

SECURITIES AND CAPITAL MARKETS

SEC DIRECTOR OF CORPORATION FINANCE PROVIDES NEEDED CLARITY TO DETERMINE WHETHER INTERNET COINS ARE SECURITIES

On June 14, 2018, the Director of the Securities and Exchange Commission's (the "SEC") Division of Corporation Finance, William Hinman, gave a speech at the Yahoo Finance All Markets Summit. In his speech, Director Hinman clarified that digital assets sold as securities may, over time, be resold as non-securities. In addition, he provided two sets of factors that companies should consider when deciding whether digital assets constitute securities, and he stressed that the transaction's economic substance, not its label or instrument, is determinative.

Background

Director Hinman's speech is in contrast with prior remarks from both SEC Chairman Jay Clayton and formal SEC guidance. In February 2018, SEC Chairman Jay Clayton made it clear that he viewed most initial coin offerings ("ICOs") as securities offerings. Further, in previous statements, the SEC indicated that it considered certain digital assets to be securities and warned sponsors of ICOs to be mindful of federal securities laws.

SEC New Guidance on Digital Assets

Director Hinman's remarks liken digital assets to the facts in *SEC v. Howey*, the case where the Supreme Court first established the "investment contract" test. In *Howey*, the Supreme Court determined that citrus grove interests, even though labeled as real estate, were an investment in a security because the transaction included a service contract to cultivate and harvest oranges. The investment contract test is used to determine whether a security is being sold. The test requires an investment of money in a common enterprise with an expectation of profit derived from the efforts of third parties. ICOs are similar to the orange groves in *Howey* as ICOs often are sold to a wide audience, and the purchaser must rely on the efforts of a third party to build a successful enterprise and return a profit. Thus, as Director Hinman noted, classifying a digital asset as a security hinges on how the asset is sold and the expectations of the purchaser.

Director Hinman Provided Two Sets of Illustrative Factors to Determine Whether Digital Assets Constitute Securities.

The first list focuses on factors relating to the *Howey* test that should be used to determine whether a digital asset is an investment contract and therefore, a security. These factors consider whether a person or group created an expectation of a profit from the enterprise:

- Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
- Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?

- Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
- Are purchasers “investing,” in an effort to seek a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
- Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
- Do persons or entities other than the promoter exercise governance rights or meaningful influence?

Director Hinman provided a second set of factors that the SEC might consider when determining that a digital asset is not a security. This second list focuses on whether the digital assets in a contract are structured to function more like a consumer item than a security:

- Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
- Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
- Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
- Are the tokens distributed in ways to meet users’ needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser’s expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
- Is the asset marketed and distributed to potential users or the general public?
- Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
- Is the application fully functioning or in early stages of development?

According to Director Hinman, each and every factor is not required to be present in order to establish that a digital asset is not a security.

Digital Assets that Originate as Securities May, Over Time, Be Sold as Non-Securities. While digital assets may at first be securities, they may later be sold as non-securities depending on the circumstances in which they exist. Where an enterprise becomes decentralized, and where an asset’s sole utility is as a means of exchange, digital assets once sold as security investments can morph into non-securities within the decentralized network.

In contrast, digital assets will remain securities where surrounding circumstances continue to involve a third party from whom the purchaser has an expectation of profit. Where the digital asset symbolizes rights and a financial interest in the enterprise itself, it constitutes a security. Likewise, the SEC will almost always consider a digital asset to be a security where the founders of an enterprise operate and manage the platform. Importantly, even where enterprises meet the above conditions of decentralization and the digital asset is solely used as a means of exchange within that network, digital assets can still be “packaged and sold as an investment strategy that can be a security.” Thus, the SEC takes an individualized approach to determining whether a digital asset functions as a security.

Bitcoin and Ether are Not Securities. Director Hinman specifically noted that, when applying the Howey test and the supplemental digital asset factors, Bitcoin and Ether are not securities due to their decentralized structure. In other words, purchasers of Bitcoin and Ether no longer “expect a person or group to carry out essential managerial or entrepreneurial efforts.” Director Hinman also explained that requiring sellers of Bitcoin and Ether to comply with the disclosure requirements of the Securities Act would “seem to add little value” since purchasers are less likely to lack material information.

Takeaways

Although Director Hinman’s speech is not binding on the SEC, his remarks clarify the SEC’s approach to analyzing whether digital assets are securities and they assist promoters of digital assets in navigating federal securities laws. If you would like more information regarding the new guidance or general compliance with federal securities laws relating to digital assets, please contact a member of Harter Secrest & Emery LLP’s Securities and Capital Markets Group. For more information, visit www.hselaw.com.

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