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Guidance on Investment Contract Analysis of Digital Assets and No-Action Letter

The U.S. Securities and Exchange Commission (the “SEC”) issued Staff Guidance on how the Howey Test will apply to digital assets, and a No-Action Letter in which the Staff of the Division of Corporation Finance of the SEC said it would not recommend an enforcement action to the Commission if, in reliance on a token issuer’s opinion as counsel that the tokens to be distributed were not securities, the token issuer offers and sells the tokens without registration under the Securities Act and the Exchange Act. There is now guidance and further clarity for market participants with respect to the SEC’s analytical framework in examining blockchain-based digital asset offerings.

On April 3, 2019, the SEC released Staff Guidance titled “Framework for ‘Investment Contract’ Analysis of Digital Assets,” which applies the factors set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), to determine whether a digital asset that is offered and sold is an investment contract under the federal securities laws. The factors set forth in *Howey* (the “*Howey Test*”) are: 1) an investment of money, 2) an expectation of profits from the investment, 3) whether the investment of money is in a common enterprise, and 4) whether any of the profits arise from the efforts of a promoter or third party. The Staff Guidance is non-binding and does not alter the requirements established in *Howey* or other related securities law analysis in existing court decisions, but it does provide insight into how the SEC intends to apply the *Howey Test* to digital assets and when the SEC may determine to pursue possible violations of the securities laws.

The Staff Guidance, for the first time, provides a roadmap for utility tokens, focusing on whether the digital asset purchaser has a reasonable expectation of profits derived from the efforts of others. This analysis is objective,

“focused on the transaction itself and the manner in which the digital asset is offered and sold.”

In determining whether a digital asset purchaser relies on the efforts of others, namely “Active Participants” (promoters, sponsors, or other parties who traditionally participate in the offer and sale of securities), the Staff analyzed two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an Active Participant; and
- Are those efforts the “undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”

The Staff Guidance focuses on a number of elements that will influence the determination, including:

- whether the Active Participant is responsible for the network, including whether the network or the digital asset is fully functional at the time of the offer or sale;
- whether essential tasks or responsibilities will be performed by an Active Participant rather than

- unaffiliated users who are spread around the globe;
- whether an Active Participant creates or supports a market or the price of the digital asset, including controlling the creation and issuance of the digital asset;
 - whether an Active Participant has a lead or central role in the direction of the ongoing development and governance of the network in which the digital asset is created;
 - whether an Active Participant has a continuing managerial role regarding the network or the characteristics of the digital asset; and
 - whether purchasers reasonably expect the Active Participant to undertake efforts to promote its interests and enhance the value of the network or digital assets.

The core focus is whether an Active Participant provides essential managerial efforts that affect the success of the enterprise. As such, the less control the Active Participants have, the less likely the SEC is to find that the purchaser was relying on the efforts of others.

With respect to whether a digital asset purchaser has a reasonable expectation of profits, the Staff looked at:

- whether the digital asset gives the holder a share in the enterprise's income or profits;
- whether the digital asset is transferable (including whether it is or may be traded on a secondary market or platform);
- whether purchasers would reasonably expect that an Active Participant's efforts would result in capital appreciation;
- whether the digital asset was offered to any potential purchaser or more narrowly targeted only to users of the goods or services associated with the digital asset;
- correlation between the offering or purchase price and the price of the goods or services to be acquired in exchange for the digital asset;
- correlation between typical quantities of digital assets traded and the amount of underlying goods or services a typical consumer would purchase for use or consumption;
- whether proceeds from the offering exceed what may be needed to create and maintain the functional network for the digital asset;
- whether the Active Participant benefits from its efforts as a result of holding the same class of digital assets;
- whether the Active Participant continues to expend funds from the proceeds to enhance the functionality or value of the network or digital asset; and
- whether there are any other relevant elements of the marketing of the digital asset that support a profit intent.

The Staff also disclosed that it will consider other factors that inform the economic reality of the transactions, such as whether the network for the digital asset is functional at launch, whether the digital asset can be used immediately to transfer value to another holder, and whether the Active Participants promote secondary market trading of the digital asset are other factors in making the determination of whether a digital asset is a security. This Staff Guidance provides additional analytical details as to how the SEC will view token offerings and where key distinctions should be made in determining whether digital asset sales fall outside of the *Howey* Test analysis regarding the reasonable expectation of profits derived from the efforts of others, thus providing a clear indication that certain utility tokens can be issued without fear of making an unregistered distribution of securities.

Also on April 3, 2019, the SEC issued a No-Action Letter regarding TurnKey Jet, Inc. ("TurnKey") related to its digital asset offering. TurnKey is an interstate air charter service provider that plans to use digital tokens to facilitate air travel transactions. In the No-Action Letter, the Staff of the Division of Corporation Finance of the SEC said it would not recommend an enforcement action to the Commission if, in reliance on a token issuer's opinion as counsel that the tokens to be distributed were not securities, the token issuer offers and sells the tokens without registration under the Securities Act and the Exchange Act because (1) funds from the digital asset sales would not be used to develop TurnKey's blockchain platform, network, or app; (2) tokens would be immediately useable upon purchase; (3) tokens would only be tradeable in the TurnKey wallet and not across external platforms; (4) the token value would be maintained at one U.S. dollar and can only be resold to TurnKey at a discount to its face value; and (5) TurnKey's marketing material focuses on the functionality of the token rather than the token's potential increase in market value. Accordingly, this No-Action Letter gives helpful insight into when the Staff will not recommend enforcement action in connection with an unregistered digital asset sale.

For more information, please contact:

Michelle Ann Gitlitz
212.885.5068 | mgitlitz@blankrome.com

Grant E. Buerstetta
212.885.5454 | gbuerstetta@blankrome.com

Michael C. Lupton
212.885.5437 | mlupton@blankrome.com