ALERT MEMORANDUM

# SEC Expands on Its Digital Asset Guidance: At Inception, (Nearly) Every New Token Is a Security

*April 5, 2019*

On April 3, 2019, staff of the Securities and Exchange Commission (the "**Staff**," and the Commission, the "**SEC**") released (1) a framework (the "**Framework**") providing principles for analyzing whether a digital asset constitutes an investment contract, and thus a security, as defined in *SEC v. W.J. Howey Co.* ("***Howey***") and (2) a no-action letter (the "**No-Action Letter**," and together with the Framework, the "**Guidance**") permitting TurnKey Jet, Inc. ("**TKJ**"), without satisfying registration requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "**Acts**"), to offer and sell "tokenized" cards that are recorded on a permissioned blockchain and can be used for the limited purpose of purchasing air charter services.

The Guidance is a logical expansion of prior SEC statements and actions applying *Howey* to digital assets. As a practical matter, it may leave two principal approaches for a new blockchain venture to satisfy the securities laws. First, like TKJ, the venture could wait to issue tokens until its platform is fully operational and limit the potential for speculation through extensive restrictions on secondary trading. Alternatively, the venture could initially issue tokens in compliance with the Acts' registration requirements (or exemptions therefrom) but later rely on statements in the Framework indicating when a digital asset might no longer be considered a security.

But either approach presents challenges: the former because it foregoes a feature—decentralized trading and settlement—that many consider to be a significant improvement that blockchains can offer relative to other ledger technologies; and the latter because of the many practical and legal issues still presented by digital securities (*e.g.*, the absence of SEC guidance regarding the custody of digital securities by investment advisers and broker-dealers and questions about how to identify precisely when a digital asset ceases to be a security).

In addition, the Guidance generally focuses on distinguishing security tokens from utility tokens. It contains comparatively little information regarding how the Staff analyzes stablecoins, virtual currencies and other so-called payment tokens. But it implies that such a token might be a security if it cannot immediately operate as a store of value that can be saved, retrieved and exchanged for something of value at a later time. Even many well-established virtual currencies arguably would not pass this test, given their volatile prices. And although many of these virtual currencies might now lack sufficient centralization to be treated as securities under the Guidance, few of them exhibited the same level of decentralization at inception.

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## Background

The SEC has generally taken the position that tokens offered in so-called initial coin offerings ("**ICOs**") constitute securities and that offers and sales of such tokens are accordingly subject to the registration requirements of the Acts. The basis for this position is the *Howey* test, under which an instrument is an investment contract, and thus a security, only if it evidences (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits from the entrepreneurial or managerial efforts of others.

In July 2017, the Staff provided its first view on how *Howey* applies to ICOs in an investigation into whether the DAO, a virtual organization run by computer code, violated the securities laws through generally offering and selling tokens to investors and using the proceeds to fund projects (the "**DAO Report**"). In subsequent enforcement cases, the SEC has relied significantly on the DAO Report in its legal analysis. First, by taking the view that DAO Report provided notice to those considering ICOs that digital assets issued on a blockchain may be offers and sales of securities. Second, by setting forth the most substantial Staff analysis (prior to the Framework) of the application of *Howey* in the context of this emerging market. The SEC has applied *Howey* in conjunction with the DAO Report in cases such as *Munchee* and *AirToken* against ICO issuers and promoters for selling unregistered securities.

Unlike with ICO tokens, with respect to Bitcoin and other more widely traded digital assets, Bill Hinman, Director of the Division of Corporation Finance, commented in June 2018 that some appear not to be securities based on certain criteria designed to help determine whether such digital assets constitute securities (the "**Hinman Factors**"). SEC Chairman Jay Clayton has also endorsed the Hinman Factors. These criteria focused on the first and third elements of the *Howey* test, namely the investment or consumptive expectations of the purchaser and whether profits would reasonably depend upon the managerial or entrepreneurial efforts of network developers or promoters of digital assets.

In remarks last year, Director Hinman noted that the Staff stood ready to provide interpretive or no-action guidance regarding how to characterize a digital asset given a particular use case. The Guidance, then, should not come as a surprise.

## The Framework

The Framework builds on the DAO Report, the Hinman Factors and SEC enforcement cases by providing more specific criteria regarding whether and how the securities laws may apply to ICOs and other offers and sales of digital assets. In particular, the Framework lists characteristics of digital assets that would implicate the *Howey* elements, presented as questions that entities considering an ICO or distribution of a digital asset should consider. Although the SEC and Staff have applied *Howey* to ICOs in enforcement cases and the DAO Report, the Framework provides more extensive and comprehensive guidance on the conduct and activities that are permissible (or not) without registration. The Framework is particularly interesting in how it lays out in greater detail the analytical points on which the Staff will evaluate whether a digital asset that may have been a security during earlier transactions may evolve to no longer be considered a security in later transactions.

The Framework focuses on three key areas.

— *Reliance on the Efforts of Others*

The Staff noted that the two key factors are, first, whether the purchaser reasonably expects to rely on efforts of a so-called active participant ("**AP**") (which may be a group of affiliated third parties) in a project and, second, whether those efforts are the "undeniably significant ones." These efforts are described as the "essential managerial efforts" that affect the project's success. The Staff noted that these circumstances are likely to be present where the network or digital asset is still in development at the time of the offer or sale; the AP creates or supports a market for or the price of the asset; and the AP has control over governance, code updates and security protocols. Compensation can be another key factor, for example, if the AP has the ability to realize capital appreciation, distributes the asset to developers of the network, and owns or controls intellectual property rights of the network.

— *Reasonable Expectation of Profits*

The Staff noted that key characteristics driving whether a purchaser has a reasonable expectation of profits include: the purchaser's ability to share in

income of the enterprise or profit from capital appreciation—taking a broad view of "appreciation," which may be in the form of increased value of the network (a position the SEC expressed in *Munchee*); a broad offering of the digital asset; little apparent correlation between the purchase/offering price or quantities of the digital asset and the market price or quantities of underlying goods that may be consumed by using the asset; whether the amount raised through the offer exceeds the amount needed to maintain the network; and the issuer marketing the asset as an investment opportunity or useful article.

— *Distinguishing Investment from Consumption*

The Framework's third key area is described as "Other Relevant Considerations" and generally sets out characteristics to distinguish investment from consumption. The key factors are whether the network and asset are fully developed and immediately able to be used; whether the asset is designed to limit the potential for price appreciation, through restrictions on external transfer outside of the network, by issuing tokens only in proportion to goods and services available for purchase and through adopting other mechanisms designed to preserve the token's stable value over time; and, for a virtual currency, whether it may be used to purchase goods or services without conversion to another asset or fiat currency.

## The No-Action Letter

The No-Action Letter represents the first application of the Framework to a digital asset.

The Staff granted TKJ no-action relief to offer and sell tokenized jet cards ("**Tokens**") that entitle the holder to purchase air charter services, with transactions recorded on a private blockchain that TKJ manages and controls. Key factors for the Staff included:

— TKJ developed the network independently, without using proceeds from the sale of the Tokens, which were usable immediately upon purchase (in fact, TKJ holds customer funds in escrow);

— TKJ maintained a closed network by restricting the transfer of Tokens to external wallets and only permitting access to vetted customers, which restricted secondary market trading and helped preserve consumptive features of the Tokens;

— TKJ maintained a stable, one-to-one valuation of the Tokens, so that one Token entitled the holder to one dollar of services; and

— TKJ undertook to market the Tokens to emphasize their consumptive use and not any potential for capital appreciation.

The thrust of the Staff's reasoning in the No-Action Letter appears to center around the following features of the Tokens in combination: (1) purely consumptive use, (2) stable value and (3) limits on transferability. Projects containing these three elements, then, are most likely to be able to rely on the No-Action Letter.

The factors listed in the No-Action Letter almost match, point-for-point, the factors described in the third category of the Framework's "Other Relevant Considerations" for assessing whether a digital asset is for consumption. Digital market participants should pay close attention to those factors (and this prong) as potentially weighing significantly in the Staff's analysis of whether a digital asset is an investment contract within the meaning of *Howey*.

## Key Issues and Observations

Below we set out some initial takeaways and observations regarding the Guidance.

— *The Guidance Favors Development of Permissioned, Centralized Blockchains*

The Guidance demonstrates that the SEC appears to view efforts to (1) create new enterprises on blockchains that are open to the public and (2) use digital assets as a tool for capital formation, as meriting regulation under the Acts. These efforts may be linked because an enterprise without the resources to build a network ordinarily turns to third-party investors to raise capital. In the context of digital assets, a primary mechanism to accomplish this is an ICO, which the Framework (and its precedents) make clear are likely to be treated as securities offerings.

The No-Action Letter has potential to spur development of digital assets as a form of prepaid cards or prepayment for goods and services. Transactions settled using digital assets are likely to be recorded on permissioned blockchains unless they involve a centralized entity who maintains a stable valuation, as without either form of centralization they would generally be unattractive as a medium of

exchange. The Guidance appears to show a bias in favor of such projects where they are developed by entities that already have the funds to build the networks.

Another way the facts and circumstances of the No-Action Letter may spur the development of centralized and permissioned blockchains is the generic use case that the Staff believed justified no-action relief for TKJ. The use case described in the No-Action Letter is instantaneous settlement of payment, which is expected to lower transaction costs and provide for faster delivery services. These uses and benefits ought to be generally applicable to many commercial enterprises.

— *The Framework Leaves Open the Ability for Promoters to Issue Digital Assets with Some Level of Capital Appreciation*

The Framework appears to leaves the door open for relief for digital assets that may appreciate in value. According to the Framework, prospects for appreciation must be "limited" (not non-existent), economic benefits derived from appreciation must be "incidental" (not irrelevant) to obtaining the right to use a digital asset as a consumptive good and appreciation resulting "solely" from external market forces is not considered profit under *Howey*. This language may imply that a stable one-to-one peg, as is the case for TKJ, may not be a strict requirement to rely on the No-Action Letter. The No-Action Letter also does not restrict TKJ from earning interest on Token holders' funds it holds in escrow. But TKJ will not offer a rebate program, rewards program, or otherwise allow for the monetization of an economic benefit or bonus for buying Tokens. Accordingly, digital asset issuers should exercise caution in connection with (1) marketing materials that highlight capital appreciation, (2) facilitating secondary market trading and (3) providing rebates or other inducements.

— *The Framework Provides Limited Clarity Regarding Tokens with Mutable Characteristics*

The Staff has reiterated its position, as expressed in the Hinman Factors, that some digital assets have mutable characteristics, meaning they may be offered as securities but over time develop utility features that make them something else (likely non-security commodities) outside the scope of the securities laws. Although the Staff has provided questions for issuers to ask regarding when an asset has lost the centralization required to be treated as a security, the Framework leaves unaddressed perhaps the most glaring conceptual questions raised by the Hinman Factors—how to determine the point at which this transition occurs, when issuers should conduct a reevaluation and what happens when token holders who previously received disclosures under the securities laws cease to receive them. The mutability criteria in the Framework unfortunately are of limited utility as general reformulations of the factors that should be applied at the time of the offering.

— *New Projects May Face Difficulty in Relying on the Guidance*

New blockchain projects may face particular challenges in applying the Guidance. One notable feature of several criteria in the Framework relates to the role of the issuer in setting up and managing the network that are outside of its control. For example, on one hand the Framework states that a digital asset is more likely to be a security if an AP creates or supports the asset's market or price, but on the other hand the Framework states that a digital asset is less likely to be a security if its design provides that its value will remain constant or degrade over time. It is difficult to envision how an AP could avoid implicating the former principle while also satisfying the latter.

— *The Guidance Does Not Address the Full Range of Characteristics that Can Make a Digital Asset a Security*

The Guidance solely addresses the *Howey* test for investment contracts. But the Acts' "security" definition contains additional prongs that can be relevant to digital assets. In particular, a digital asset that is not an investment contract could still be consider a "note" under the "family resemblance" test established by the Supreme Court in *Reves v. Ernst & Young*. Digital asset issuers should carefully consider this analysis, especially in connection with stablecoins and other digital assets that some might view as akin to debt obligations.

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