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## Digital Assets as “Securities” Under Federal Law: A New Framework and an ICO No-Action Letter from the SEC

On April 3, 2019, the SEC published a “Framework for ‘Investment Contract’ Analysis of Digital Assets” (the “Framework”). On the same day, the SEC granted relief in a “no-action” letter to the issuer in an “initial coin offering” (“ICO”), TurnKey Jet, Inc. The Framework and the *TurnKey Jet* no-action letter provide additional guidance to companies in determining whether a digital asset, such as a “token” issued in an ICO, is a security for purposes of the U.S. federal securities laws.

The Framework focuses on the *Howey* definition of a security. The Securities Act of 1933 includes an “investment contract” in the definition of a security, but does not further define “investment contract”. The 1946 *Howey* case and later case law define an “investment contract” as the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. The Framework indicates that the first two “prongs” of *Howey* (investment of money in a common enterprise) are typically met by digital assets and focuses on the third prong: a reasonable expectation of profits to be derived from the efforts of others.

Various factors and characteristics of a digital asset are relevant in determining whether the “efforts of others” portion of the third prong of *Howey* is satisfied, including, among others:

- A promoter, sponsor or other third party (called an “Active Participant” or “AP” in the Framework) is responsible for the development, operation or promotion of the network, including causing the network or digital asset to achieve its intended functionality. This is likely to be the case where, as in many ICOs, the network and token are under development at the time of the ICO.
- The AP creates or supports a market for the digital asset.
- The AP has a continuing managerial role (e.g., compensating service providers, issuing additional tokens, deploying funds raised).
- The AP is expected to take steps to promote its own interests by enhancing the value of the network or digital asset, by, e.g., benefiting from the increased value of the token (which we would expect to be the case in nearly all ICOs).

The Framework also addresses in depth which factors should be considered in determining whether the “reasonable expectation of profits” part of *Howey*’s third prong is satisfied, including, among others:

- The digital asset gives the holder the right to share in the enterprise's income or profits or to realize gain from the capital appreciation of the digital asset (again, a factor we would expect to be present in all or nearly all ICOs).
- The digital asset is transferable or traded on a secondary market or platform, or the AP promises to create or support a trading market for the asset.
- The asset is offered in quantities and to a number of purchasers suggestive of investment intent rather than use of the functionality of the network.
- The AP raises more funds than are needed merely to establish a functional network or digital asset.
- The assets are marketed based on the future, not present, functionality of the network or digital asset.

The Framework introduces the concept of reevaluation of digital assets that may no longer be a *Howey* investment contract. For example, as to the “efforts of others” element, it may no longer be present if the digital asset network no longer depends on the essential managerial or entrepreneurial efforts of an AP. As to the “reasonable expectation of profits” element, reevaluation may be justified, if, for example, the development efforts of the AP are no longer a key factor in determining the value of the digital asset or if holders are able to use the digital asset for its intended functionality, such as acquiring goods or services on the network.

The Framework also tries to distinguish virtual currencies from securities. A virtual currency can be used to make payments in a wide variety of contexts or act as a substitute for real (or fiat) currency.

In the *TurnKey Jet* no-action letter, the SEC puts these concepts into practice, finding that the ICO does not require registration under the federal securities laws because:

- The platform, network and app are fully developed at the time of the sale of the tokens in the ICO;
- The tokens will be immediately usable for their intended functionality (the purchase of air charter services);
- Transfer of tokens is restricted;
- Tokens represent an obligation of TurnKey Jet to provide air charter services having a value equal to the purchase price of the token;
- Repurchases will be made at a discount to the face value;
- Marketing of the tokens will emphasize the functionality of the token, not the potential for an increase in value.

In summary, the Framework, as exemplified by *TurnKey Jet*, offers detailed guidance for companies in the digital asset space and their counsel as to how to avoid the characterization of a digital asset as a security for purposes of the federal securities laws. However, the potential exemptions are very narrow, and companies subject to the jurisdiction of the U.S. securities laws should seek advice from counsel before undertaking an ICO or other activities involving digital assets.

## Additional Information

If you have questions about the Framework, please contact your Kutak Rock attorney or one of the authors listed below. For more information regarding our practices, please visit us at [www.KutakRock.com](http://www.KutakRock.com).

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