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# SEC gives guidance on securities analysis for digital assets

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The Securities and Exchange Commission ("SEC") recently issued highly anticipated guidance to assist market participants in determining whether a digital asset is offered and sold as a security.

On April 3, 2019, the SEC's Strategic Hub for Innovation and Financial Technology[1] ("FinHub") published an analytical framework for evaluating whether the offer and sale of a digital asset is an "investment contract" and therefore a security subject to regulation under the federal securities laws.[2]

On the same day, the Division of Corporation Finance issued a no-action letter permitting a company to offer and sell digital assets without registering or qualifying for an exemption under the Securities Act of 1933 ("Securities Act") or the Securities Exchange Act of 1934 ("Exchange Act").[3]

Together, the no-action letter and the framework provide insight into the evolving regulatory landscape for blockchain technology and digital assets in the United States. The no-action letter confirms the SEC staff's willingness to forgo regulating certain digital asset offerings as securities transactions. While this is a positive sign for the industry, the SEC's no-action relief addressed only a narrow set of facts that are not applicable to many blockchain-based networks.

The framework, however, could facilitate market participant and staff analysis of offerings involving digital assets, allowing for more rapid resolution of issues.

Both the no-action letter and framework are discussed in depth below.

## FRAMEWORK FOR INVESTMENT CONTRACT ANALYSIS OF DIGITAL ASSET TRANSACTIONS

Last November, Corporation Finance Director William Hinman announced plans to release "plain English" guidance to help developers determine whether any potential digital asset offering may be classified as a securities transaction.[4]

The new FinHub framework delivers on that announcement, providing a useful analytical tool for assessing whether the federal securities laws apply to the offer or sale of a particular digital asset.

FinHub's framework explains the staff's views on how the "investment contract" analysis, first articulated by the Supreme Court in the 1964 case *SEC v. W.J. Howey Co.*, should be applied to transactions involving digital assets.[5]

Under the *Howey* test, an investment contract exists when there is a contract, scheme or transaction involving (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits derived predominantly from the efforts of others. To constitute an investment contract, all three of these prongs must be met.

The framework takes the position that the first two prongs of the *Howey* test will be satisfied in a typical offering of digital assets, while the third prong usually serves as the decision point.

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### *Investment of money*

The framework restates the principle, well established in case law, that for purposes of the *Howey* test "money" need not actually be government-backed money. Other forms of consideration, including payment in digital assets like bitcoin or ether, or non-monetary consideration such as providing promotional services for the issuer via, *e.g.*, "bounty programs," can be sufficient to satisfy the prong.[6]

### *Common enterprise*

Regarding the second prong of the *Howey* test, the framework states that (1) investments in digital assets typically involve a common enterprise and (2) the SEC does not view a common enterprise as a distinct element of an investment contract.[7]

### *Reasonable expectation of profits*

For the third prong, the framework identifies a number of factors that, if found, increase the likelihood that the requisite expectation of profit is present. These include whether:

- The digital asset gives the holder rights to share in the enterprise's income or profits, or to realize gain from capital appreciation[8];
- The digital asset is transferable or traded on a secondary market or platform, or is expected to be in the future; or
- The digital asset is marketed, directly or indirectly, in a manner that emphasizes the offering as an investment opportunity.[9]

Conversely, the framework also recognizes that, when purchasers are motivated to use or consume the digital asset, *e.g.*, as payment for a good or service, they may be less likely to have a reasonable expectation of profits.

The framework accordingly identifies additional characteristics that should be considered to determine whether the digital asset is offered and sold for use or consumption by the purchasers, including whether:

- Holders are immediately able to use the digital asset for its intended functionality;
- The digital asset's creation and structure is designed and implemented to meet the needs of users; or
- Prospects for appreciation in the value of the digital asset are limited.

### *Efforts of others*

The technical and decentralized nature of digital asset networks can sometimes create uncertainty about whether any profits would be derived from the efforts of others (and how broadly the notion of "others" should be construed).

> The framework restates the principle, well established in case law, that for purposes of the Howey test "money" need not actually be government-backed money.

To address these points, the framework notes that when a promoter, sponsor, third party or affiliated group of third parties (each, an "Active Participant" or "AP") provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profits from those efforts, then the third prong of the Howey test is satisfied.[10]

The framework again identifies a number of characteristics that tend to demonstrate whether the requisite "efforts of others" is present, including whether:

- There are essential managerial tasks or responsibilities to be performed by an AP rather than an unaffiliated, dispersed community of network users;
- An AP creates or supports a market for, or the price of, the digital asset; or
- An AP has a lead or central role in the direction of the ongoing development of the network or the digital asset (including, in particular, with respect to deciding governance issues, code updates, or how transactions are validated).

According to the framework, while no one characteristic is necessarily determinative, the stronger their presence, the more likely it is that a purchaser is relying on the efforts of others.

### *'Mutability'*

Additionally, the framework confirms earlier staff statements that the analysis of whether a digital asset represents an investment contract is not strictly inherent to the instrument and may change over time, depending on how the asset is used, offered and sold.[11]

The framework specifically notes further considerations that are relevant to evaluating whether, under the third prong of *Howey*, a digital asset previously sold in a securities offering can later be sold in a manner that does not constitute the offering of a security.

## TURNKEY JET, INC. ("TKJ") NO-ACTION LETTER

The TKJ no-action letter provides a clear example of how a digital asset can be offered and sold for use or consumption by purchasers without necessarily implicating registration requirements under the federal securities laws.

TKJ is a private air charter service provider that proposed to operate a platform for selling digital assets ("TKJ Tokens") to customers who could exchange those tokens for prepaid, on demand air charter services. TKJ would sell the TKJ Tokens continuously at a fixed price of $1.00 per token, with no limit on the number of tokens that could be issued.

The TKJ Tokens could be transferred only within TKJ's network and could be redeemed only to purchase air charter services. TKJ asserted that the TKJ Tokens would facilitate more rapid payment settlement, which in turn would allow for faster delivery of air charter flights.

In granting no-action relief, the staff focused on several factors that distinguish the TKJ Token offering from digital assets offered and sold as investment contracts, consistent

with the guidance provided in the framework. Specifically, the staff noted that:

- TKJ will not use any funds from the TKJ Token offering to develop its platform, which will be fully developed and operational when the tokens are sold;
- The TKJ Tokens will be immediately usable for their intended functionality (purchasing air charter services);
- TKJ will restrict transfers of the TKJ Tokens to its internal platform;
- TKJ will sell the TKJ Tokens at a price of $1 per token, and each token will be redeemable for air charter service on a dollar-per-dollar basis;
- If TKJ offers to repurchase TKJ Tokens, it will only do so at a discount, unless a U.S. court orders TKJ to liquidate the tokens; and
- TKJ will market the TKJ Tokens in a manner than emphasizes their functionality, and not potential for increase in market value.

While the staff's no-action position is not binding on the Commission, it does shed light on how certain digital assets can be offered and sold in a manner unlikely to implicate the registration requirements of the federal securities laws.

## REGULATORY IMPLICATIONS

Neither the framework nor the TKJ no-action letter depart significantly from previous staff or SEC guidance, but instead provide additional insights about what facts will be relevant to the analysis.

The characteristics identified in the framework as signaling when a digital asset may represent an investment contract are largely consistent with characteristics previously identified by Commission and the staff.[12] Similarly, the staff's response in the TKJ letter focuses on factors that also are identified in the framework.

The framework will help market participants answer fact-specific questions when contemplating whether and how to engage in transactions involving digital assets. Furthermore, the continued recognition that the regulatory status of transactions involving a particular digital asset may change in character over time as the network matures is an important point of flexibility to bear in mind.

In all cases, issuers and other parties engaged in the marketing, offer, sale or distribution of digital assets must continue to carefully evaluate their specific facts and circumstances to determine whether the federal securities laws apply.

## NOTES

[1] The SEC established FinHub in October 2018 to serve as a resource for public engagement on the SEC's FinTech related issues and initiatives.

[2] The full text of the framework is available at https://bit.ly/2HXfEdZ.

[3] The full text of the no-action letter is available at https://bit.ly/2YOeel3.

[4] *See* Nikhilesh De and Aaron Stanley, *SEC Official Says 'Plain English' Guidance on ICOs is Coming*, COINDESK (Nov. 5, 2018), available at https://bit.ly/2WNhcLz.

[5] 328 U.S. 293 (1946).

[6] The framework further states that distributing digital assets by way of "airdrop" (generally, the widespread distribution of a digital asset for free or nominal consideration) does not necessarily mean that the investment of money prong is not satisfied. While the framework does not provide further guidance on the topic of airdrops, it is incumbent on parties looking to catalyze adoption of a digital asset network via airdrop to consider whether the undertakings required for third parties to receive and claim their airdropped digital assets amount to providing consideration that would constitute an investment of money under *Howey* (and separately, whether the airdrop distribution program amounts to an "offer" within the meaning of Section 2(a)(3) of the Securities Act).

[7] In support of the latter position, the framework cites the Commission opinion rendered in *In re Barkate*, 57 S.E.C. 488 (Apr. 8, 2004) and the Commission's Supplemental Brief in *SEC v. Edwards*, 540 U.S. 389 (2004). Some parties, notably including Kik Interactive, Inc. and the Kin Ecosystem Foundation, have sharply criticized the notion that horizontal or vertical commonality (divergent tests, applied by courts on a jurisdiction-specific basis, for finding a common enterprise) is not per se required under the *Howey* test. See Wells Submission of Kik Interactive, Inc. and the Kin Ecosystem Foundation (Dec. 10, 2018) [available at https://bit.ly/2E1erPh]. Depending on the test used in the relevant jurisdiction for finding a common enterprise, this prong could easily be satisfied by most "typical" digital asset offerings; however, eliminating the prong from the investment contract analysis altogether may result in a considerably broader jurisdictional ambit for the SEC. For example, projects that distribute a blockchain-native digital asset on an ongoing basis solely in the form of block rewards issued to triumphant proof-of-work miners should take no comfort in the knowledge that the SEC may not undertake to find either horizontal or vertical commonality prior to bringing regulatory action for an alleged Section 5 violation.

[8] Importantly, the framework distinguishes (1) an expectation of profits due to potential capital appreciation derived at least in part from an AP's operation, promotion, improvement or other positive developments to the network, from (2) price appreciation resulting solely from external market forces.

[9] As made clear in the SEC's December 11, 2017 Cease and Desist Order against Munchee, Inc. [covered at https://bit.ly/2EpyCGC], and reinforced by subsequent guidance (as well as existing case law), digital assets that otherwise do not constitute securities may nonetheless represent investment contracts if offered and sold in a manner that conditions purchasers to reasonably expect profits derived from the efforts of others.

[10] The framework contemplates that the existence and identities of APs may change as a particular network evolves over time. How this construct would be applied in practice to potentially extend or shift registration and reporting requirements among otherwise unaffiliated parties is unclear.

[11] *See* "Digital Asset Transactions: When Howey Met Gary (Plastics)," Speech by William Hinman, Director, Divison of Corporation Finance (June 14, 2018) [hereinafter, the "Hinman Speech"] [covered at https://bit.ly/2Yvw4i3].

[12] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (Release No. 81207, July 25, 2017) [covered at https://bit.ly/2VFiBHz]; The Hinman Speech.

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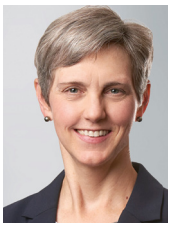

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