KUTAKROCK

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The SEC Agrees That an Eighth-Grader's "Quarters" Tokens Are Not Securities

The Securities and Exchange Commission ("SEC") sent a "no-action" letter on July 25, 2019 allowing a crypto gaming company to issue blockchain tokens without registration under the federal securities laws because the tokens are not securities. Pocketful of Quarters, Inc. (the "Company"), co-founded by an eighth-grader named George Weiksner, proposes to sell "Quarters" tokens to online gamers. Quarters are intended to be a universal gaming token that will be a common in-game currency for purchases in participating online games such as Fortnite and PUBG. The tokens will not be transferable, and gamers will be able to use them only in participating games and online sports tournaments "[l]ike arcade tokens that . . . cannot be used outside the arcade," according to the Company's letter to the SEC.

Game developers and influencers who develop and promote participating games will be compensated in part by Quarters and, unlike gamers, will have the ability to exchange them for Ether (ETH), an exchange-traded cryptocurrency.

Notably, the Company's blockchain-based technology platform has already been financed and "fully developed," in part by using the proceeds from earlier offerings of tokens that were, in fact, securities. Gamers will have access to 30 participating games upon launch of the platform. Quarters will be marketed and sold "solely for consumptive use" in connection with participating games, and not as an investment that will appreciate in value.

Quarters will have an unlimited supply and fixed price, unlike many cryptocurrencies and tokens. For example, bitcoin has a limited supply of 21,000,000 coins (thereby creating scarcity) and a volatile market price.

According to recent guidance from the SEC in its Framework for "Investment Contract" Analysis of Digital Assets (the "Framework"), as discussed in our recent Client Alert, tokens are viewed by the SEC as "investment contracts" and, hence, securities if they involve the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others, a formulation known as the *Howey* test after the 1946 Supreme Court case.

The SEC accepts the Company's argument that the third prong of the *Howey* test—the reasonable expectation of profits—is not met by the Quarters tokens. The SEC notes with approval, in its no-action letter, that there are technological and contractual restrictions on the transfer of the tokens, that Quarters will be made available in unlimited quantities at a fixed price, and that the tokens will be marketed and sold to gamers solely for their consumptive use in participating games rather than as an investment.

The SEC also emphasizes that the Quarters ecosystem is already developed and that funds from sales of the Quarters will not be used to build the platform, which will be fully functional upon launch. Accordingly, the Quarters tokens will be immediately usable for their intended purpose (gaming) when they are sold, as opposed to financing development that could result in appreciation in value of the tokens themselves.

Game developers and influencers, as noted above, will have the ability to receive Quarters and to redeem them for ETH at pre-determined exchange rates. The SEC appears to accept the Company's argument that, in doing so, they are merely receiving payment for services, not securities. (The SEC makes note of the KYC/AML checks on developers and influencers, but does not make it clear how that factor fits into its analysis.)

As discussed in our recent Client Alert about the Blockstack initial coin offering, the SEC has suggested that a sufficiently developed and decentralized network will liberate the token from being characterized as a security, and registration (or an exemption) with the SEC will not be necessary. In the case of the Quarters platform, however, the SEC seems to be content with relatively full development of the ecosystem and does not mention any concerns with ongoing centralized administration by the issuer of the tokens. This may be because the SEC is satisfied that the "reasonable expectation of profits" prong of the *Howey* test is not met in the case of the Quarters offering and that the "efforts of others" element of the test is therefore moot.

As additional offerings of tokens are either cleared or subjected to enforcement actions, the fog will eventually lift as to the SEC's position on when blockchain tokens constitute securities under the federal securities laws. The Pocketful of Quarters no-action letter is a step in that direction.

Additional Information

If you have any questions regarding this Client Alert, please contact your Kutak Rock attorney or one of the authors listed below. For more information regarding our practices, please visit us at www.KutakRock.com.

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