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CLIENT ALERT

SEC Releases Statement on "Framework for 'Investment Contract' Analysis of Digital Assets" and Grants First No-Action Letter on Digital Assets

April 5, 2019

On Wednesday, April 3, 2019, the Securities and Exchange Commission's Strategic Hub for Innovation and Financial Technology, known as FinHub, published a "plain English" digital assets framework (the "Framework") to help participants in the space analyze whether a digital asset is offered and sold as an investment contract, and, therefore, is a "security" subject to U.S. federal securities laws and regulations.

Also on Wednesday, the SEC provided the first no-action relief involving the sale of digital assets in response to TurnKey Jet, Inc.'s no-action request.

Links to the relevant materials discussed in this Client Alert are available below.

Digital Assets Framework
Bill Hinman, Director of Division of Corporation Finance, and Valerie Szczepanik, Senior Advisor for Digital Assets and Innovation, stated that depending on the nature of the digital asset, "including what rights it purports to convey and how it is offered and sold, it may fall within the definition of a security under the U.S. federal securities laws."

The Framework provides a broad overview of elements that should be considered when analyzing whether the sale of a digital asset constitutes the sale of security, and addresses the three prongs of the well-known *Howey* test: (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profit to be derived from the efforts of others.

The Framework provides little guidance on the first two prongs—investment of money and common enterprise—stating only that the SEC "typically" has found both are satisfied when evaluating digital assets. Consistent with the SEC's August 2018 order in *In re Tomahawk Exploration LLC*, the Framework specifies (in a footnote) that "the lack of monetary consideration for digital assets, such as those distributed via a so-called 'air drop,' does not mean that the investment of money prong is not satisfied; therefore, an airdrop may constitute a sale or distribution of securities."

The SEC also clarified (again in a footnote) that, despite a robust body of securities law precedent from courts stating otherwise, it does not consider the "common enterprise" prong to be "a distinct element of the term 'investment contract.'"

The Framework—directed towards those "considering an Initial Coin Offering . . . or otherwise engaging in the offering, sale, or distribution of a digital asset"— provides practical, "real world" examples of when an investor has an "expectation of profit" or is "relying on efforts of others," the latter of which can be derived from the efforts of others can be from the promoters, issuers or other third parties. The examples

of the "efforts of others" offered in the Framework parallel certain examples enumerated by Director Hinman in his June 14, 2018 speech of when a network is "sufficiently decentralized," and thus, is no longer sufficient to establish that a digital asset is an "investment contract" subject to the securities laws.

Although not explicit, the Framework continued with the theme of "decentralization" that Director Hinman raised in June 2018. For example, the Framework notes that an investors' reliance on the efforts of others may arise when "essential tasks or responsibilities [are] performed and expected to be performed by [a promoter, issuer or other third party], rather than an unaffiliated, dispersed community of network users (commonly known as a 'decentralized' network)."

The Framework presents a view on additional elements to consider when analyzing whether a digital asset previously sold as a security should be reevaluated at the time of later offers and sales. Implied in the Framework is the notion that a digital asset that was once sold as a security could later be sold not as a security if there is no longer any reasonable expectation of profit or reliance on efforts of others.

No-Action Relief

After an eleven-month process, the SEC granted no-action relief to TurnKey Jet, Inc. ("TurnKey") in connection with TurnKey's sale of digital assets in the form of tokenized jet cards. That relief means that the SEC's staff will not recommend that the SEC take an enforcement action against TurnKey so long as it sells the tokens in a manner *entirely consistent* with the facts set forth the no-action request letter. Specifically, the SEC stated, "Any different facts or conditions [from those represented by TurnKey to the SEC regarding the digital asset sale] might require the Division to reach a different conclusion."

Facts highlighted by the SEC as being determinative in issuing the no action letter were, among others:

- TurnKey would not use any funds from the token sale to develop its platform, network or app;
- TurnKey's tokens will be "fully developed and operational" at the time the tokens are sold;
- TurnKey's tokens will *only* be transferred among TurnKey digital wallets—and will not be transferred to any external digital wallet; and
- TurnKey will market its tokens to emphasize the token's "functionality"—*not* the "potential for the increase in the market value" of the tokens.

The SEC's no action letter also emphasized that the SEC's position derived from the representations made by TurnKey's counsel regarding the facts relevant to TurnKey's token offering.

Both the Framework and the no action letter implicitly emphasize the importance of having skilled counsel who will work with the Commission on any token offering.

The Framework may be accessed at: https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets

Director Hinman's public statement on the Framework is available here: https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets

Director Hinman's June 14, 2018 speech is available here: https://www.sec.gov/news/speech/speech-hinman-061418.

The no-action request is available here: https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1-incoming.pdf

The SEC's response to the no-action request may be accessed at: https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm

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