

Harter Secrest & Emery LLP

ATTORNEYS AND COUNSELORS

SECURITIES AND CAPITAL MARKETS

SEC RELEASES FRAMEWORK FOR ANALYSIS OF WHETHER DIGITAL ASSETS ARE REGULATED AS SECURITIES AND ISSUES A NO-ACTION LETTER APPLYING THE FRAMEWORK

Authors: Alexander R. McClean and Michelle L. Bouton

The Strategic Hub for Innovation and Financial Technology (“FinHub”), a division of the Securities and Exchange Commission’s Division of Corporate Finance (“CorpFin”), recently released a “Framework for ‘Investment Contract’ analysis of Digital Assets” (“Framework”). On the same day, CorpFin issued a no-action letter to TurnKey Jet, Inc. (“TurnKey”), providing additional guidance on whether or not digital assets such as cryptocurrency, blockchain tokens, or initial coin offerings (“digital assets”) are a form of security known as an “investment contract” as set forth in Section 2(a)(1) of the Securities Act of 1933, as amended and Section 3(a)(10) of the Securities Exchange Act of 1934, as amended. Although not determinative of the SEC’s position on whether or not digital assets are securities, the Framework and no-action letter provide further insight into the SEC’s view on this topic, leave open the possibility of non-security digital assets, and demonstrate the engagement of the SEC with this issue.

Framework Analysis

The Framework restates the factors to be considered when determining whether or not an “investment contract” is a security as established by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Under the *Howey* test, an “investment contract” or security exists when there is (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits to be derived from the efforts of others. Whether or not an “investment contract” and therefore, a security exists, will depend upon the specific facts and circumstances surrounding the proposed sale or offering.

The Investment of Money in a Common Enterprise Prongs. The Framework quickly passes on prongs 1 and 2 of the *Howey* test reasoning that most sales and offerings of digital assets involve investment of money into a common enterprise. Prong 3, however, is not so easily disposed of as the Framework goes on to list dozens of factors to be considered when determining whether or not an investment is made with a reasonable expectation of profits to be derived from the efforts of others.

The Efforts of Others Prong. There are two key factors to consider when evaluating prong 3 of the *Howey* test: (i) does the purchaser of a digital asset expect to rely on the efforts of an “Active Participant” (“AP”) such as “promoter, sponsor, or other third party that provides essential managerial efforts”; and (ii) are the AP’s efforts significant managerial efforts that will affect the success or failure of the business enterprise? If an AP is involved in distributing or promoting the digital asset, an investment contract may be found to exist where:

- The digital asset or network upon which the digital asset is used is still in development and the AP is responsible for the development, improvement, enhancement, operation, or promotion thereof;

- The AP creates the market for, or price of, the digital asset, whether and where the digital assets will trade, and who will receive additional digital assets and under what conditions;
- The AP retains a stake in the digital asset or network such that a purchaser would expect the AP to promote its own interests and enhance the value of the network or digital asset;
- The AP directly or indirectly owns the intellectual property rights to the digital assets and/or network; and
- The AP maintains a managerial role with respect to the network or digital assets.

The Reasonable Expectation of Profits Prong. The Framework also lays out key factors that influence whether or not there is a “reasonable expectation of profits” some of which include:

- 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 asset;
- The holder of the digital asset has the right to receive dividends or distributions;
- The digital asset is transferrable or tradeable on or through the secondary market or is expected to be in the future;
- The digital asset is offered broadly to potential purchasers rather than being targeted to expected users of the goods or services or those who have a need for the functionality of the digital assets or network;
- The digital asset is offered or purchased in quantities larger or smaller than what is needed to take advantage of the digital asset’s functionality;
- There is an absence of a correlation between the offering price of a digital asset and the market price of the good or service that the digital asset can be exchanged for; and
- The offer and sale of the digital assets have raised more funds than are necessary to establish the digital asset or network.

The Framework makes it clear that the “economic realities” of the transaction must be taken into account when evaluating whether or not there is a reasonable expectation of profits based on the efforts of others and to evaluate if the digital asset serves a primarily consumptive purpose rather than an investment purpose. The Framework also makes it clear that price appreciation resulting solely from market forces is *not* profit under the *Howey* test.

It is also important to note that the Framework leaves open the possibility that a digital asset that was once offered as a registered security can be re-evaluated in a subsequent offer and be deemed not to be a security should the facts and circumstances surrounding the offer change.

Other Relevant Considerations. In “Other Relevant Considerations” the Framework sets forth certain characteristics that, if present, would indicate that a digital asset is intended more for consumption purposes rather than investment purposes, and, therefore, less likely to be a security such as:

- The digital asset is fully functional at the time it is sold and can be immediately used for its intended functionality, particularly where there are built-in incentives for its use;
- The digital asset can be used to pay for goods and services immediately without having to be converted to another digital asset or currency and can be used to make payments in a wide variety of contexts and can be used as a substitute for real currency;

- The digital asset can be redeemed within a developed network or platform and there is a correlation between the value of the digital asset and the value of the goods and services it is being exchanged for; and
- Transfers of the digital asset can only be made between users of the network or platform for which the digital asset was developed.

Background

On April 2, 2019, counsel for TurnKey requested that the staff of CorpFin confirm that it would not recommend that the SEC take enforcement action against TurnKey should TurnKey offer and sell blockchain-based digital assets in the form of “tokenized” jet cards. TurnKey is launching a token membership program and platform to facilitate the sale of tokens for air charter services via a private blockchain network. Consumers can purchase flights on the TurnKey platform from carriers via third-party brokers by redeeming the tokens as payment. The intent of the program is to eliminate the costs and inefficiencies around payment and regulatory compliance for chartered jet travel. TurnKey plans to use its own funds to develop the platform, application, and tokens. Tokens are freely transferrable only among the consumers, carriers, and brokers in the program (i.e. those who possess wallets and have agreed to the terms and conditions of the program) and can be redeemed immediately upon issue for charter air travel services only and there is no time limit within which tokens must be redeemed. Only TurnKey has the right to put tokens into circulation or to remove tokens from circulation once they have been redeemed. Tokens are non-refundable.

TurnKey plans to market the tokens as an opportunity to purchase prepaid on-demand air charter services and not as an investment opportunity. In addition, prior to purchasing tokens, consumers and later transferees must represent and warrant in a written membership agreement that they are not purchasing the tokens as an investment opportunity and they have no expectation of economic benefit or profit. They must also acknowledge that the tokens are non-refundable, that they are not receiving an ownership interest in TurnKey as a result of the purchase of tokens, nor will they obtain any voting rights or rights to receive distributions and dividends as a result of their purchase. In addition, tokens may not be pledged or hypothecated.

No-action Letter

The no-action letter issued to TurnKey is the first time that such a letter has been provided to a token issuer by the SEC staff. In issuing this letter, CorpFin noted that its agreement not to recommend enforcement action to the SEC is in reliance on the following facts which closely track some, but not all of, the factors set out in the Framework:

- TurnKey will not use any proceeds from the sale of the tokens to develop the platform, tokens, or application and all of these will be fully functional by the time tokens are sold;
- TurnKey will restrict transfer of the tokens to the “members” of the program (i.e. consumers, carriers and brokers who have agreed in writing to the terms and conditions of membership and who have “wallets” issued by TurnKey);
- The tokens will be immediately usable for their intended functionality (i.e. redemption for charter air travel services) at the time they are sold;

- TurnKey will sell the tokens at a price of \$1 per token for the duration of the program and each token will represent an obligation to supply charter air travel services at a value of \$1 per token;
- If TurnKey offers to repurchase tokens, it will only do so at a discount to the face value of the token that the holder seeks to resell, unless a court within the United States orders TurnKey to liquidate the tokens; and
- The token is marketed in a manner that emphasizes the functionality of the token and not the potential for the increase in the market value of the token.

The no-action letter clearly indicates that the determination of whether or not digital assets constitute securities is very fact-specific. In fact, CorpFin states in the letter that its position is based on the facts presented by TurnKey's counsel and that any different facts might result in a different conclusion.

Takeaway

Although the Framework essentially reiterates prior guidance set forth in *Howey* and despite the fact that the SEC has not stated whether or not it considers digital assets to be securities generally, the analysis that the SEC undertakes in the Framework does give a bit more detail into how the SEC might approach the issue. In addition, the guidance was the first time that the SEC provided a no-action letter with respect to the offer and sale of a particular token, although the facts in the TurnKey use case vary from those of more common digital asset offerings where companies are selling digital assets to raise funds necessary to continue their development. Companies are advised to carefully evaluate their proposed offer of digital assets against the factors set forth in the Framework prior to moving forward to determine whether or not they will be deemed to be securities by the SEC and thus subject to registration requirements. Although any one of the factors listed above is not determinative, the more factors that are met, the more likely the digital asset will be deemed a security by the SEC.

Although the Framework may be helpful to companies who are contemplating the offer of digital assets, one should be mindful of the fact that the Framework does not constitute formal rules and regulations approved by the SEC and is not binding on the SEC.

If you would like more information regarding the Framework and how it may impact an offering of digital assets, please contact a member of Harter Secrest & Emery LLP's Securities and Capital Markets Group. For more information, visit www.hselaw.com.

Alexander R. McClean, 585.231.1248, amcclean@hselaw.com

Michelle L. Bouton, 716.844.3767, mbouton@hselaw.com

Attorney Advertising. Prior results do not guarantee a similar outcome. This publication is provided as a service to clients and friends of Harter Secrest & Emery LLP. It is intended for general information purposes only and should not be considered as legal advice. The contents are neither an exhaustive discussion nor do they purport to cover all developments in the area. The reader should consult with legal counsel to determine how applicable laws relate to specific situations. © 2019 Harter Secrest & Emery LLP

