A CASE OF THE MIDNIGHT MUNCHEES: SEC ACTION SIGNALS CAUTION IN ICO OFFERINGS

Date: December 2017

U.S. FinTech, Investment Management and Policy & Regulatory Alert

By: Ed Dartley, Clifford C. Histed, Judith Rinearson, Anthony R.G. Nolan

On December 11, 2017, the Securities and Exchange Commission ("SEC") filed an administrative proceeding in which it issued a settled cease and desist order (the "Order") concluding that a purported "utility token" issued by Munchee Inc. ("Munchee") constituted an unregistered offering of securities. On the same day, SEC Chairman Jay Clayton released a cautionary Statement on Cryptocurrencies and Initial Coin Offerings (the "Statement"). Together, these releases will serve as important guidance to sponsors of initial coin offerings ("ICOs"), their intermediaries and the investing public. We have published a separate analysis of the Statement, which may be found here.

IN THE MATTER OF MUNCHEE INC.

Munchee created a smartphone app for restaurant reviews. Munchee sold digital tokens to raise funds to improve its existing app and create an "ecosystem" wherein users could buy advertisements, write interviews, sell food, and conduct other transactions within the app. The Munchee utility token ("MUN token") was meant to be the currency of denomination within the app and was expected to trade on secondary markets.

The SEC analyzed the MUN token under the *Howey* test, [1] which essentially holds that an instrument is a security if it involves: (i) the investment of money; (ii) in a common enterprise; (iii) with a reasonable expectation of profits; (iv) to be derived from the entrepreneurial or managerial efforts of others. The SEC's analysis focused primarily on the third element (a reasonable expectation of profits) and the fourth element (derived from the entrepreneurial and managerial efforts of others). [2] With respect to the third element of the *Howey* test, the SEC cited multiple public statements by Munchee and its agents promising significant returns. [3] The SEC also took issue with Munchee's incentives to third parties to promote the MUN token offering. More than 300 people promoted the MUN token offering through social media in response to such incentives. [4] The SEC noted that Munchee targeted investors interested in ICOs and digital assets rather than current users of the Munchee app or restaurant owners or those in the restaurant industry. [5]

With respect to the fourth element of the *Howey* test, the SEC focused on the sponsor's intent to create a valuable "ecosystem" that would inspire users to create new reviews, encourage restaurants to obtain MUN tokens to reward diners and pay Munchee for advertising and inspire users to obtain MUN tokens to buy meals and attain higher status within the Munchee app. [6] Significantly, the sponsors emphasized that they would take steps to create and support a secondary market for the MUN tokens. [7]

The SEC did not consider that the purported nature of MUN tokens as "utility" tokens, altered in any way the characterization of the MUN tokens as securities, noting that "[e]ven if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security." Regardless of the label or the degree of

©2005-2026 K&L Gates LLP. All Rights Reserved.

utility, the SEC will apply a facts and circumstances analysis and will consider the "terms of the offer, the plan of distribution and the economic inducements held out to the prospect." [8]

TAKEAWAYS

The Munchee order is an important warning for the ICO market. As in the case of the SEC's July 25, 2017 investigative report of the DAO (found here; our client alert on the DAO report may be found here), the SEC did not assess penalties against Munchee and its principals because investors had not suffered a loss. Indeed, the sponsor ceased the token sale within hours of being contacted by the SEC, cooperated with the investigation, refrained from delivering any tokens, and fully reimbursed the investors. [9] Nevertheless, the Order, together with the Statement, should put the ICO industry on notice that the SEC is paying close attention to the development of the ICO markets and will not hesitate to proactively exercise its jurisdiction where it believes it to be necessary. The Munchee enforcement action represents the second action brought by the SEC's new Cyber Unit in respect of ICOs in as many weeks. [10]

The SEC's releases have called into question the position of some in the industry that structuring a token to provide some utility will prevent the token from being a security, particularly when (in the words of the Statement):

prospective purchasers are being sold on the potential for tokens to increase in value—with the ability to lock in those increases by reselling the tokens on a secondary market—or to otherwise profit from the tokens based on the efforts of others. These are the hallmarks of a security and a securities offering.

The manner in which tokens are expected to trade will be a crucial determinant of whether a token is a security and whether an ICO must be registered under the federal securities law or exempt from such registration.

The SEC appears to be signaling a more proactive enforcement environment after a period in which it apparently has been absorbing the impact of smart contracts and application blockchain protocols on securities laws and the SEC's investor protection mandate. In a deliberate fashion, the SEC has recently been more vocal on these issues, expressing in clear and timely pronouncements its concerns with cryptocurrencies and tokens. The simultaneous release of the Statement shows that it is not just the Division of Enforcement that is speaking but that there is an interest in sending a clear message on protection of investors and the integrity of the markets. Indeed, shortly after the Order and the Statement appeared, all three commissioners of the SEC issued a joint statement in support of a paper issued by the North American Securities Administrators Association to highlight investor protection issues in ICOs and other cryptocurrency-related investment products.

For those in the ICO industry that want to continue to explore launching an ICO, there remain paths forward, but careful consideration of the matters discussed herein must be undertaken.

---

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

[2] *See* Order at 8 ["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* SEC v. Edwards, 540 U.S. 389, 393 (2004); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); *see also* United Housing Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.")].

©2005-2026 K&L Gates LLP. All Rights Reserved.

[3] *See* Order at 5–6.

[4] *Id.* at 6.

[5] *Id.*

[6] *Id.* at 6–7.

[7] *Id.* at 5.

[8] *Id.* at 9 (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352–523 (1943)).

[9] *See* SEC Press Release, Company Halts ICO After SEC Raises Registration Concerns (December 11, 2017).

[10] *See* In the Matter of Plexcoin.

KEY CONTACTS



ED DARTLEY
PRACTICE AREA LEADER - ASSET MANAGEMENT AND INVESTMENT FUNDS

NEW YORK
+1.212.536.4874
ED.DARTLEY@KLGATES.COM



CLIFFORD C. HISTED
PARTNER

CHICAGO
+1.312.807.4448
CLIFFORD.HISTED@KLGATES.COM



JUDITH RINEARSON
PARTNER

NEW YORK
+1.212.536.3928
JUDITH.RINEARSON@KLGATES.COM



ANTHONY R.G. NOLAN
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.