

Updates

April 10, 2019



The U.S. Securities and Exchange Commission (SEC) Strategic Hub for Innovation and Financial Technology (FinHub) published a [framework](#) on April 3, 2019, for analyzing whether a digital asset is offered and sold as a security under the federal securities laws. The framework includes "common sense guidance" that provides greater detail and clarity regarding the application of the federal securities laws to digital assets. In the accompanying press release, William H. Hinman, Director of the Division of Corporation Finance, and Valerie A. Szczepanik, Senior Advisor for Digital Assets and Innovation, stated that the framework is intended to be "an analytical tool to help market participants assess whether the federal securities laws apply to the offer, sale, or resale of a particular digital asset."

Concurrent with the announcement of the framework, the SEC's Division of Corporation Finance issued a [no-action letter](#) in connection with TurnKey Jet, Inc.'s (TurnKey) [proposed offering](#) of a digital asset for use in its air charter business. This no-action letter provides the first illustrative example of how a digital asset can be sold without having to register it as a security.

Significant aspects of the framework and no-action letter, which we discuss in more detail below, include:

- **Consolidation of SEC Guidance, Positions and Statements.** The framework consolidates into one document previous SEC staff guidance, positions and statements regarding the application of the investment contract test established in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (the *Howey* test)[1] to digital assets.
- **New Considerations.** In addition to consolidating previous SEC staff guidance, the framework introduces new emphases and considerations for analyzing digital assets, with the net effect of setting a low bar for concluding that a digital asset is an investment contract and therefore a security. Notable new emphases and considerations include: (1) introducing a new term, "active participant," which broadly defines the participants in a digital asset network whose efforts may form the basis of a purchaser's expectation of profits; (2) focusing on an active participant's compensation practices, intellectual property rights and self-interest (through retained inventory of digital assets) in a digital asset network; (3) suggesting that when an active participant facilitates creation of a secondary market, transfers may only be made by and among users of a network; and (4) suggesting that digital assets that are virtual currencies must be immediately useable to make payments in a wide variety of contexts.
- **Once a Security, Not Always a Security.** The framework includes considerations for the analysis of digital assets that were once sold as securities but are no longer securities.
- **No-Action Relief for a Limited-Use Digital Asset.** The TurnKey no-action letter provides relief to a U.S. dollar-pegged digital asset that is part of a membership program for an air charter services company. The digital asset fails the "expectation of profits" prong of the *Howey* test because of characteristics related to the manner of the proposed offering, price restrictions, and contractual and technical transferability restrictions TurnKey plans to impose on the digital asset.
- **No-Action Relief Is Available.** The digital asset in the TurnKey no-action letter is not representative of most digital assets in operation today. While the TurnKey token leverages blockchain technology, it is a legal instrument that functions as a "closed loop" pre-paid gift certificate, rather than a typical virtual currency or utility token. This relief shows that the SEC staff is willing to issue no-action relief related to digital assets under certain circumstances.

The Framework

The framework consolidates existing SEC staff guidance from [speeches](#), [joint statements](#), [enforcement actions](#) and [congressional testimony](#) regarding the application of the *Howey* test to digital assets, and introduces new emphases and considerations regarding securities analysis of digital assets not present in prior SEC staff guidance. In addition, it covers some potential considerations for digital assets that could begin as investment contracts but over time evolve into non-securities. Notably, the framework concludes with an example of a non-transferable digital asset that would not constitute a security.

The framework, as noted by the SEC staff, is intended to be instructive guidance based on the SEC staff's experiences to date and is not an exhaustive treatment of the legal and regulatory issues relevant to digital assets. We have summarized the discussion of the *Howey* test in the framework below.

The "Investment of Money" in a "Common Enterprise"

The first two elements of the *Howey* test, "investment of money" and "common enterprise," are covered at a high level, implying that the SEC staff generally does not find that these two elements are points of contention. The framework notes that the first element, an investment of money, is typically satisfied when there is an offer and sale of a digital asset in exchange for value, whether that value is in the form of fiat currency, a digital asset or some other type of consideration. The SEC staff uses a bounty program and an airdrop as examples, noting that a sale can occur where there is a lack of monetary consideration. This provides insight as to how broadly the SEC staff construes this particular element and highlights that an actual exchange of cash is not required. In support of this proposition, the SEC staff points to the SEC's explanation in The DAO Report from 2017 and the Tomahawk Exploration LLC enforcement action from 2019.[2]

With regard to the "common enterprise" element of the *Howey* test, the framework states that, based on the SEC staff's experience to date, a common enterprise typically exists with digital assets because "the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts." Although federal courts require that there be either "horizontal commonality" or "vertical commonality" to satisfy this element, the framework states that "the Commission...does not require vertical or horizontal commonality *per se*, nor does it view a 'common enterprise' as a distinct element of the term 'investment contract.'"

"Reasonable Expectation of Profits Derived From Efforts of Others"

The primary focus of the framework deals with the final element of the *Howey* test, the "reasonable expectation of profits derived from the efforts of others." The amount of attention devoted to this element underscores its importance in the *Howey* test analysis from the SEC staff's view. The SEC staff analyzes both prongs: (1) the reliance on the efforts of others and (2) the reasonable expectation of profits. The framework provides a series of characteristics that render it more likely that a purchaser of a digital asset has an "expectation of profits" from the "efforts of others." Notably, the framework casts a broad net in defining whose efforts are material for analysis. In a new term, "active participant" or "AP," the SEC staff includes any promoter, sponsor or other third party (or affiliated group of third parties) that provides essential managerial efforts related to a given digital asset.[3]

"Efforts of Others"

The framework addresses a number of potential characteristics of "efforts of others." Of note are the following:

- Is an AP responsible for the development, improvement (or enhancement), operation or promotion of the network underpinning the digital asset, 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? The SEC staff acknowledges that some form of effort may be expended by a holder of digital assets, but those efforts do not negate the fact that the holders of digital assets may be relying on the efforts of the AP for essential managerial efforts. In this respect, to help analyze the quantum of efforts indicating an investment contract, the framework asks whether the efforts are "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise," as opposed to the efforts that are more ministerial in nature.
- Are essential tasks performed by an AP rather than an unaffiliated, dispersed community of network users? This characteristic focuses on the *decentralized* nature of the network (i.e., the methods by which changes to the network occur, how consensus is achieved and who may assert influence in other forms over the network).
- Does an AP create or support a market for, or the price of, the digital asset? This includes controlling the creation and issuance of the digital asset or taking other actions to support a market price of the digital asset, such as by limiting supply or ensuring scarcity through buybacks, "burning" or other activities. The SEC staff includes both arranging as well as promising to arrange for trading in its example.

- Does an AP have a continuing managerial role in making decisions or exercising judgment concerning the network? The SEC staff provides some examples of managerial judgments that may indirectly or directly impact the success of a digital asset and its network.
- Are purchasers reasonably expecting an AP to make efforts to promote its own interest and the value of the network or the digital asset? The SEC staff points out that this is particularly true if the AP has retained a stake in the digital asset, compensates management based on the value of the digital asset, owns the intellectual property underlying the digital asset or monetizes the value of the digital asset (especially when the digital asset has limited functionality).

The SEC staff also offers considerations that might trigger the reevaluation of a digital asset that may have been sold as a security with respect to the "efforts of others" prong. These considerations are consistent with prior statements made by SEC Director William H. Hinman in his June 2018 speech, [Digital Assets Transactions: When Howey Met Gary \(Plastic\)](#), including the following:

- Whether or not the efforts of an AP continue to be important to the value of an investment in the digital asset.
- Whether the network on which the digital asset is to function operates in such a manner that purchasers would no longer reasonably expect an AP to carry out essential managerial or entrepreneurial efforts.
- Whether the efforts of an AP no longer affect the enterprise's success.

"Reasonable Expectation of Profits"

The framework then turns to the "reasonable expectation of profits" prong, and describes characteristics that render it more likely that a purchaser of a digital asset has an "expectation of profits." The SEC staff points out that "profits" can include capital appreciation from resales of the digital asset in addition to more direct types of financial return. Consistent with settled law on the topic generally, price appreciation resulting *solely* from external market forces affecting supply and demand (such as macro trends in the economy) would not be considered "profit" under the *Howey* test.

In general, the more the following characteristics are present, the more likely it is that there is a reasonable expectation of profit:

- Any right to share income or profits or to realize gain from capital appreciation of the digital asset that comes, at least in part, from the operation, promotion, improvement or other positive developments in the network, particularly if there is a secondary trading market that enables digital asset holders to resell their digital assets and realize gains.
- The digital asset is transferable or traded on or through a secondary market or is expected to be available on a secondary market in the future. Notably, the framework states that digital assets that are exchangeable solely for goods or services within the network and may not otherwise be transferred or sold, are more likely to be indicative of purchasers' consumptive intent.
- Purchasers reasonably expect an AP's efforts will result in capital appreciation of the digital asset.
- The digital asset is offered broadly to potential purchasers as compared to targeting expected users of the digital asset. This includes offering in quantities indicative of investment intent instead of in quantities indicative of use of the network.
- There is little apparent correlation between the purchase/offering price and the market price of the goods or services that can be acquired in exchange for the digital asset.
- There is little apparent correlation between the quantities in which the digital asset typically trades and the amount of the underlying goods or services a typical consumer would purchase for use or consumption.
- The AP raised funds in excess of what is needed to establish a functional network.

- The AP benefits from its efforts as a result of holding the same class of digital assets as those distributed to the public.
- The AP continues to expend funds from proceeds or operations to enhance functionality or value of the network.
- The framework also enumerates various marketing activities by APs that would tend to indicate an expectation of profits, including describing the AP's expertise, using words like investor or investment, disclosing that proceeds will be used to build out the network and discussing future features and functionality of the network or digital asset.

As with the "efforts of others" prong, the SEC staff also offers considerations with respect to the "expectations of profits" prong for determining whether to reconsider the status of a digital asset that may have been previously sold as a security. These considerations include the following:

- Whether purchasers no longer reasonably expect that continued development efforts of an AP will be a key factor for determining the value of the digital asset.
- Whether the value of the digital asset shows a direct and stable correlation to the value of the good or service for which it can be exchanged or redeemed.
- Whether the trading volume for the digital asset corresponds with the level of demand for the good or service for which the digital asset can be exchanged or redeemed.
- Whether the holders of the digital asset can use the digital asset for its intended functionality.
- Whether the economic benefits derived from appreciation of the digital asset are incidental to obtaining the digital asset for its intended functionality.
- Whether any AP still has access to material, non-public information or could otherwise be deemed to hold material inside information about the digital asset.

Other Relevant Considerations - "Use or Consumption"

When assessing whether the last two elements of the *Howey* test are satisfied, the framework points out that federal courts look to the economic reality of the transaction and in doing so, have considered whether the instrument is offered and sold for use or consumption by purchasers.

While the SEC staff provides the following characteristics of use or consumption and notes that no one characteristic is determinative, the SEC staff also underscores that the stronger their presence, the less likely the *Howey* test is met:

- The network upon which the digital asset operates is fully developed and operational, and the holders of the digital asset can immediately use the digital asset for its intended functionality.
- The structure of the digital asset is designed and implemented to meet the needs of its users rather than to feed speculation.
- The digital asset has limited prospects for appreciation. For example, the digital asset is designed such that its value will remain constant or even degrade over time (e.g., via inflation).
- For digital assets meant to represent virtual currency, the framework asks whether the virtual currency (1) can be immediately used to make payments; (2) can substitute for real currency without the need to convert it to another digital asset or real currency; and (3) can serve as a store of value that can be saved, retrieved and exchanged for something of value at a later time.
- For digital assets meant to represent rights to goods or services, the framework asks whether (1) the digital asset can be redeemed within a developed network; (2) there is correlation between the purchase price and the market price for the good or service; and (3) the good or service underlying the digital asset can only be acquired, or acquired more efficiently, using the digital asset on the network.

- Any economic benefit that may be derived from appreciation in value of the digital asset is incidental to obtaining the right to use it for its intended functionality.
- The digital asset is marketed consistent with its function.
- Purchasers have the ability to use (or have used) the digital asset for its intended functionality.
- There are restrictions on transferability that are consistent with the digital asset's use and not facilitating a speculative market.
- If an AP creates a secondary market for the digital asset, transfers of the digital asset can only be made by and among users of the platform.

The framework concludes by offering an example of a digital asset that would not be an investment contract and therefore a security under the *Howey* test. The example is an online retailer with a fully developed operating business that creates a non-transferable digital asset to be used by consumers to purchase products only on the retailer's network. The retailer offers the digital asset for sale in exchange for fiat currency and the digital asset is redeemable only for products commensurately priced in real currency. The retailer markets its products and advertises the digital asset as a payment method, and may offer to "reward" customers with the digital asset based on product purchases. Upon receipt of the digital asset, customers can immediately use the digital asset to purchase products on the network. Under these circumstances, the SEC staff states that the offer and sale of the digital asset would not constitute an investment contract.

In addition, the SEC staff cautions that even where a digital asset can be used to purchase goods or services on a network, if that network's or digital asset's functionality is still being developed or improved, certain facts tend to demonstrate an investment contract. These facts include selling the digital asset at a discount to the value of the goods and services or in quantities exceeding reasonable use or imposing limited or no resale restrictions, particularly where an AP is still taking steps to increase value in the digital asset or has facilitated a secondary market.

No-Action Letter

On the same day the framework was announced, the SEC's Division of Corporation Finance (Division) issued a no-action letter in connection with TurnKey's proposed sale of digital assets in the form of "tokenized" jet cards (Jet Tokens) for use in TurnKey's charter jet business. The no-action letter confirmed that the Division would not recommend enforcement action if TurnKey offered and sold Jet Tokens without registering the offering under Section 5 of the Securities Act of 1933 or registering the digital assets under Section 12(g) of the Securities Exchange Act of 1934.[4]

Facts

TurnKey provides interstate air charter services as a licensed United States air carrier and air taxi operator and currently operates two business jets. TurnKey proposes to launch a new membership program and platform that would facilitate the sale and transfer of Jet Tokens via a private blockchain network (TKJ Platform), which would be private, permissioned and centrally controlled by TurnKey. Each Jet Token would only be capable of purchase by "consumers" (a specific subset of users in the TKJ Platform) for one U.S. dollar. Once Jet Tokens are acquired by consumers, they would be freely transferable between all other users of the TKJ Platform. Jet Tokens would not be transferable outside of the TKJ Platform, including to any form of external digital asset wallet other than the proprietary digital asset wallets created by TurnKey. Further, each participant in the TKJ Platform would be required to enter into membership agreements with TurnKey, make various representations and submit to extensive customer identification procedures.

Division Response

In issuing its response that it would not recommend enforcement, the Division noted the following:

- No funds will be used to develop the TKJ Platform and the TKJ Platform will be fully operational at the time any Jet Tokens are sold.
- The Jet Tokens are planned to be immediately useable for their intended functionality at the time they are sold.
- TurnKey will restrict transfers of Jet Tokens to TurnKey wallets only, and no wallets external to the TKJ Platform will be allowed to transact in Jet Tokens.
- The Jet Token price will be pegged 1:1 to a U.S. dollar value.
- Any repurchase of Jet Tokens by TurnKey will be at a discount to face value.
- The Jet Tokens will be marketed in a manner that emphasizes their functionality.

The fact pattern in the TurnKey no-action letter indicates that the SEC staff is not averse to issuing no-action relief where digital assets are involved. Importantly, a party can generally rely on no-action relief to the extent that the third party's facts and circumstances are substantially similar to those described in the underlying request. Since the parameters of the Jet Token project hew closely to the considerations outlined in the framework, it is no surprise that relief was granted. The SEC has consistently expressed willingness to engage with market participants on the application of the securities laws to digital assets, and continues to encourage individuals and enterprises considering the sale of digital assets to speak with the [FinHub](#), preferably before taking action. The TurnKey no-action letter represents the first public relief arising from such engagement.

Conclusion

The guidance issued by the SEC staff in both the framework and the TurnKey no-action letter is a distilled and refined written articulation of the guidance the SEC staff has been giving to date, with new emphases and considerations for analyzing digital assets. These documents further demonstrate the SEC's continued focus in the digital asset space. However, the framework and TurnKey no-action letter also raise new questions that will likely take time to resolve. The SEC has taken a methodical and deliberative approach to putting market participants on notice that where federal securities laws are implicated, it will continue to exercise the full scope of its powers, from enforcement to relief.

We are witnessing another piece of the regulatory framework being established. We encourage industry participants, whether they are early in their process or believe they have regulatory exposure related to digital assets, to contact an experienced securities lawyer for advice to best navigate this complex area.

ENDNOTES

[1] In a 1946 U.S. Supreme Court decision, *SEC v. W.J. Howey Co.*, the Court held that a transaction is an investment contract, or security, if "a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." 328 U.S. 293, 298-99 (1946).

[2] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Release No. 81207, at 11 (July 25, 2017) ("In determining whether an investment contract exists, the investment of 'money' need not take the form of cash" and "in spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract.") (citation and alteration omitted). See *In re Tomahawk Exploration LLC*, Securities Act Release No. 10530, Exchange Act Release No.83839 (Aug. 14, 2018) (issuance of tokens under a so-called "bounty program" constituted an offer and sale of securities because the issuer provided tokens to investors in exchange for services designed to advance the issuer's economic interests and foster a trading market for its

securities).

[3] Elsewhere in the framework the SEC also highlights the possibility of a successor AP, whereby a new promoter, sponsor or other third party may become an AP by virtue of its participation in the network.

[4] No-action letters are a voluntary method by which individuals and entities who are not certain whether a particular product, service or action would constitute a violation of the federal securities laws may request relief from the SEC staff. Importantly, any no-action relief provided by the SEC to the requestor is based on the specific facts and circumstances set forth in the request. In some cases, the SEC staff may permit parties other than the requestor to rely on the no-action relief to the extent that the third party's facts and circumstances are substantially similar to those described in the underlying request, but typically the relief is specific only to the requestor. More information regarding the SEC no-action letter process is available on the SEC fast answers section of its website, available here: <https://www.sec.gov/fast-answers/answersnoactionhtm.html>.

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