

CLIENT ALERT

SEC Releases Framework for Analyzing When a Digital Asset is a Security

Issues No-Action Letter Applying Guidance

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The Securities and Exchange Commission has continued to closely monitor the digital asset marketplace and guard against fraudulent or unregistered security offerings. Building on commentary by its Directors and enforcement actions regarding digital assets, the SEC recently released a framework for analyzing whether a digital asset constitutes a security and issued a no-action position applying this guidance to a token offering.

SEC Framework for “Investment Contract” Analysis of Digital Assets

On April 3, 2019, the SEC’s FinHub released a “Framework for ‘Investment Contract’ Analysis of Digital Assets.”¹ The Framework is the SEC staff’s most detailed pronouncement to date on when the staff would consider Initial Coin Offerings (“ICOs”) and offerings of certain other digital assets to be “investment contracts,” and thus “securities,” under the U.S.

¹ Framework for “Investment Contract” Analysis of Digital Assets, SEC, April 3, 2019, [available here](#).

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securities laws, applying the test set forth in the Supreme Court's *SEC v. Howey Co.*² decision. The Framework follows the SEC's DAO Report³ and various subsequent enforcement actions finding that ICOs have constituted securities.⁴

As the SEC notes in the Framework, under the *Howey* test and later case law, an investment contract exists when there is (i) the investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profits and (iv) to be derived from the efforts of others. The SEC also notes that the first and second prongs of the *Howey* test are typically triggered in an offer and sale of a digital asset. The SEC then focuses on the third and fourth prongs, setting out a number of characteristics that make it more or less likely that a purchaser is relying on the "efforts of others," with a particular emphasis on the efforts of "Active Participants" such as promoters, sponsors or other third parties and whether an investor has a reasonable expectation of profit to be derived from such efforts.

The key items for determining whether a purchaser is relying on the efforts of others are whether the purchaser reasonably expects to rely on the efforts of an Active Participant and whether those efforts are "essential managerial efforts which affect the failure or success of the enterprise." To assess this, the SEC will evaluate, among other characteristics, whether the Active Participant is responsible for the development, operation or promotion of the network, whether the essential tasks are performed by an Active Participant rather than a decentralized network, whether the Active Participant creates or supports a market for the price of the digital asset and whether the Active Participant has a continuing managerial role in making decisions about the network or the rights the digital assets represent. None of these characteristics are determinative, but the stronger their presence, the more likely it is that a purchaser of a digital asset is relying on the efforts of others.

To determine whether there is a reasonable expectation of profits, the SEC will evaluate, among other characteristics, whether the digital asset gives the purchaser rights to share in the enterprise's income or profits or to realize gain from capital appreciation of the digital asset, whether the digital asset is transferable or traded through a secondary market and whether the digital asset is offered broadly instead of being narrowly targeted to expected users of the network. Similarly, none of these characteristics are determinative, but the greater their presence, the more likely it is that there is a reasonable expectation of profits.

² 328 U.S. 293 (1946).

³ *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Release No. 81207 (July 25, 2017), [available here](#).

⁴ See, for example, the discussion in the recent white paper on "Digital and Digitized Assets: Federal and State Jurisdictional Issues" prepared by the American Bar Association Derivatives and Futures Law Committee's Innovative Digital Products and Processes Subcommittee Jurisdiction Working Group, [available here](#).

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The staff also notes that the characteristics of digital assets may change over time, and thus a token that initially may have been a security may be re-evaluated and determined to no longer be a security.

TurnKey Jet, Inc. No-Action Position

In conjunction with the Framework, the SEC's Division of Corporation Finance issued its first no-action position related to an ICO. The Division of Corporation Finance's no-action position was granted to TurnKey Jet, Inc.⁵ TurnKey proposed to issue tokens, each fixed at a value of one dollar, which can be used by consumers, brokers and providers of charter flights. The tokens will be redeemable for vouchers for air charter services and will resemble business jet card programs that are common in the industry. The transactions will operate as "smart contracts" and will settle on a private, permissioned blockchain. TurnKey will use its own resources, and not the proceeds from token sales, to build the platform, which will be operational before token issuance. Transferability of the tokens will be restricted in such a manner that it will be highly unlikely that a TurnKey purchaser will be able to buy tokens and resell them for financial gain. The SEC staff found that the offering of these tokens would not involve a reasonable expectation of profits based on the efforts of others and accordingly would not constitute securities under U.S. securities laws.

However, the SEC no-action position for TurnKey may have limited precedential value since the tokens in TurnKey are materially different from the tokens with respect to which the SEC has previously brought enforcement actions. In previous actions brought by the SEC, the tokens did not have a fixed value and were not prohibited from trading on a secondary marketplace. Also, in previous actions brought by the SEC, the companies were in the process of developing a business or framework and the proceeds from the token sales would be used, in part, to fund that development. In addition, in the case of TurnKey, the benefits of the tokens and their related platform are likely to stem, to a great extent, from technological advantages related to the use of distributed ledger technology.

⁵ *TurnKey Jet, Inc. No Action Letter*, SEC Division of Corporation Finance, April 3, 2019, [available here](#).

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