associated with issuing security tokens, thereby prompting issuers to find creative ways to avoid their tokens being labelled as security tokens.[131] For example, crypto-companies issued so-called "utility" tokens to raise funds for development.[132] By mislabeling their tokens, issuers sought to avoid friction with regulators, though this tactic did not last.[133] The SEC addressed this tactic, most notably in the

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[124] Kate Rooney, *SEC's Clayton needs to see key upgrades in cryptocurrency markets before approving a bitcoin ETF*, CNBC (Nov. 27, 2018), https://www.cnbc.com/2018/11/27/sec-wants-key-upgrades-in-crypto-markets-before-approving-bitcoin-etf.html ("The SEC has said explicitly that bitcoin and ether are treated as commodities and therefore aren't subject to that test. But all other cryptocurrencies are still seen by the SEC as securities and need to register with the agency.").

[125] Stefan Stankovic, *State of Play: The SEC's Current Positions on Cryptocurrency*, CRYPTO BRIEFING (Aug. 20, 2018), https://cryptobriefing.com/state-of-play-the-secs-current-positions-on-cryptocurrency/.

[126] Kate Rooney, *SEC chief says agency won't change securities laws to cater to cryptocurrencies*, CNBC (June 6, 2018), https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html.

[127] Stankovic, *supra* note 127.

[128] Rooney, *supra* note 128.

[129] Katalyse, *Security Tokens v. Utility Tokens- How different are they?*, HACKERNOON (Sep. 26, 2018), https://hackernoon.com/security-tokens-vs-utility-tokens-how-different-are-they-22d6be8901c2.

[130] Tang, *supra* note 121.

[131] *Id*.

[132] Tang, *supra* note 121.

[133] Audrey Nesbitt, *Security Tokens, Utility Tokens and the Evolution of Cryptocurrency*, MEDIUM (Nov. 2, 2018), https://medium.com/datadriveninvestor/security-tokens-utility-

Munchee Order.[134] On December 11, 2017, the SEC issued a cease and desist order against Munchee Inc. for offering and selling unregistered security tokens.[135] Although the California company labeled its MUN tokens as utility tokens, the SEC found the tokens were security tokens pursuant to the *Howey* test. [136]

Chairman Clayton further vocalized the SEC's stance on issuer's mislabeling strategy:

> "[m]erely calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security.[137] Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law."[138]

The blurred line between utility tokens and security tokens has led to SEC investigations of cases involving digital tokens on an ad hoc basis, applying the *Howey* test to the particular facts and circumstances in each case.[139]

B. *The Howey Test: Pulling Apart the Prongs*

The SEC's regulation of cryptocurrency has been difficult because the agency lacks power to create new laws or modify existing ones. Therefore, the SEC must rely on the *Howey* test to determine whether certain tokens and transactions are within its jurisdiction, and whether these items can be properly classified as *securities.*[140]

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tokens-and-the-evolution-of-cryptocurrency-5f1bdcde1845 ("The majority of tokens released in 2017 claimed to be utility tokens to avoid any friction with the SEC but in fact, they were actually security tokens.").

[134] *In re Munchee Inc*., Securities Act Release No. 10445 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf.

[135] *Id*.

[136] *Id*.

[137] Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings,* U.S. SEC. & EXCH. COMM'N (Dec. 11, 2011), https://www.sec.gov/news/public-statement/statement-clayton-2017- 12-11; see also Hinman, supra note 37.

[138] *Id*.

[139] *Id*.

[140] *Framework for "Investment Contract" Analysis of Digital Assets,* U.S. SEC. & EXCH. COMM'N (Apr. 3, 2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets ("The Securities Act of 1933 defines a 'security' in part as 'an investment contract,' the definition of which was set forth by the Supreme Court in the landmark case *SEC v. W.J.* Howey Co.").

Director of the U.S. SEC's Division of Corporate Finance, William Hinman, specifically addressed application of the *Howey* test to digital asset transactions in July 2018, marking an important milestone for the agency.[141] A transaction involving a "security" automatically triggers application of the federal securities laws, permitting the SEC to step in.[142] The Securities Act of 1933 ("Securities Act"), and the Securities Exchange Act of 1934 ("Exchange Act"), have nearly identical definitions[143] for the term "security", which is broadly defined to furnish investors with as much protection as possible.[144] Whether a token is a security also becomes crucial for token issuers and people who facilitate the promotion and issuance of tokens because of liability under the federal securities laws.[145]

The definition of security denotes a laundry list of instruments deemed to be securities, including "investment contracts."[146] The Supreme Court demarcated the boundaries of this vague term through its decision in *SEC v. W.J. Howey Co*.[147] In *Howey,* an investment contract was defined as "a contract, transaction or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of the promoter or a third party."[148]

In determining whether the underlying transaction meets the *Howey test*, emphasis is placed on its economic implications rather than the name provided by its creator.[149] Examining the economic realities of each

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[141] *Id*. (Hinman analogized the digital assets, which are essentially computer codes, to orange groves in *Howey*: "Just as in the *Howey* case, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit.").

[142] *See generally* Division of Enforcement and Trading and Markets, *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets,* U.S. SEC. & EXCH. COMM'N (Mar. 7, 2018), https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[143] *See* 15. U.S.C. § 77b(a)(1) (1933) ; *see also* 15 U.S.C. § 78c(a)(10) (1934); *see also* SEC v. Edwards, 540 U.S. 389, 393 (2004) (holding that, while these definitions are not identical, the U.S. Supreme Court has "treated [them] as essentially identical in meaning").

[144] Reves v. Ernst & Young, 494 U.S. 56, 60-61 (1990) ("Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits,' and determined that the best way to achieve its goal of protecting investors was to define the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.").

[145] Tang, *supra* note 121.

[146] *See* 15 U.S.C. § 77b(a)(1) (1934); *see also* 15 U.S.C. § 78c(a)(10) (2012).

[147] *See generally* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[148] *Id.; see also* BRENT A. OLSON, PUBLICLY TRADED CORPORATIONS HANDBOOK § 4:10 (2019).

[149] *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 853 (1975); *see also* Reves, 494 U.S. at 61 ("In discharging our duty, we are not bound by legal formalisms, but instead

transaction aligns with Congress' purpose in enacting the Federal securities laws: "to regulate *investments,* in whatever form they are made and by whatever name they are called."[150] Emerging as the "catchall category" for securities that do not fit plainly within the definition of "security," the term "investment contract" embodies a flexible standard, and is capable of adapting to meet various schemes.[151]

The first prong of the *Howey* test requires an investment of money, though this should not be read literally.[152] An investment of money does not need to be money per se. Instead, "the 'investment' may take the form of 'goods and services,'[153] or some other 'exchange of value'".[154] Both courts and regulators interpret "money" broadly, reflecting the flexible nature of the federal securities laws.[155]

The second prong, commonality, is established where it is shown that investors have interrelated interests in a common scheme.[156] In analyzing whether a "common enterprise" exists, the courts look to three different approaches: the horizontal approach, the broad vertical approach and the narrow vertical approach.[157] The horizontal approach focuses on the relationship among investors in an economic venture, looking to whether investors "share the risks and benefits of the business enterprise."[158] The narrow vertical approach assesses commonality with regard to whether the promoter and investor are both exposed to risk and the profits and losses of each are interwoven.[159] The broad vertical approach is less constrictive

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take account of the economics of the transaction under investigation."); *see also Tcherepnin v. Knight,* 389 U.S. 332, 336 (1967) ("[I]n searching for the meaning and scope of the word 'security'. . . form should be disregarded for substance and the emphasis should be on economic reality.").

[150] SEC v. Edwards, 540 U.S. 389, 396 (2004) ("Congress[] inten[ded] to regulate all of the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.") (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946)).

[151] *See Howey*, 328 U.S. at 301 ("investment contract" is not a defined term, rather "[i]t embodies a flexible rather than a static principle, one that is 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.").

[152] *Id*.

[153] *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979) (an investment may take the form of "goods and "services" rather than just "cash").

[154] *See* Hocking v. Dubois, 885 F.2d 1449, 1471 (9th Cir. 1989) (explaining an exchange of value satisfies the first prong of the *Howey* test).

[155] *See id*.

[156] *See generally* Howey, 328 U.S. at 293.

[157] Ryan Borneman, *Why the Common Enterprise Test Lacks a Common Definition: A Look Into the Supreme Court's Decision of SEC v. Edwards*, 5 U.C. DAVIS BUS. L.J. 16 (2005), https://blj.ucdavis.edu/archives/vol-5-no-2/why-the-common-enterprise-test.html#_ftn25.

[158] Sec. & Exch. Comm'n v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002).

[159] Borneman, *supra* note 159.

because it requires only that the profits and losses of the investor and promoter be related in some fashion.[160] The "pooling"[161] of investors' assets is the integral part of the horizontal approach, making it more difficult to satisfy because it depends on the coordination of multiple investors.[162]

The third prong of the *Howey* test is crucial and weighs heavily on the overall investment contract determination.[163] This prong is met when shown that investors are led to believe there is a reasonable expectation of profits and where they are motivated by financial return, rather than by consumption of the goods or services received.[164] Simply stated, it must be shown that investors are expecting profits in return for their investment.

Finally, the last prong of the *Howey* Test requires that expected profits come "solely from the efforts of others." "Solely" should not be interpreted literally,[165] but should represent situations where investors have passive roles in the success or failure of the investment.[166] The instrument is typically considered a security where the promoter or issuer remains in control over the managerial conduct of the investment and the investor is unable to participate in decision making.[167]

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[160] *Payphones*, 300 F.3d at 1284 ("Broad vertical commonality . . . only requires a movant to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns . . . .").

[161] *Id*. at 1283-84 ("Most circuits that have considered the issue find it satisfied where a movant shows 'horizontal commonality,' that is the 'pooling' of investors' funds as a result of which the individual investors share all the risks and benefits of the business enterprise.").

[162] Jeffrey A. Bekiares, Esq., *What is the Howey Test? How to Tell if a Coin Passes the Test,* SMART UP LEGAL (July 20, 2018), https://www.smartuplegal.com/learn-center/what-is-the-howey-test- how-to-tell-if-a-coin-passes-the-test/.

[163] Hinman, *supra* note 37 ("What are some of the factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security? Primarily, consider whether a third party – be it a person, entity or coordinated group of actors – drives the expectation of a return. That question will always depend on the particular facts and circumstances[.]").

[164] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 858 (1975) (describing a security transaction as "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 living quarters for personal use.").

[165] Hirsch v. Dupont, 396 F. Supp. 1214, 1218-20 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

[166] *A Securities Law Framework for Blockchain Tokens*, COINBASE (last updated Dec. 7, 2016), https://www.coinbase.com/legal/securities-law-framework.pdf.

[167] *See* Lino v. City Investing Co., 487 F.2d 689, 692 (3d Cir. 1973) (holding that "an investment contract can exist where the investor is required to perform some duties, as long as they are nominal or limited and would have little direct effect upon receipt by the participants of the benefits promised by the promoters.").

C. *Registration Requirements*

1. Securities Act of 1933

Once a token is labeled a security it must be registered unless it otherwise qualifies under an exemption.[168] Enacted in 1933, the Securities Act regulates the offer and sale of securities within the United States.[169] Specifically, Section 5(a)and 5(c) of the act prohibit the offer and sale of unregistered securities unless an exemption is available that negates the registration requirement.[170] Section 5 is a mechanism for regulating the timeline and distribution process for issuers offering securities for sale.[171] Like the term "security", Section 2(a)(3) of the Securities Act broadly defines the terms "offer" and "sale":[172] "Any attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, *for value*"[173] constitutes an offer, and a sale is defined as "every disposition

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[168] *Small Business: Exempt Offerings*, U.S. SEC & EXCH. COMM'N (last modified Feb. 7, 2020), https://www.sec.gov/smallbusiness/exemptofferings (illustrating the different exemptions to registration, which include Regulation Crowdfunding, Regulation D, and Regulation A).

[169] *See generally Fast Answers: The Laws That Govern the Securities Industry*, U.S.SEC& EXCH. COMM'N (last modified Oct. 1, 2013), https://www.sec.gov/answers/about-lawsshtml.html.

[170] *See* 15 U.S.C. § 77b(e)(a) (1933) (explaining that Section 5(a) of the Securities Act of 1933 prohibits the offer and sale of securities through interstate commerce and the mails: "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale."); *see also* 15 U.S.C. § 77b(e)(c) (explaining that Section 5(c) of the Securities Act of 1933 prohibits the offer and sale of securities unless a registration statement is filed: " It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.") ; *see generally* U.S.SEC&EXCH. COMM'N, *supra* note 171.

[171] Osama Khan**,** Robert Weber and Robert L. Wernli, Jr.**,** *Airdrop of Crypto Tokens Hits Regulatory Flak*, NATIONAL LAW REVIEW (Aug. 28, 2018), https://www.natlawreview.com/article/airdrop-crypto-tokens-hits-regulatory-flak.

[172] *See* 15 U.S.C. § 77b(a)(3) (1933) ("The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value. The term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.").

[173] *Id.; see also* Diskin v. Lomasney & Co., 452 F.2d 871, 875 (2d Cir. 1971) (explaining that the definition has been interpreted as going well beyond the common law concept of

of a security or interest in a security, *for value*."[174] Thus, an offer might be interpreted to include any activity on the part of the issuer which affects the public by conditioning the market.[175] For purposes of Section 5, an offer and sale can occur even if there is no exchange of monetary consideration.[176] While a bona fide gift would not implicate Section 5, in situations where the "donor derives some benefit from the purported gift, the transaction will be treated as a sale."[177]

2. Exchange Act of 1934

i. Securities Exchanges

In addition to the requirements of the Securities Act of 1933, the Securities Exchange Act of 1934 mandates registration requirements for a variety of market participants, including any broker, dealer or exchange.[178] Section 5 of the Exchange Act makes it unlawful to operate a securities exchange without registering with the SEC, unless the exchange operates under a registration exemption.[179] Section 3(a)(1) of the Exchange Act defines an "exchange" as:

> "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."[180]

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an offer to encompass circumstances that would require the protection of the securities laws).

[174] 15 U.S.C. § 77b(a)(3) (1933); *see also SEC v. Datronics Engineers, Inc.*, 490 F.2d 250, 253 (4th Cir. 1973) (explaining that the entire transaction must be considered to determine whether value was received).

[175] SULLIVAN & CROMWELL LLP, *Securities Offering Reform Memorandum*, (Aug. 2, 2005), https://www.sullcrom.com/siteFiles/Publications/SecuritiesOfferingReformFullText.pdf.

[176] *See* Dror Futter, *You Can't Even Give Them Away . . No, Seriously,* CROWDFUND INSIDER (Aug. 16, 2018), https://www.crowdfundinsider.com/2018/08/137933-ico-tokens-the-sec-you-cant-even-give-them-away-no-seriously/.

[177] 2 Thomas Lee Hazen, *Law of Securities Regulation,* § 5.1 (6th ed. 2009).

[178] *See generally* U.S. SEC & EXCH. COMM'N, *supra* note 171.

[179] 15 U.S.C. § 78e (2018).

[180] 15 U.S.C. § 78c (2018).

To determine whether a trading system meets the definition of "exchange", the SEC looks to Exchange Act Rule 3b-16(a), which provides a functional two-part test: whether the trading system "(1) [b]rings together the orders for securities of multiple buyers and sellers; and (2) [u]ses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade."[181] The SEC will take relevant facts and circumstances into account when evaluating an entity's characterization of its trading system, looking to the activity actually occurring between the buyers and sellers rather than the technology or terminology used by the entity to determine whether the system operates as an exchange.[182] Moreover, the term "order" is broadly construed and labels assigned to trading interests are disregarded for the actual activities taking place on the system.[183]

This exchange analysis also includes an evaluation of the totality of activities and technology used to bring orders of buyers and sellers together on the system.[184] If the system displays, or otherwise represents, trading interests entered on a system to users or centrally receives orders for processing and execution, then it meets the first prong of the test.[185] Additionally, the second prong is easily met if set rules or a trading facility is provided.[186] A system that meets the criteria of the test must register as a national securities exchange under Section 6 of the Exchange Act, as proscribed by Section 5.[187]

ii. Broker-Dealers

Under Section 15(a) of the Exchange Act, absent an exemption, it is unlawful for any broker or dealer to induce the purchase or sale of any

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[181] 17 CFR § 240.3b-16 (2018).

[182] *See* Division of Enforcement and Trading and Markets, *Statement on Digital Asset Securities Issuance and Trading,* U.S. SEC. & EXCH. COMM'N (Nov. 6, 2018), https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading#_edn18.

[183] *Id*.

[184] *Id*.

[185] *Id*.

[186] *Id*.

[187] *See* 17 CFR § 240.3b-16 (2018) (explaining Exchange Act Rule 3b-16(b) explicitly excludes certain systems that the Commission believes are not exchanges, and a system is not included in the Commission's interpretation of 'exchange' if: (1) the system fails to meet the two-part test in paragraph (a) of Rule 3(b)-16; (2) the system falls within one of the exclusions in paragraph (b) of Rule 3b-16; or (3) the Commission otherwise conditionally or unconditionally exempts the system from the definition); *see also* 15 U.S.C. § 78f (2018); *see also* 15 U.S.C. § 77e (2018).

security, unless the requisite registration requirements are satisfied in accordance with section 15(b).[188] This section requires brokers and dealers utilizing exchange facilities to effect transactions to register with the SEC and become members of a self-regulatory organization, like Financial Industry Regulatory Authority ("FINRA").[189] Section 3(a)(4) defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others,"[190] while section 3(a)(5) defines a "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[191] These definitions are interpreted broadly and a "person" can include an entity.[192] As with the foregoing "exchange determination," a functional approach must be used to assess whether an entity meets the definition of a broker dealer.[193] Thus, SEC-registered broker-dealers are subject to regulatory and legal requirements that govern their conduct in the marketplace.[194]

In sum, these registration requirements provide important safeguards for main street investors while also promoting market stability by encouraging an informed investment, so that capital is allocated efficiently.

D. *Regulating ICOs*

Based on the federal regulatory framework administered by the SEC, the first step in regulating ICOs is determining whether an ICO involves the sale of utility or security tokens. As previously discussed, security tokens fall within the SEC's jurisdiction because they resemble traditional investment vehicles, i.e., securities. Therefore, similar to offering and selling traditional securities, offerings of security tokens require SEC registration.[195] This is one of the reasons ICOs have come under immense scrutiny[196] as most, if not all, ICOs have not been registered with the SEC.[197]

Before the ICO boom in the latter half of 2017, the SEC issued an investigative report ("DAO Report") that applied the federal securities

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[188] *See* U.S. SEC. & EXCH. COMM'N, *supra* note 180; *see also* 15 U.S.C. §78o (a-b) (1934).
[189] *See* U.S. SEC. & EXCH. COMM'N, *supra* note 180.
[190] 15 U.S.C. § 78c(a)(4) (2018).
[191] 15 U.S.C. § 78c(a)(5) (2018).
[192] *See* U.S. SEC & EXCH. COMM'N, *supra* note 171.
[193] *See* U.S. SEC. & EXCH. COMM'N, *supra* note 180.
[194] *Id*.
[195] *See* Clayton, *supra* note 1.
[196] *Id*.
[197] *Id*. ("Investors should understand that to date no initial coin offerings have been registered with the SEC.").

laws to the Decentralized Autonomous Organization's ("DAO") token distribution during it's ICO. [198] The DAO token offering raised around $150 million, catching the eyes of regulators, even though they did not pursue any enforcement action.[199] Applying the *Howey* test to the DAO tokens led the SEC to conclude that the tokens acted as securities, and therefore the DAO ICO was an unregistered offering of securities.[200] The DAO Report reiterated the fact that the federal securities laws would require registration of ICOs distributing security tokens and reminded issuers that a platform meeting the definition of "exchange" would need to be registered under the Exchange Act.[201]

Unfortunately, rather than heeding the warning of the SEC, many issuers mistook the report for an opportunity to test the SEC's limits. However, after the DAO Report, the SEC issued a cease and desist order [to DAO?], signifying its new policy towards unregistered ICOs.[202] In *In re Munchee Inc.,* the SEC found that Munchee Inc.'s ICO was an unregistered offering of securities and concluded that the company violated the registration requirements under Section 5 of the Securities Act.[203] Since *Munchee,* the SEC has sued on a number of cases involving ICOs, both successfully and unsuccessfully,[204] as evidenced in the chart below:[205]

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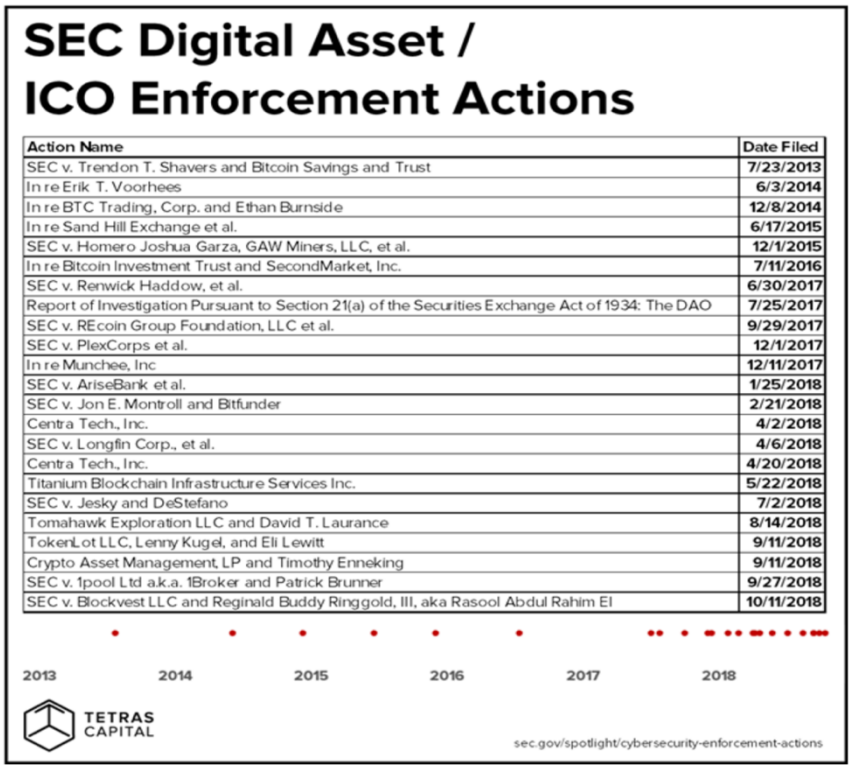
[198] *See Report of Investigation*, *supra* note 122.
[199] *Id*.
[200] *Id*.
[201] *Id*.; *see also* Tang, *supra* note 123.
[202] *In re Munchee Inc*., Securities Act Release No. 10445 (Dec. 11, 2017), https://www.sec.gov/litigation/admin/2017/33-10445.pdf.
[203] *Id*.
[204] *See generally Cybersecurity Enforcement Actions*, U.S. SEC. & EXCH. COMM'N (last updated Jan. 7, 2020), https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.
[205] Alex Sunnarborg, *The Incoming Wave of ICO Regulation (Yes, It's Coming)*, COINDESK (Nov. 3, 2018) https://www.coindesk.com/the-incoming-wave-of-ico-regulation-yes-its-coming.



Particularly, in November 2018, the SEC announced a settlement with two companies that were charged with the offer and sale of unregistered securities.[206] The companies both sold digital tokens in ICOs, marking the first cases where the SEC imposed civil penalties solely for ICO securities offering violations.[207] Co-Director of the SEC's Enforcement Division, Stephanie Ativan, warned other issuers that "[t]hese cases tell those who are considering taking similar actions that [the SEC] continue[s] to be on the lookout for violations of the federal securities laws with respect to digital assets."[208] However, the SEC's approach to regulating ICOs was brought into question when a federal court denied the agency's motion for a preliminary injunction enjoining the ICO of Blockvest, LLC.[209]

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[206] *Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities*, U.S. SEC. & EXCH. COMM'N, Press Release No. 2018-264 (Nov. 16, 2018), https://www.sec.gov/news/press-release/2018-264.
[207] *Id*.
[208] *Id*.
[209] Daniel McAvoy, *SEC imposes penalties and provides path to compliance for unregistered ICOs and digital asset exchanges*, NIXON PEABODY (Dec. 14, 2018),

On the front lines, SEC Chairman Jay Clayton articulated his disapproval of unregistered ICOs, warning cryptocurrency entrepreneurs to "get their act together" by registering their ICOs with the SEC to avoid running into problems down the road.[210] Clayton's remark comes after the SEC announced its first civil penalties against two crypto companies for violating the registration requirements.[211] Clayton has previously spoken out about regulating ICOs as securities, stating that "[t]here are none that I've seen that aren't securities . . . [and] [t]o the extent something is a security, we should regulate it as a security."[212]

Registration is an important mechanism for investors because it provides them with adequate information regarding important financial information about a company's securities. Without a registration statement on file, investors are left in the dark and might be lured into investing into fraudulent schemes. For example, a recent study revealed that over 80% of ICOs are scams.[213] Thus, due to the popularity of ICOs, investors need the protection of the SEC now more than ever.

In an effort to protect people from fraudulent ICOs, social media and search engine giants have gone as far as banning advertising and sponsored posts relating to ICOs and cryptocurrencies.[214] Facebook first announced its ban in early 2018, with Google, Snapchat and Twitter following suit shortly after.[215] Yet it is unlikely that ICOs will halt entirely anytime soon, even though their use has declined due to increased regulatory action and bans by online advertising giants. Instead, risk-averse developers have turned to airdrops as an alternative way to create buzz and separate their projects from the dense token landscape.[216]

E. *Platform Regulation*

The SEC seeks to regulate trading platforms as an alternative way to shield the market from fraudulent and manipulative trading practices and

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https://www.nixonpeabody.com/-/media/Files/Alerts/2018-December/SEC-enforcement-actions-for-unregistered-ICOs.ashx.

[210] Andrew Ramonas, *SEC Chair Tells Unregistered ICOs to 'Get Your Act Together'*, BLOOMBERG LAW (Nov. 27, 2018), https://news.bloomberglaw.com/securities-law/sec-chair-tellsunregistered-icos-to-get-your-act-together-1.

[211] U.S. SEC. & EXCH. COMM'N, *supra* note 207.

[212] Torsten Hartmann, *Are security tokens the new standard? What is the difference between security vs. utility tokens*, CAPTAINALTCOIN (Nov. 11, 2018), https://captainaltcoin.com/security-vsutility-tokens/.

[213] Shobhit Seth, *80% of ICOs are Scams: Report*, INVESTOPEDIA (Apr. 2, 2018), https://www.investopedia.com/news/80-icos-are-scams-report/.

[214] Bonnie Chan, *Will airdrop be an alternative to the ICO,* GATECOIN (Apr. 2, 2018), https://blog.gatecoin.com/will-the-airdrop-be-an-alternative-to-the-ico-1b1bdff716c6.

[215] *Id*.

[216] *Id*.

to protect investors from ICO scams.[217] These trading platforms provide a method to buy and sell digital assets, including tokens offered and sold in ICOs.[218] By targeting platforms and ICOs, the SEC can expand its civil enforcement powers.

On March 7, 2018, the SEC released a "Statement on Potentially Unlawful Online Platforms for Trading Digital Assets", which reiterated its position that platforms acting as exchanges and trade tokens that meet the definition of a security *"must register as a national securities exchange or operate under an exemption from registration."*[219] Once a trading platform is labeled as a "securities exchange", or otherwise operates as an "alternative trading system",[220] the platform comes the SEC's direct, and is thus subject to the federal securities laws.[221]

On November 8, 2018, the SEC announced that it had settled charges against Zachary Coburn, the founder of EtherDelta, a digital trading platform.[222] This was the first instance of enforcement based on findings that the platform operated as an unregistered national securities exchange.[223] To date, no crypto exchanges have been registered with the SEC, though Coinbase is the first platform to apply for registration.[224]

F. *Broker-Dealer Regulation*

By gaining command over digital asset transactions, the SEC extended its registration requirements to investment companies, broker dealers, ICOs, and other digital assets.[225] Under Section 15 of the Exchange Act, any entity that facilitates the issuance of digital security tokens in ICOs

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[217] Stankovic, *supra* note 127.
[218] *See generally* U.S. SEC. & EXCH. COMM'N, *supra* note 144.
[219] *Id*.
[220] *Data: Alternative Trading System ("ATS") List*, U.S. SEC. & EXCH. COMM'N (last modified Feb. 28, 2019), https://www.sec.gov/foia/docs/atslist.htm ("An ATS is a trading system that meets the definition of "exchange" under federal securities laws but is not required to register as a national securities exchange if the ATS operates under the exemption provided under Exchange Act Rule 3a1-1(a). To operate under this exemption, an ATS must comply with the requirements set forth in Rules 300-303 of Regulation ATS.").
[221] Stankovic, *supra* note 127.
[222] *See In re* Zachary Coburn, Securities Exchange Act Release No. 84553 (Nov. 8, 2018), https://www.sec.gov/litigation/admin/2018/34-84553.pdf; *see also* SEC Charges EtherDelta Founder With Operating an Unregistered Exchange, U.S. SEC. & EXCH. COMM'N, Press Release No. 2018-258 (Nov. 8, 2018), https://www.sec.gov/news/press-release/2018-258.
[223] *Id*.
[224] Stankovic, *supra* note 127.
[225] *Id*.

and secondary trading in digital security tokens is required to register with the SEC as a "broker" or "dealer."[226]

In *In re Tokenlot, LLC*, the SEC Commission applied the broker-dealer registration requirements to an entity trading or facilitating transactions in digital securities for the first time.[227] There, an online "ICO superstore" offered investors a way to purchase digital tokens during ICOs and engage in secondary trading.[228] It further demonstrated that entities facilitating ICOs and transactions in secondary markets can meet the broker-dealer definition even though they do not meet the definition of an exchange.[229]

IV. ASSESSING AIRDROPS UNDER THE FEDERAL SECURITIES LAWS

> "You can't just send shares of stock to people. The problem with an airdrop is that it's generally incongruent with US security laws. My general advice for STO issuers, I would put that airdrop concept on hold. I would advise anyone in the US not to do it. I get it, it's a good marketing tactic, but there's too much risk and uncertainty."[230]

There are always people looking for shortcuts, and the use of airdrops is no different. In the United States, federal securities laws aim to regulate the economy and protect investors by requiring full and fair disclosure concerning the offer or sale of securities.[231] Complying with these complex statutes can be extremely costly and burdensome for issuers, which is why digital coin offerings are an increasingly attractive "alternative" for raising capital and enticing investors.[232] Although they are clever attempts to bypass federal securities laws, certain cryptocurrencies, ICOs and airdrops may be within their broad scope.[233] And following the determination that an instrument is a security,

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[226] *Id*.
[227] *SEC Charges ICO Superstore and Owners with Operating As Unregistered Broker - Dealers*, U.S. SEC. & EXCH. COMM'N, Press Release No. 2018-185 (Sept. 11, 2018), https://www.sec.gov/news/press-release/2018-185; *see also In re* Tokenlot, LLC, Lenny Kugel and Eli L. Lewitt, Securities Act Release No. 10453 (Sept. 11, 2018), https://www.sec.gov/litigation/admin/2018/33-10543.pdf.
[228] *Id*.
[229] U.S. SEC. & EXCH. COMM'N, *supra* note 144.
[230] *See id*. (quoting Darren Marble, CEO of CrowdfundX, a marketing firm for STO).
[231] *See generally* U.S.SEC&EXCH. COMM'N, *supra* note 171.
[232] *See* Kyriakides, supra note 101.
[233] *See* Clayton, supra note 1.

registration is required unless an exemption is met.[234] Additionally, any entity or person engaging in exchange activities must register as a national securities exchange or operate under an exemption from registration.[235]

A. *What's an Airdrop to and Orange Grove? Applying the Howey Test*

In reaction to the SEC's attacks on ICOs, issuers have attempted to bypass securities laws through the use of airdrops.[236] Determining whether a transaction involves digital securities is fact intensive and the outcome may differ from case to case.[237] Nonetheless, the *Howey* test has become a common legal litmus test for deciding whether or not a digital asset is a security.

Because airdrops involve distributing "free" digital tokens, how can the first prong of the *Howey* test be satisfied if there is no investment of money? In fact, "the investment of money" doesn't necessarily mean *money*.[238] The SEC's DAO Report established that an investment contract can be created whether or not the underlying investment consisted of money or cash. [239] Instead, "the 'investment' may take the form of 'goods and services,'[240] or some other 'exchange of value.'"[241] Thus, where an issuer provides investors with "free" tokens in exchange for services designed to advance their company's interests, the so-called "free" tokens are no longer free.[242]

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[234] 15 U.S.C. § 77b(e)(c) (2011).
[235] Tang, *supra* note 123.
[236] Stankovic, *supra* note 127.
[237] *Id*.
[238] *See* Uselton v. Comm. Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) (explaining that, in determining whether an investment contract exists, cash is not the only form of contribution or investment that will create an investment contract).
[239] *See Report of Investigation*, *supra* note 122 (This report evidenced the investigation of DAO Tokens. DAO is an example of Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger of blockchain. The investigation of DAO tokens raised question regarding the application of the U.S federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the facts presented in this investigation the Commission determined that DAO tokens are securities under the federal securities laws.).
[240] *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979) (an investment may take the form of "goods and services" rather than just "cash").
[241] *See Hocking v. Dubois,* 885 F.2d 1449, 1471 (9th Cir.1989) (explaining that an exchange of value satisfies the first prong of the *Howey* test).
[242] *See In* re Tomahawk Exploration LLC and David Thompson Laurance, Securities Act Release No. 10530, at 8 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf.

In the airdrop context, investors trade their services—promoting a marketplace—for the issuing company's virtual token.[243] However a separate problem occurs in a situation where the tokens are no longer defined as conditional gifts because the issuers do not demand anything from the investors. In that scenario, the question is whether the issuers' reliance on the airdrop recipients' self-interest sufficient to satisfy *Howey*'s first prong? The answer requires viewing a case in its entirety. At this point, the SEC's is that the *Howey*'s first prong is satisfied when airdrop recipients provide marketing or promotional services to the issuer.[244]

Airdrops can fulfill the "common enterprise" element of *Howey*'s second prong under the horizontal commonality approach. Developers pool the recipient's "investments" together to build the network, i.e., by utilizing the investors' marketing services to promote the underlying project. However, the argument against this approach is that the "investments" do not lead to capital raising to be used to develop the issuer's project.

Out of the four prongs, the third prong bears the most weight.[245] While airdrop recipients do not "purchase" the coins per se, they are incentivized to engage in the transactions and promote the tokens to the rest of the market in light of the chance to earn a return.[246] Thus, by virtue of their involvement, the investors are looking to gain some economic benefit from these "free" tokens.[247] To investors, the tokens are like a golden ticket that may enable them to earn a few dollars.[248] As long as the "opportunity provided to offerees tend[s] to induce [investors] by emphasizing the possibility of profits"[249] the third *Howey* prong is met. Thus, the test does

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[243] David Canellis, *SEC Ruling Suggests Cryptocurrency Airdrops violate Securities Law*, THE NEXT WEB, (Aug. 15, 2018), https://thenextweb.com/hardfork/2018/08/15/securities-sec-airdrops-cryptocurrency/.

[244] Brad R. Jacobsen, *Free! Does not mean Freedom from Compliance with U.S. Securities Laws – Do ICOs through the Use of AirDrops violate U.S. Securities Laws?*, LEXOLOGY (Sep. 4, 2018), https://www.lexology.com/library/detail.aspx?g=3bd0e112-3b84-4419-99e6-df42fcf1a0b1.

[245] Hinman, *supra* note 37.

[246] COINBASE, *supra* note 168.

[247] Jacobsen, *supra* note 246 ("As the SEC views it, a person receiving 'airdropped' digital tokens provides a service (i.e., pays value) to the company giving away the airdropped tokens. The people receiving the tokens are essentially marketers and promoters, spreading the popularity of a particular token in the hope that the value will rise.").

[248] Jay B. Sykes, CONG. RES. SERV., R45301, *Securities Regulation and Initial Coin Offerings*: *A Legal Primer,* (last updated Aug. 31, 2018), https://fas.org/sgp/crs/misc/R45301.pdf.

[249] Teague v. Bakker, 35 F.3d 978, 987 (4th Cir. 1994) ("By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or

not require that profits actually be attained but may be sufficed merely by the *opportunity provided* to make a profit.

Lastly, an airdrop must fulfill the fourth prong of the *Howey* test, which looks to whether the profits are derived "solely from the efforts of others."[250] Although airdrop investors contribute their services by promoting the digital tokens, they ultimately rely on the issuers for the success of the underlying tokens. The viability of the business model at the outset of the "free" token distribution is unknown, with each recipient having no choice but to rely on the promoter to further build the network and make the enterprise fruitful.[251] To further illustrate, when a recipient of an airdropped token merely waits for the token's value to appreciate and does little to market the token themselves, their profits are "from the efforts of others." Furthermore, even if the profits from digital tokens are attributed to price speculation, developers significantly influence a token's price on secondary markets through their own actions. Teams of developers might release updates online or might tout investors with advertising or through social media.

The endorsers of airdrops might feel differently, finding that airdrop recipients do not rely on the efforts of others since they are providing marketing services. Accordingly, if the relevant token network is sufficiently decentralized, this outcome could change because investors may no longer reasonably expect another person or group to carry out the managerial efforts. In effect, the tokens distributed would not represent an investment contract.[252]

B. *Registration Requirements under the Securities Act: "For Value"*

After assessing whether the subject tokens are securities, the next step would be to determine whether an airdrop qualifies as an "offer and sale," which requires registration under section 5 of the Securities Act.[253] As previously mentioned, an offer is defined as "any attempt to offer or to dispose of, or solicitation of an offer to buy a security or interest in a security, *for value*," while a sale is defined as "every disposition of a security or interest in a security, *for value."*[254] Even where there is a lack

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a participation in earnings resulting from the use of investors' funds. . . In such cases the investor is "attracted solely by the prospects of a return" on his investment.").

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

[251] Hinman, *supra* note 37.

[252] *Id*.

[253] 15 U.S.C. § 77b(e)(c) (1933).

[254] 15 U.S.C. § 77b(a)(1) (1933).

of monetary consideration exchanged for the securities, there can be an offer or sale.[255]

Airdrops clearly meet the criteria for an offer but determining whether these "free" distributions qualify as sales requires more attention. In the case of airdrops, developers attempt to bypass registration requirements by "gifting" tokens. However, this tactic is flawed because only bona fide gifts do not implicate the registration requirements.[256] Thus, a gifted security is deemed a sale when the donor receives some real benefit, though this benefit does not need to be monetary.[257] Upon "gifting" tokens, an issuer (donor) of an airdrop receives benefits in the form of online marketing and promotional activities by the donee.

Airdrops are not the first occurrence of "gifting" securities. In the landmark case, *SEC v. Datronics Engineers,* the Fourth Circuit focused on whether the donor received value from the gifting of "spin-off" stock.[258] Datronics contended that there was no statutory sale because the transfers of stock were not "for value."[259] Contrary to this, the court found that value accrued to Datronics because "a market for the stock was created by its transfer to so many new assignees," and "the stock retained by Datronics was thereby given an added increment of value."[260] After dissemination, the value of the stock appreciated substantially, benefiting Datronics.[261] Thus, the court held that where a "'gift' disperses corporate ownership and thereby helps to create a public trading market it is treated as a sale."[262] Similarly, in *SEC v. Sierra Brokerage Services, Inc.*, the Southern District Court in Ohio held that the "gifted" shares of stock constituted sales of securities since they were intended to create a market.[263] In effect, permitting these "gifts" would allow companies to evade registration requirements and "go public by the backdoor."[264]

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[255] *See In re* Tomahawk Exploration LLC and David Thompson Laurance, Securities Act Release No. 10530, at 7 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf.

[256] *See* Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir. 1949) (transfers were not sales under Section 16(b) of the Exchange Act where the parties conceded they were bona fide gifts).

[257] *See SEC v. Sierra Brokerage Servs., Inc.*, 608 F. Supp. 2d 923, 940–43 (S.D. Ohio 2009), *aff'd*, 712 F.3d 321 (6th Cir. 2013).

[258] SEC v. Datronics Engineers, Inc., 490 F.2d 250, 253 (4th Cir. 1973).

[259] *Id*. at 253.

[260] *Id*.

[261] *Id*. at 254.

[262] *Id*. at 253–54.

[263] *See SEC v. Sierra Brokerage Servs., Inc.*, 608 F. Supp. 2d 923, 940–43 (S.D. Ohio 2009), *aff'd*, 712 F.3d 321 (6th Cir. 2013).

[264] Glossary of Stock Market Terms: *Going Public Through the Backdoor*, NASDAQ, https://www.nasdaq.com/investing/glossary/g/going-public-through-the-backdoor (last visited Mar. 2, 2019) (Defining "going public through the backdoor" as "[t]he process by which a company comes to have publicly traded shares without an IPO. This could happen

Airdropping tokens presents obvious similarities to the gifting of stock shares that took place in these cases. In reality, an issuer is not distributing these tokens for a charitable purpose.[265] Issuers primarily use airdrops to market and distribute their tokens.[266] The underlying purpose of these "gifts" is to create a public market for the digital project, which provides value to the issuer.[267] By "gifting" the tokens, the developers hope to create a community of users and a public marketplace.[268]

Airdrop issuers also receive value through online marketing, including the promotion of the project on online forums and blogs.[269] Additionally, an airdrop may generate some form of economic benefit or value for the issuer by generating promotional benefits related to the blockchain platform or even by producing more interest in a related token sale.[270] Airdrop issuers are actually "gifting" tokens to recipients in exchange for promotional services to advance their own economic objectives and generate interest for their projects.[271] As a result, issuers rely on these "gifts" as a mechanism to disseminate their tokens among users and ultimately create a marketplace.[272] Essentially, issuers are looking to circumvent the registration requirements and the scrutiny that surrounds conducting an ICO by creating a public market for their tokens through a back-door offering. Despite this clever ruse to evade registration requirements these "gifts" unavoidably qualify as sales because they create value for issuers.[273]

The SEC chose to attack the gift problem under Rule 15c2-11, which requires that a broker-dealer have information equivalent to that in a registration statement before effecting a transaction.[274] This contemporary

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through a reverse shell merger, or through acquisition of a public company and offering shares to previous owners. Another way is through a series of private placements, selling shares on an exchange to institutional and other sophisticated investors.").

[265] Bitcoin Exchange Guide News Team, *Cryptocurrency Airdrops Controversy: Philanthropy or Effective Marketing Strategy?*, BITCOIN EXCHANGE GUIDE (Nov. 13, 2018), https://bitcoinexchangeguide.com/cryptocurrency-airdrops-controversy-philanthropy-or- effective-marketing-strategy/.

[266] Gina Conheady & Christian Munoz, *Airdrops: Are free tokens free from regulation?*, BLOOMBERG LAW (June 1, 2018), https://news.bloomberglaw.com/banking-law/airdrops-are-free-tokens-free-from-regulation.

[267] Bekiares, *supra* note 164.

[268] *See generally* Lee, *supra* note 65.

[269] *See* Conheady & Munoz, supra note 268.

[270] *Id*.

[271] *Id*.

[272] *Id*.

[273] SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp.2d 923, 940-943 (S.D. Ohio 2009) ("[W]here a gift is followed by widespread downstream sales of those securities, these would-be gifts may be characterized as a subterfuge to evade registration.").

[274] 17 CFR § 240.15c2-11 (2015).

means of dealing with the "gifted" securities issue and companies going public through the back door is intended to ensure that a market-maker has adequate information and has completed adequate due diligence before it quotes securities.[275]

In effect, the SEC has principally used its 1934 Exchange Act powers to prevent broker-dealers from making a market for securities for which there is no adequate information provided.[276] To some degree, the SEC has attempted to indirectly engage the airdrop problem by regulating trading platforms and broker-dealers. By requiring registration of exchanges and broker-dealers, the SEC has tightened its grip on the situation.

As the evolution of capital formation continues, regulators are guiding companies to conduct compliant digital-asset distributions by using exemptions available under the existing regulatory framework.[277]

C. *History Repeats Itself: "Free Stock" Offerings vs. Airdrops*

> "Free stock is really a misnomer[.] While cash did not change hands, the companies that issued the stock received valuable benefits."[278]

Reminiscent of the "Dot.com" bubble burst that occurred roughly two decades ago, airdrops share blatant similarities with what was once termed "free stock."[279] Internet companies that distributed this so called "free stock" were eventually targeted and eradicated by the SEC's enforcement actions.[280] As a method of swindling investors into participating in newly launched internet ventures, companies offered stock to people who provided personal information or agreed to solicit other investors by word of mouth.[281] In these cases, the SEC was forced to consider whether the distribution of free shares of stock triggered the registration requirements

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[275] *See* ANTHONY L.G., PLLC, *15c2-11 Application,* http://www.legalandcompliance.com/securities-law/15c2-11-application/ (last visited Mar. 3, 2019).

[276] *Id*.

[277] *Id*.

[278] *SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock"*, U.S. SEC. & EXCH. COMM'N (99-83) (last modified Jul. 22, 1999), https://www.sec.gov/news/headlines/webstock.htm.

[279] *See* Scott H Kimpel, and Mayme Beth F. Donohue, *SEC Brings Enforcement Case Involving "Airdrop" of Securities*, HUNTON ANDREWS KURTH LLP (Aug. 21, 2018), https://www.blockchainlegalresource.com/2018/08/sec-brings-enforcement-case-involving-airdrop-securities/#page=1.

[280] U.S. SEC. & EXCH. COMM'N, *supra* note 280.

[281] Edward Wyatt, *S.E.C. Settles 4 Cases Offering 'Free Stock'*, N.Y. TIMES (July 23, 1999), https://www.nytimes.com/1999/07/23/business/sec-settles-4-cases-offering-free-stock.html.

of the Securities Act.[282] The SEC's analysis focused on whether an offer or sale of securities *for value* took place.[283] This empowered the SEC to take the position that the issuers were not giving the stocks away for free because they were receiving value from the recipients, who acted as marketing liaisons by referring the companies to others or engaging in some sort of activity to draw the attention of other individuals.[284] Accordingly, there was an offer and sale for value for the purposes of the Securities Act.[285] Once more, history repeats itself; though this time it is airdrop issuers conditioning the market with "free" distributions, thus triggering application of the securities laws.

1. Four Seminal Free Stock Cases

In four seminal cases the SEC's enforcement division brought, and settled against, distributors of free stock. The common theme was unmistakably clear: "free" did not mean free from regulatory compliance.[286] In each of these cases, prospective recipients were required to perform some action—whether that meant signing up on the issuer's website, providing personal information, or email addresses—to receive free shares. Additional free shares may also have been offered in exchange for referrals. Consequently, issuers received economic benefit from these "free stock" offerings. Therefore, there was an offer and sale of securities.

First, in *In re Joe Loofbourrow*, the SEC found that Loofbourrow had violated the registration provisions of the Securities Act when he represented that his company, American Space Corp., would give ten shares of "free" stock to individuals who filled out an online registration form.[287] The online registration form required individuals to provide their names, home addresses, and email addresses, and additionally included a series of questions aimed at ensuring that registrants had read through portions of the website that discussed "financial partner offers."[288] Loofbourrow also offered additional "free" shares to individuals who referred others to his website.[289] Based on these actions, the SEC held that the primary purpose of the offering was to generate interest and encourage

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[282] *See* Conheady & Munoz, supra note 268.
[283] *Id*.
[284] *Id*.
[285] *Id*.
[286] Jacobsen, *supra* note 246.
[287] *See* U.S. SEC. & EXCH. COMM'N, *supra* note 280; *see also In re* Joe Loofbourrow, Securities Act Release No. 7700 (July 21, 1999), https://www.sec.gov/litigation/admin/34-41631.htm.
[288] *In re* Joe Loofbourrow, Securities Act Release No. 7700 (July 21, 1999), https://www.sec.gov/litigation/admin/34-41631.htm.
[289] *Id*.

individuals to invest capital in the company, which constituted an offer or sale of securities *for value*.[290]

Second, in *In re Web Works Marketing.Com, Inc. and Trace D. Cornell*, the SEC found dissemination of "free" stock in violation of the registration requirements.[291] Under Web Works's scheme, an individual would: (1) receive three free shares if they registered with Web Works; (2) receive up to ten additional free shares for referrals; (3) receive twenty-four shares by subscribing to long distance phone services offered by Telco; (4) receive 25 extra shares if they remained a Telco customer for six months.[292] Like in *Loofbourrow*, Web Works sought to attract visitors to its website and generate interest through it's "free stock offering."[293] Web Works's website even went so far as to explain that "high site traffic was essential to a successful website . . . When you tell others about the site, you create value for the company. That is exactly why we are offering the shares as a gift."[294] The SEC held that Web Works's scheme constituted an unregistered free stock offering.

Third, the SEC a made similar finding that unregistered free stock was offered online in *In re WowAuction.com Inc. and Steven M. Gaddis, Sr.*, where WowAuction offered three shares of "free" stock to individuals who registered with the company.[295] WowAuction also offered up to seven additional free shares for referrals.[296] Additionally, five registered users were eligible to be selected to receive 10,00 free shares in a drawing.[297] Gaddis and WowAuction disseminated the "free" stock to generate interest in WowAuction and attract visitors to the website.[298] The SEC held

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[290] *Id*. ("The primary purpose of the 'free' stock offering was to generate publicity for ASC and encourage members of the public to become 'financial partners" by investing capital in ASC.").

[291] *SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock"*, U.S. SEC. & EXCH. COMM'N (99-83) (Modified Jul. 22, 1999), https://www.sec.gov/news/headlines/webstock.htm (quoting SEC Enforcement Director Richard H. Walker).; *see also In re* Web Works Marketing.com, Inc. and Trace D. Cornell, Securities Act Release No. 7703 (July 21, 1999), https://www.sec.gov/litigation/admin/34-41632.htm.

[292] *Id*.

[293] *Id*.

[294] *Id*.

[295] *SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock"*, U.S. SEC. & EXCH. COMM'N (99-83) (modified Jul. 22, 1999), https://www.sec.gov/news/headlines/webstock.htm (quoting SEC Enforcement Director Richard H. Walker); *See also In re* Wowauction.com Inc. and Steven Michael Gaddis, Securities Act Release No. 7702 (July 21, 1999), https://www.sec.gov/litigation/admin/33-7702.htm.

[296] *Id*.

[297] *Id*.

[298] *Id*.

that WOWAuction's scheme qualified as a free stock offering and thus violated the registration requirements of Section 5 of the Securities Act.

Fourth, *In re Theodore Sotirakis*, also involved an offering of unregistered "free" stock.[299] Here, individuals who registered on the website Sotirakis created for his Kinesis business ("the Kinesis site") and linked a website to the Kinesis site received "free" shares.[300] Additionally, individuals could also earn extra shares by signaling additional registrants to the Kinesis site, like the referral incentive in *In re WowAuction.com Inc. and Steven M. Gaddis, Sr*.[301] Once more, the SEC held that free shares were distributed to generate site traffic and attract investors, thus demonstrating that the shares were disposed of *for value.*[302]

2. "Free" Token Offerings

The bottom line is that the SEC is not fond of any attempt to offer "free" unregistered securities.[303] "Free stocks" require recipients to bring in additional investors, sign up on the issuers' websites or link their own websites to those of the distributor, hence providing exposure and circulation of the stock.[304] By creating an interest in their respective websites, and a market for their shares, the "free stock" issuers receive economic value. Therefore, under the Securities Act, there is an offer or sale *for value*.[305]

The SEC's analysis of the foregoing cases is directly relevant to airdrops.[306] Airdrops undoubtedly mirror free stock offerings, which, while ostensibly "free," are not intended as "gift[s] for simple reasons of generosity."[307] In view of the "free stock" precedent, an airdrop of tokens

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[299] SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock", U.S. SEC. & EXCH. COMM'N (99-83) (Modified Jul. 22, 1999), https://www.sec.gov/news/headlines/webstock.htm (quoting SEC Enforcement Director Richard H. Walker) ; *see also In re* Theodore Sotirakis, Securities Act Release No. 7701 (July 21, 1999), https://www.sec.gov/litigation/admin/33-7701.htm.

[300] *Id*.

[301] *Id*

[302] *See generally id*.

[303] Stefan Stankovic, *Are Airdrops Compliant With U.S. Securities Laws?*, CRYPTO BRIEFING (Aug. 20, 2018), https://cryptobriefing.com/airdrops-compliant-us-securities-laws/.

[304] *Id*.

[305] *See* Scott H Kimpel & Mayme Beth F. Donohue, *SEC Brings Enforcement Case Involving "Airdrop" of Securities*, HUNTON ANDREWS KURTH LLP: BLOCKCHAIN LEGAL RESOURCE (Aug. 21, 2018), https://www.blockchainlegalresource.com/2018/08/sec-brings-enforcement-case-involving-airdrop-securities/#page=1.

[306] Conheady & Munoz, *supra* note 268.

[307] *Id*.; *see also In re* UniversalScience.com, Inc. and Rene Perez, Securities Act Release No. 7879 (Aug. 8, 2000), https://www.sec.gov/litigation/admin/33-7702.htm ("Thus, a gift of stock is a 'sale' within the meaning of the Securities Act when the purpose of the 'gift'

without monetary consideration may qualify as an offer or sale when the purpose of the airdrop is to advance the network's economic objectives.[308] This might include establishing a trading market for the tokens, rather than making a gift out of generosity.[309] In light of the foregoing, airdrops are a prime example of history repeating itself.[310]

D. *Taking down TOM: The SEC's Unsurprising Crackdown*

It was only a matter of time before the SEC caught up to speed and came down on developers using airdrops in place of ICOs. On August 14, 2018, the SEC issued a cease and desist order against Tomahawk Exploration LLC ("Tomahawk") and David Thompson Laurence for violating the registration and antifraud provisions of the federal securities acts.[311] Following unsuccessful attempts at trying to find private funding, Tomahawk and Laurence needed another way to support their oil drilling and gas exploration project, which they envisioned taking place in Kern County, California.[312]

In the summer of 2017, the Tomahawk ICO website was launched , stating the ICO would be open from July through August.[313] Through its ICO, 200 million Tomahawkcoins ("TOM") would be issued with the hope of raising roughly five million dollars to fund the cost of drilling the oil wells.[314] Only half of these 200 million coins would be up for purchase for potential investors who were willing to gamble the low amount: $0.05 per token.[315] Rather than just offer tokens for purchase, Tomahawk

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is to advance the donor's economic objectives rather than to make a gift for simple reasons of generosity.").

[308] DiStefano & Raghuvanshi, *supra* note 75.

[309] *Id*.

[310] *See generally* Dennis M. Wilson, *Why Airdrops Are The Next Big Thing in Cryptocurrency,* MEDIUM (June 26, 2018), https://medium.com/@dennismwilson0901/why-airdrops-are-the-next-big-thing-in-cryptocurrency-3508d5654122.

[311] *See In re* Tomahawk Exploration LLC and David Thompson Laurance, Securities Act Release No. 10530 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf; *see also SEC Bars Perpetrator of Initial Coin Offering Fraud*, U.S. SEC. & EXCH. COMM'N, Press Release No.2018-152 (Aug. 14, 2018), https://www.sec.gov/news/press-release/2018-152.

[312] *Id*.

[313] *Id*.

[314] *Id*.

[315] *Id*.

introduced a "Bounty Program"[316] as a way to further promote the ICO.[317] According to the SEC's order:

> "Tomahawk dedicated 200,000 TOM to pay to third parties in exchange for the third parties' marketing efforts. Tomahawk featured the Bounty Program prominently on the ICO Website, offering between 10 and 4,000 TOM for activities such as making requests to list TOM on token trading platforms, promoting TOM on blogs and other online forums like Twitter or Facebook, and creating professional picture file designs, YouTube videos or other promotional materials."[318]

Ultimately, more than 80,000 TOM tokens were airdropped to approximately forty wallet holders with Tomahawk, receiving "value in the form of online promotional efforts that targeted potential investors and directed them to Tomahawk's offering."[319] Unfortunately for Tomahawk, the profitless ICO and airdropping came with a hefty price tag, including fines and a professional sanction against Laurence.[320]

To get to its holding, the SEC applied the Howey test.[321] Under the Howey test, the SEC found that the TOM tokens were investment contracts, and therefore securities.[322] Then, under the second part of its

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[316] *See* Stefan Stankovic, *Are Airdrops Compliant With U.S. Securities Laws?*, CRYPTO BRIEFING (Aug. 20, 2018), https://cryptobriefing.com/airdrops-compliant-us-securities-laws/ ("The Bounty Program that the SEC is referring to in this quote is *de facto* an airdrop – which only reiterates the aforementioned point that the SEC may well consider the offering of 'free' tokens in exchange for services (such as marketing in this case) as a securities offering.").

[317] *See In re* Tomahawk Exploration LLC and David Thompson Laurance, Securities Act Release No. 10530 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf; *see also SEC Bars Perpetrator of Initial Coin Offering Fraud*, U.S. SEC. & EXCH. COMM'N, Press Release No.2018-152 (Aug. 14, 2018), https://www.sec.gov/news/press-release/2018-152.

[318] *See id*.

[319] *See id*.

[320] *See* Dror Futter, *You Can't Even Give Them Away . . No, Seriously*, CROWDFUND INSIDER (Aug. 16, 2018), https://www.crowdfundinsider.com/2018/08/137933-ico-tokens-the-sec-you-cant-even-give-them-away-no-seriously/.

[321] *See SEC v. W.J. Howey Co.,* 328 U.S. 293, 301 (1946).

[322] *See In re* Tomahawk Exploration LLC and David Thompson Laurance, Securities Act Release No. 10530 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf ("TOM constituted securities under the federal securities laws during the time when Respondents offered and sold them. First, they constituted 'investment contracts.' An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."); *see also SEC v. Edwards*, 540 U.S. 389, 393 (2004); *see also SEC v. W.J. Howey Co.,* 328 U.S. 293, 301 (1946) ("[T]he TOM tokens were offered in exchange

analysis, the SEC considered whether the distribution of tokens constituted an "offer and sale of securities."[323] The SEC held that "[t]he distribution of TOM . . . constituted sales under Section 2(a)(3) of the Securities Act, which applies to 'every disposition of a security or interest in a security, for value.'"[324] Notably, the lack of monetary consideration for "free" shares did not suggest that there was no sale or offer for purposes of Section 5 of the Securities Act.[325] Therefore, Tomahawk offered and sold TOM tokens without complying with registration requirements or qualifying for an exemption from registration, thus violating the federal Securities laws.[326]

Since Tomahawk and Laurence's actions were similar to other recent SEC orders relating to digital assets,[327] it is not shocking that the SEC found the TOM tokens to be securities.[328] However, the Tomahawk Order is noteworthy because it is the first order to address the airdrop phenomena.[329] It demonstrates the SEC's view of "free" crypto distributions, and also serves as a warning to developers attempting to dodge complying with the federal securities laws via airdrops.[330]

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for the investment of money or other contributions of value, including other digital assets. The representations in the online offering materials created an expectation of profits derived from the efforts of others, namely from the oil exploration and production operations conducted by Tomahawk and Laurance and from the opportunity to trade TOM on a secondary trading platform.").

[323] *Id*. ("Tomahawk's issuance of tokens under the Bounty Program constituted an offer and sale of securities because the Company provided TOM to investors in exchange for services designed to advance Tomahawk's economic interests and foster a trading market for its securities.").

[324] *Id*.

[325] Brad R. Jacobsen, *Free! Does not mean Freedom from Compliance with U.S. Securities Laws – Do ICOs through the Use of AirDrops violate U.S.* Securities Laws?, BLOCKCHAIN PLUS THE LAW (Sep. 4, 2018), https://blockchainplusthelaw.com/2018/09/04/free-does-not-mean-freedom-from-compliance-with-u-s-securities-laws-do-icos-through-the-use-of-airdrops-violate-u-s-securities-laws/.

[326] *See In re* Tomahawk Exploration LLC and David Thompson Laurance, Securities Act Release No. 10530 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf.

[327] *See Cyber Enforcement Actions*, U.S. SEC. & EXCH. COMM'N (Modified Dec.13, 2018) https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.

[328] Osama Khan**,** Robert Weber and Robert L. Wernli, Jr.**,** *Airdrop of Crypto Tokens Hits Regulatory Flak*, THE NAT'L L. REV. (Aug. 28, 2018), https://www.natlawreview.com/article/airdrop-crypto-tokens-hits-regulatory-flak.

[329] *See* Dror Futter, *You Can't Even Give Them Away . . No, Seriously,* CROWDFUND INSIDER (Aug. 16, 2018), https://www.crowdfundinsider.com/2018/08/137933-ico-tokens-the-sec-you-cant-even-give-them-away-no-seriously/.

[330] *Id*.

V. WHAT DOES THIS MEAN FOR AIRDROPS?

Regulators' heightened scrutiny of ICOs has undoubtedly paved the way for the emergence of airdrops. Airdrops have become a tool for innovative developers to disguise their securities offerings as "free" token giveaways. Yet these distributions have caught the SEC's eye, which continues to maintain a firm stance on its regulation of digital asset transactions. The notion of regulation through enforcement stands true as the SEC continues to use its enforcement authority to make examples of those who fail to comply with the laws, and deter those who might otherwise participate in such schemes.[331] *In Re Tomahawk* marks the first instance of enforcement over airdrops, demonstrating that even "free" tokens are not free from regulatory compliance.[332]

The SEC has attempted to clarify its position with regard to digital asset transactions through an investigative report, public statements, and a slew of lawsuits against emerging tech companies. It is through these actions that the SEC has provided its application of the *Howey* test to digital assets. Even without specific reference to airdrops in any of those action, it can be concluded that the SEC's broad jurisdiction encompasses airdrop distributions, as evidenced by *In re Tomahawk*.

Historically, the SEC's stop to "free" stock involved preventing broker-dealers from making a market in securities for which there is no adequate issuer-provided information. To some degree, the SEC has followed that strategy with respect to airdrops and cryptocurrencies, by regulating trading platforms instead of specifically regulating the token offerings. By regulating intermediaries, the SEC seeks to ensure that there is no way to circumvent the federal securities laws.

However, applying this tactic to airdrops and digital assets is trickier since their peer-to-peer transactions eliminates the intermediary issue. Nonetheless, regulators are encroaching on whatever gray area remains; they are quickly closing in on digital asset transactions altogether. We can expect to see the SEC continue to expand its oversight of digital assets with the goal of creating a marketplace inhabited only by compliant digital transactions. But it is also clear that developers will continue to come up with new methods for evading securities laws as regulators become

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[331] *Coinbase's Written Testimony for the Subcommittee on Capital Markets, Securities and Investment*, COINBASE (Mar. 13, 2018), https:/Iblog.coinbase.com/coinbases-written-testimony-for-the-subcommittee-on-capital-markets-securities-and-investment-47f8a260ce41.

[332] *See In re* Tomahawk Exploration LLC and David Thompson Laurance, Securities Act Release No. 10530 (Aug. 14, 2018), https://www.sec.gov/litigation/admin/2018/33-10530.pdf.

stricter. Eliminating one way of distributing virtual securities opens the door to another way.

Are regulators approaching the situation all wrong? Regulators continue to walk the tightrope of trying to balance protecting investors, avoiding system failures, and fostering innovation. As the crypto market continues to develop, regulators must ensure that protection is afforded to investors without unduly limiting opportunities for growth. In a sense, overly restrictive interpretations of the securities laws might inhibit the economy's growth—punishing not only the bad actors, but the good ones as well. Even though many skeptics are against digital asset transactions,[333] the underlying technology may prove invaluable for future technological innovations. While regulators are required to maintain the integrity of the market by weeding out bad actors, they also need to balance this interest with the effect of chilling good innovation brought about by new technology and good actors.[334] If regulators continue on the path of heavy-handed regulation, then capital from these digital transactions might stop flowing into the U.S., pushing U.S. investors to send their money to foreign companies where securities laws are less harsh and more certain.[335] Market participants may also fear the uncertainty surrounding token offerings in the U.S., thus driving token sales overseas. SEC enforcement actions have provided some guidance with respect to when digital assets are considered securities but have not fully addressed the market's need for comprehensive clarity.

To achieve further regulatory clarity, Congress should pass legislation that establishes a comprehensive legislative and regulatory system governing domestic digital assets. Currently, two federal agencies share jurisdiction over cryptocurrency regulation: the SEC has jurisdiction over "security tokens" and the CFTC has jurisdiction over "commodity tokens." Congress should also vest one agency with regulatory jurisdiction over all types of cryptocurrency, especially since determining which tokens are commodities and which are securities can be difficult.[336]

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[333] David W. Perkins, *Cryptocurrency: The Economics of Money and Selected Policy Issues*, CONG. RES. SERV. (updated Apr. 9, 2020), https://fas.org/sgp/crs/misc/R45427.pdf ("Skeptics doubt that cryptocurrencies can effectively act as money and achieve widespread use. They note various obstacles to extensive adoption of cryptocurrencies, including economic (e.g., existing trust in traditional systems and volatile cryptocurrency value), technological (e.g., scalability), and usability obstacles (e.g., access to equipment necessary to participate). In addition, skeptics assert that cryptocurrencies are currently overvalued and under-regulated.").

[334] *Examining the Cryptocurrencies and ICO Markets: Hearing Before the Subcomm. on Capital Markets, Securities, and Investment of the Committee on Financial Services*, 115th Cong. (2018).

[335] *Id*.

[336] *Id*.

Otherwise, regulators need to co-coordinate to provide clear guidance to the market.

Furthermore, Congress should authorize the SEC to modify and amend its rules to better assist digital asset issuers in meeting the requirements of the federal securities laws. The current infrastructure, and the federal securities laws, are inadequate to appropriately address digital asset transactions.[337] While there are already a number of disclosure and registration requirements in place, they do not work well with digital asset offerings.[338] Regulations that needlessly impede on the innovation and capital formation opportunities offered by the development of digital technologies should be supplemented or modified so that compliance is possible.[339]

One example of supplementing the existing legal framework is for the SEC to promulgate an exemption from the registration requirements modeled after Regulation A[340] (or as amended by the JOBS Act: Regulation A+) or Regulation D under the Securities Act.[341] Currently, Regulation A is an exemption from registration for public offerings of up to $50 million, providing two tiers of exempt offerings.[342] This exemption also permits resales and does not require that investors be accredited.[343]

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[337] *Id*. ("[T]he existing rules that apply to the sales of securities and the exemptions from registration with the SEC, such as Rule 506 of Regulation D, and Regulation A, though helpful, do not fully meet the needs of companies seeking to issue digital assets.").

[338] *Id*. ("ICOs present a novel form of capital raising, in which the token investor's primary concerns are the likely future commercial viability of the related token platform, and (usually) the ability of the Token Company to develop, maintain and operate the token platform and the token economy. This is very different from the situation in traditional capital raising techniques, such as the sale of stock and bonds, in which investors are primarily concerned with the future economic activities and well-being of the company that issued the stock or bonds. Not surprisingly, a securities- regulatory scheme developed for stocks and bonds does not fit perfectly for tokens and token platforms.").

[339] *Id*. ("[R]egulations either need to be created or modified to better suit this type of business model, as registering digital assets as securities is impracticable for these companies.").

[340] 17 CFR § 230.251 (2019).

[341] 17 CFR § 230.500 (2013).

[342] *Raising Capital Using a Regulation A+ Mini IPO*, SEEDINVEST (Oct. 28, 2016), https://www.seedinvest.com/blog/jobs-act/raising-capital-reg-a-mini-ipo (explaining that Tier 1 offerings are up to $20 million and Tier 2 offerings are up to $50 million, with investors of Tier 2 subject to investment limits of the greater of 10% of their net worth or 10% of their net income).

[343] *Id*.; *see also* James Chen, Accredited Investor, INVESTOPEDIA (last updated Feb. 23, 2019), https://www.investopedia.com/terms/a/accreditedinvestor.asp (last visited Mar. 2, 2019) ("An accredited investor is a person or a business entity who is allowed to deal in securities that may not be registered with financial authorities. They are entitled to such privileged access if they satisfy one (or more) requirements regarding income, net worth, asset size, governance status or professional experience. In the U.S., the term is used by the Securities and Exchange Commission (SEC) under Regulation D to refer to investors

Regulation D also has two "tiers", Rule 506(b), and Rule 506(c), with no cap on the amount of the offering.[344] Rule 506(b) allows for an unlimited number of accredited investors, and thirty-five non-accredited investors, but does not allow for general solicitation or advertising.[345] On the other hand, Rule 506(c) requires that all investors be accredited and their status verified by the issuer, but allows for general solicitation.[346]

A hybrid of Regulations A and D might offer an exemption suitable for digital token issuers. This exemption may retain some features of both Regulations A and D, or modify them. For example, the proposed exemption could have no resale restrictions, an offering cap of $100 million, only allow for accredited investors, and permit general solicitation. Furthermore, the disclosure requirements would need to be particular to token offerings and might require the white paper to include the prospectus (or vice versa). Moreover, the prospectus would need to be available on the online platform. Information about the platform's supporting network might also need to be included as per the disclosure requirements. And airdrops could be allowed so long as they are outlined within the prospectus.

For token exchanges, Congress or the SEC could propose a safe harbor rule allowing for the trade of security tokens if the issuer has either registered with the SEC or qualifies for an exemption from registration.

While the federal securities laws have served our capital markets well since their adoption in the 1930s, it is time for Congress and the SEC to address technological innovations and amend the outdated rules. Without clearer guidelines regarding the regulation of digital securities, the growth of the nation's capital markets will be hindered.

CONCLUSION

In the twenty-first century, cryptocurrency has emerged as a new wonder of the world. Building off blockchain technology, new digital platforms have consumed the virtual marketplace, disrupting it and fashioning innovative branding strategies. For issuers seeking a way around compliance and the scrutiny following ICOs, airdrops seem like the next best option. But based on past enforcement actions halting "free stock" offerings and gifted securities, the current regulatory regime

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who are financially sophisticated and have a reduced need for the protection provided by regulatory disclosure filings. Accredited investors include natural high net worth individuals (HNWI), banks, insurance companies, brokers and trusts.").

[344] *See generally Fast Answers: Rule 506 of Regulation D*, U.S. SEC. & EXCH. COMM'N (last modified Nov. 27, 2017), https://www.sec.gov/fast-answers/answers-rule506htm.html.

[345] *Id*.

[346] *Id*.

surrounding ICOs and the SEC's framework for analyzing digital asset transactions, airdrops cannot avoid the SECs broadly casted jurisdiction. Ultimately, these "free" tokens are not free from regulatory compliance.