Client Alert | Capital Markets

SEC Issues Guidance on "Investment Contract" Analysis of Digital Assets

April 2019

Authors: Era Anagnosti, Rupa Briggs, Colin Diamond, John Vetterli, Danielle Herrick

For all those market participants who were unclear as to whether or not their token constituted a security, on April 3, 2019, the SEC released its long-awaited guidance titled "Framework for 'Investment Contract' Analysis of Digital Assets"[1] (the "Framework"). The Framework represents the Staff's views and is not a rule, regulation or statement of the SEC. Simultaneously, the SEC's Division of Corporation Finance ("Corp Fin") issued a response to a no-action request[2] dealing with a particular fact pattern whereby the digital asset described in the request would not be considered a security. Through the Framework and the no-action letter, the SEC delivers a clear message that in the presence of significant managerial efforts by the promoter to create or further develop the network or the digital asset, coupled with a purchaser's reasonable expectation of value appreciation tied to such efforts and ability to transfer or trade the digital asset (including on a secondary market), the digital asset would most likely represent an investment contract.

The Framework

The Framework examines each component of the US Supreme Court's *Howey* test, which provides the foundational framework for when an "investment contract," and therefore a security, exists. The Framework provides a helpful discussion of factors a market participant must consider when analyzing whether a digital asset represents an investment contract, especially with respect to the third prong of the *Howey* test: whether a purchaser of the digital asset would make the purchase with a reasonable expectation of profits to be derived from the efforts of others.[3] The Framework spends little time discussing the first two prongs of the *Howey* test, remarking that "investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts."

1 The Framework is available here. If after applying the Framework, market participants have questions regarding whether a particular digital asset is a security, they are encouraged to reach out to the Staff through FinHub's webform.

2 The no-action response is available here.

3 The *Howey* case and subsequent case law have found that an "investment contract" exists when there is: (i) the investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profits to be derived from the efforts of others.

Reasonable Expectation of Profits Derived from Efforts of Others

The Framework emphasizes that when a promoter, sponsor, or other third party (or affiliated group of third parties) (each, an "AP") provides *essential managerial efforts that affect the success of the enterprise*, and *investors reasonably expect to derive profit from those efforts*, then this prong of the test is met. The SEC notes that profit may be in the form of a return through participation in distributions or through other methods of realizing appreciation of assets, such as selling at a gain in the secondary market. This is an objective inquiry, focused on the transaction itself and the manner in which the digital asset is offered and sold. The Framework approaches this inquiry in three parts:

1. Reliance on the Efforts of Others

Whether a purchaser is relying on the efforts of others hinges on two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an AP?
- Are those efforts "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise," as opposed to efforts that are more ministerial in nature?

Although not necessarily determinative, the Framework sets out a list of factors that make it more likely that a purchaser of a digital asset is relying on the "efforts of others." These factors center around the AP playing a lead or central role in:

- building out the network[4] or the digital asset or its continuing development;
- creating or supporting the market for, or the, price of, the digital asset (through, for example, buybacks, "burning," or other activities); and
- continuously managing the network or the rights of the digital assets, including, but not limited to:
  - determining compensation of persons providing direct or indirect services to the network;
  - deciding whether and where the digital assets will trade;
  - making or contributing to decisions on how to deploy funds raised from the sales of digital assets; and
  - making managerial judgements having a direct or indirect impact on the success of the network or the value of the digital asset.

The Framework also highlights that the purchasers would likely be relying on the efforts of others if they would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset by: (1) retaining a stake in the digital assets; (2) using the digital assets as compensation to management or other APs, or tying such compensation to the value of the digital assets in the secondary market; or (3) controlling the IP ownership of the network of the digital asset and monetizing its value, especially when it has limited functionality.

The Framework sets out a number of additional factors to consider when evaluating whether a digital asset previously sold as a security should be re-evaluated at the time of later offers or sales, including whether the efforts of an AP continue to be important to the value of an investment in the digital asset or the enterprise's success, and 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.

2. Reasonable Expectation of Profits

In examining whether a purchaser would have a reasonable expectation of profits, including capital appreciation resulting from the development of the initial investment or business enterprise, or a participation in earnings resulting from the use of purchaser's funds, the Framework sets out several characteristics, the

---

[4] The Framework defines "network" broadly as to encompass the various elements that comprise a digital asset's network, enterprise, platform, or application.

pervasive presence of which would be indicative of a reasonable expectation of profit. Some of the most relevant characteristics include:

- The holder's rights to share in the enterprise's income or profits or to realize gains from capital appreciation of the digital asset, including through dividends or distributions;
- The ability to transfer or trade the digital asset on or through a secondary market or platform, or the expectation of the ability to do so in the future;
- A broad offering to potential purchasers, rather than an offering targeted to expected users of the goods or services;
- Purchasers reasonably expect that an AP's efforts will result in capital appreciation of the asset, including if the marketing of the asset promotes the AP's expertise or ability to build or grow the value of the network or digital asset, the digital assets' investment properties, the future functionality of the network or digital asset or the transferability of the digital asset;
- Little apparent correlation between: (i) 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; or (ii) quantities the digital asset typically trades in (or the amounts that purchasers typically purchase) and the amount of the underlying goods or services a typical consumer would purchase for use or consumption;
- Funds raised in excess of those needed to establish a functional network or digital asset or continuous spending of funds from proceeds or operations to enhance the functionality or value of the network or digital asset; and
- The digital asset is marketed directly or indirectly, among other things, in terms that indicate an investment or the future development and functionality of the network or the digital asset, through the use of proceeds from the sale of such digital assets.

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.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, the Framework sets forth additional considerations as they relate to the "reasonable expectation of profits," including whether or not the value of the digital assets continues to be dependent on the continuing development efforts of an AP and whether the value and trading volume of digital assets correlate to the value of and level of demand for, respectively, the goods and services for which they may be exchanged for or redeemed.

3. Other Relevant Considerations

When assessing whether there is a reasonable expectation of profit derived from the efforts of others, US federal courts look to the economic reality of the transaction, including considering whether the instrument is offered and sold for use or consumption by purchasers. An instrument for use or consumption would be less likely to be considered a security under *Howey.* The Framework sets forth factors that primarily focus on whether:

- the network and digital asset are fully developed and operational, and implemented for their intended purposes;
- the digital asset's marketing emphasizes its functionality rather than the potential for the increase in its market value;
- appreciation in value would be incidental to obtaining the right to use the asset for its intended functionality; and
- restrictions on the transferability of the digital asset are consistent with its use and not facilitating a speculative market and, if the AP facilitates the creation of a secondary market, transfers of the digital asset may only be made by and among users of the platform.

The Framework emphasizes that it is only a guideline for analyzing whether the digital asset represents an investment contract, and that no single factor is determinative. It also indicates that even in cases where a digital asset can be used to purchase goods or services on a network, where that network's or digital asset's functionality is being developed or improved, these transactions may be securities transactions if, among other factors, the following is present:

- the digital asset is offered or sold to purchasers at a discount to the value of the goods or services;
- the digital asset is offered or sold to purchasers in quantities that exceed reasonable use; and/or
- there are limited or no restrictions on reselling those digital assets, particularly where an AP is continuing in its efforts to increase the value of the digital assets or has facilitated a secondary market.

No-Action Letter

TurnKey Jet, Inc. ("TJK"), a provider of interstate air charter services and air taxis, submitted a no-action letter[5] to Corp Fin requesting a determination that it would not recommend enforcement action if TJK made offers and sales of certain blockchain-based digital assets in the form of "tokenized" jet cards ("Tokens") without registering the Tokens under Section 5 of the Securities Act of 1933, as amended, or Section 12(g) of the Securities Exchange Act of 1934, as amended. TJK plans to offer individuals (and brokers) the opportunity to participate in a program to purchase digital tokens to obtain pre-paid on-demand air charter services, similar to current business jet card programs that are prevalent in the chartered air services space. The no-action letter described the interest represented by a Token as "a consumptive right to redeem the escrowed funds to pay for air charter services…[with] no reasonable expectation of profit derived from the efforts of others" and emphasized that "the Consumer's expectation will be to enter into a consumer transaction for prepayment of air charter services." In reaching its position that it would not recommend enforcement action if TKJ offers and sells the Tokens without registration, Corp Fin highlighted that:

- TKJ will not use any funds from Token sales to develop the TKJ platform, network, or app (collectively, the means by which Tokens will be purchased and redeemed), which will be fully developed and operational at the time any Tokens are sold;
- the Tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold;
- TKJ will restrict transfers of Tokens to TKJ digital wallets only;
- TKJ will sell Tokens at a price of one USD per Token throughout the life of the program, and each Token will represent a TKJ obligation to supply air charter services at a value of one USD per Token;
- If TKJ offers to repurchase Tokens, it will only do so at a discount to the face value of the Tokens (one USD per Token) that the holder seeks to resell to TKJ; 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 factors emphasized in the no-action response track several of those set forth in the Framework and help illustrate certain circumstances under which a digital asset would not be considered an investment contract.

Conclusion

Determining whether a new type of financial instrument, including a digital asset, is a security requires a careful analysis of the nature of the instrument and how it is offered and sold. Issuers and other persons and entities engaged in the marketing, offer, sale, resale, or distribution of any digital asset, are cautioned that, as technology and methods of capital formation continue to evolve, they may engage in activities that require registration of transactions with the SEC and even if no registration is required, activities involving digital assets that are securities may still be subject to the SEC's regulation and oversight. Moreover, the delineated Framework is not only applicable to offers and sales, but may apply to entities conducting other activities

5 Available here.

related to digital assets, including: marketing or promoting; buying, selling, or trading; facilitating exchanges; holding or storing; offering financial services such as management or advice; or other professional services.

The Framework does *not* provide an exhaustive list of factors to enable a market participant to always come to a clear determination as to whether or not their digital asset represents a security for federal securities law purposes. The SEC continues to encourage market participants to reach out through Corp Fin's FinHub webpage if they have questions regarding whether a particular digital asset is a security. As both the technological and regulatory landscapes continue to evolve, market participants are advised to carefully scrutinize digital asset transactions for compliance with existing securities laws, aided by existing and future formal and informal guidance from the SEC.

White & Case LLP
1221 Avenue of the Americas
New York, New York 10020-1095
United States

T +1 212 819 8200

White & Case LLP
701 Thirteenth Street, NW
Washington, District of Columbia 20005-3807
United States

T +1 202 626 3600