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SEC Publishes Framework for Investment Contract Analysis of Digital Assets and Issues First No-Action Letter for a Token Sale

On April 3, 2019, the SEC’s Strategic Hub for Innovation and Financial Technology (“FinHub”)¹ published a framework for analyzing whether a digital asset is offered and sold as an investment contract and, therefore, is a security (the “Framework”).² At the same time, the Division of Corporation Finance issued a no-action response to an aviation company in connection with its proposed offer and sale of blockchain-based digital assets in the form of “tokenized” jet cards without registration under the U.S. federal securities laws (the “TKJ Letter”). The Framework and the TKJ Letter provide the latest guidance to market participants to help them assess whether a particular digital asset is a “security” and, therefore, its offer and sale must be registered under the federal securities laws or qualify for an exemption. Taken together, they confirm that the “not a security” path for most digital assets will be a very steep one.

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The Framework

The SEC has applied the “investment contract” analysis outlined in the U.S. Supreme Court’s *Howey* case³ to analyze whether a digital asset – an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called virtual currencies, coins and tokens – is a security. Under the *Howey* test, an “investment contract” exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.

The Framework primarily focuses on the “reasonable expectation of profits to be derived from efforts of others” prong of the *Howey* test and only mentions the “investment of money” and “common enterprise” prongs of the *Howey* test in passing. The amount of attention devoted to the “reasonable expectation of profits to be derived from efforts of others” prong could reflect the number of factors involved in the securities law analysis as well as the need to reevaluate that analysis at different points in time. For example, in a [June 2018 speech](#), Director of Corporation Finance William Hinman stated that neither bitcoin nor ether are securities (discussed in this Ropes & Gray [Alert](#)). In his speech, Director Hinman allowed for the possibility that the status of a digital asset could change over time. The Framework also confirms that a digital asset that was part of an offering of securities may become, over time, something other than a security and identifies certain considerations to be examined when reevaluating the status of the digital asset at the time of later offers and sales.

The Framework divides the third prong of the *Howey* test into three areas and then provides a non-exhaustive list of factors with respect to each area: (1) reliance on the efforts of others; (2) reasonable expectation of profits; and (3) other relevant considerations. We note that the below section includes only a summary discussion of the factors outlined in the Framework. You may find the full text of the Framework [here](#) to review other factors that should also be considered under each area. Notably, the Framework includes many more factors than what Director Hinman identified in his June 2018 speech, which perhaps represents the evolution of the Staff’s securities law analysis of digital assets.

¹ Launched in October 2018, FinHub serves as a resource for public engagement on the SEC’s FinTech-related issues and initiatives, such as distributed ledger technology (including digital assets), automated investment advice, digital marketplace financing, and artificial intelligence/machine learning. Led by Valerie A. Szczepanik, Senior Advisor for Digital Assets and Innovation and Associate Director in the SEC’s Division of Corporation Finance, FinHub is staffed by representatives from the SEC’s Divisions and Offices who have expertise and involvement in FinTech-related issues.

² Framework for “Investment Contract” Analysis of Digital Assets (Apr. 3, 2019). (available [here](#)).

³ See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

Reliance on the Efforts of Others

The Framework states that the inquiry into whether a purchaser is relying on the efforts of others focuses on two key issues:

- Does the purchaser reasonably expect to rely on the efforts of a promoter, sponsor, or other third party (referred to as an “Active Participant” or “AP” in the Framework)?
- Are those efforts essential managerial efforts that affect the failure or success of the enterprise as opposed to efforts that are more ministerial in nature?

The stronger the presence of the following factors, the ***more likely*** it is that a purchaser of a digital asset is relying on the efforts of others.

- An AP is responsible for the development, improvement (or enhancement), operation, or promotion of the network, particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.
- There are essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users (commonly known as a “decentralized” network).
- An AP creates or supports a market for, or the price of, the digital asset.
- An AP has a lead or central role in the direction of the ongoing development of the network or the digital asset.
- An AP has a continuing managerial role in making decisions about or exercising judgment concerning the network or the characteristics or rights of the digital asset.
- Purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset, such as where (i) the AP has the ability to realize capital appreciation from the value of the digital asset; (ii) the AP distributes the digital asset as management compensation or the AP’s compensation is tied to the price of the digital asset on the secondary market; (iii) the AP owns or controls (directly or indirectly) ownership of intellectual property rights of the network or digital asset; or (iv) the AP monetizes the value of the digital asset, especially where the digital asset has limited functionality.

Reasonable Expectation of Profits

The Framework states that an evaluation of the digital asset should also consider whether there is a reasonable expectation of profits. The Framework makes clear that price appreciation resulting solely from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered “profit” under the *Howey* test. The stronger the presence of the following factors, the ***more likely*** it is that there is a reasonable expectation of profit.

- The digital asset gives the holder rights to share in the enterprise’s income or profits or to realize gain from capital appreciation of the digital asset.
- The digital asset is transferable or traded on or through a secondary market or platform, or is expected to be in the future.

- Purchasers reasonably would expect that an AP's efforts will result in capital appreciation of the digital asset and therefore be able to earn a return on their purchase.
- The digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network.
- There is little apparent correlation between the purchase/offering price of the digital asset and the market price of the particular goods or services that can be acquired in exchange for the digital asset.
- The digital asset is marketed, directly or indirectly, using any of the following: (i) the expertise of an AP or its ability to build or grow the value of the network or digital asset; (ii) terms that indicate it is an investment or that the solicited holders are investors; (iii) the intended use of the proceeds from the sale of the digital asset is to develop the network or digital asset; (iv) the future (and not present) functionality of the network or digital asset, and the prospect that an AP will deliver that functionality; or (v) the ready transferability of the digital asset is a key selling feature.

Other Relevant Considerations

The Framework explains that when assessing whether there is a reasonable expectation of profit derived from the efforts of others, federal courts look to the economic reality of the transaction, and in so doing, the courts have considered whether the instrument is offered and sold for use or consumption by purchasers. The stronger the presence of the following factors, the *less likely* it is that the digital asset is an investment contract.

- The distributed ledger network and digital asset are fully developed and operational.
- Holders of the digital asset are immediately able to use it for its intended functionality on the network, particularly where there are built-in incentives to encourage such use.
- Prospects for appreciation in the value of the digital asset are limited.
- With respect to a digital asset referred to as a virtual currency, it can be immediately used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency.
- With respect to a digital asset that represents a right to a good or service, it currently can be redeemed within a developed network or platform to acquire or otherwise use those goods or services.
- The digital asset is marketed in a manner that emphasizes the functionality of the digital asset, and not the potential for the increase in market value of the digital asset.

The No-Action Letter

In the TKJ Letter, the Division's first no-action letter for a token sale, the Staff confirmed that it would not recommend enforcement action against TurnKey if the company offered and sold digital assets in the form of "tokenized" jet cards ("TKJ Tokens") without registration under the U.S. federal securities laws.

TurnKey, which provides interstate air charter services to customers, proposed to allow customers to buy TKJ Tokens at a price of \$1 each that could be redeemed for air charter services. TurnKey believes that it can achieve improved efficiencies in using blockchain technology for the payment settlement process of air charter services that would allow for faster delivery of air charter flights.

In the TKJ Letter, the Staff identified the following factors that supported its no-action position:

- TurnKey will not use any funds from TKJ Token sales to develop the TKJ platform, network or app, and each of these will be fully developed and operational at the time any TKJ Tokens are sold;
- the TKJ Tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold;
- TurnKey will restrict transfers of TKJ Tokens to TKJ “wallets” only (accounts that are analogous to physical wallets) and not to wallets external to the platform;
- TurnKey will fix a price of \$1 per TKJ Token throughout the life of the program, and each TKJ Token will represent a TKJ obligation to supply air charter services at a value of \$1 per TKJ Token;
- If TurnKey offers to repurchase TKJ Tokens, it will only do so at a discount to the face value of the TKJ Tokens (\$1 per TKJ Token) that the holder seeks to resell to the company, unless a U.S. court orders the company to liquidate the TKJ Tokens; and
- The TKJ Token will be marketed in a manner that emphasizes the functionality of the TKJ Token, and not the potential for the increase in the market value of the TKJ Token.

These factors can be easily compared against some of the factors outlined in the Framework. The result in the TKJ Letter was hardly surprising, as the business model was a lot closer to Chuck E. Cheese’s than to some of the more exotic token offerings that have been problematic. Still, it is a first step in an area that has been fraught with concerns about investor protection.

Implications

The Framework is not intended to be an exhaustive overview of the law and, in some respects, reiterates positions that the SEC has taken or expressed through past investigative reports, enforcement actions or speeches. The Framework should provide market participants with a helpful tool in evaluating whether the federal securities laws apply to the offer, sale, or resale of a particular digital asset. Significantly, in its discussion of the inquiries pertaining to the reliance on the efforts of others and the reasonable expectation of profits, the Framework also confirms that a digital asset that was part of an offering of securities may become, over time, something other than a security and identifies certain considerations to be examined when reevaluating the status of the digital asset at the time of later offers and sales.

Where there is a fully functioning network and no transferability of tokens except within the network, the inquiry is relatively straightforward and the TKJ Letter provides relevant guidance. In contrast, the Framework will be most helpful when the current facts are subject to interpretation. The Framework provides a useful outline of the various factors that token issuers should weigh in reaching the appropriate conclusion regarding whether or not it will be necessary to register the tokens as securities.

As with all guidance, FinHub notes that the Framework represents the Staff’s views and is not a rule, regulation, or statement of the SEC and is not binding on the SEC or any of its Divisions. Furthermore, since no single factor in the Framework is determinative as to whether a digital asset is a security, the Staff encourages market participants to reach out and engage with the Staff through FinHub’s [website](#).

Separately, the SEC recently announced the [agenda](#) for a FinTech Forum to discuss distributed ledger technology and digital assets. The Forum, which will be held on May 31, 2019, will feature four panels that will focus on topics such as capital formation considerations, trading and market considerations, investment management considerations, and

industry trends and specific use cases of distributed technology for financial markets. The Forum is open to the public and will also be presented via webcast on the SEC's website.

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Members of Ropes & Gray's [FinTech](#) team continue to monitor these and related legal developments on behalf of our clients. If you have any questions regarding the matters discussed in this Alert, please feel free to reach out to the authors or your normal Ropes & Gray contact.