ALERTS

SEC Publishes First-Ever No-Action Letter for a Cryptocurrency Enterprise and a Framework for when a Cryptocurrency Is a Security

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On April 3, the U.S. Securities and Exchange Commission published a framework aimed at assisting in determining whether a digital asset is a security (the "Framework").[1] Alongside the Framework, the SEC also published a no-action letter for TurnKey Jet, Inc., the first ever no-action letter for a digital asset enterprise.[2]

This is an important development for any parties interested in developing, selling or investing in digital assets, as it is the most robust analysis yet published on how the SEC sees these assets and finally provides concrete information on how to avoid an SEC enforcement action in an industry that has recently suffered from regulatory uncertainty. The Framework and the conditions the SEC notes in advising TurnKey that it will not recommend an enforcement action, however, lead to the conclusion that, in the eyes of the SEC, digital assets *cannot* be used to raise capital without implicating U.S. securities laws. Furthermore, many of the Framework's considerations go beyond the traditional test for determining whether an asset is a security. A thorough understanding of the SEC's position as reflected in these documents is essential for any party interested in dealing with digital assets.

Background

The question of whether a cryptocurrency is a security has a significant impact on the regulatory implications of dealing in digital assets or

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conducting an initial coin offering ("ICO"). The SEC has previously acknowledged that the sale of digital assets may not implicate U.S. securities laws and may be an efficient way to raise proceeds.[3] Nevertheless, prior to April 3, the SEC had provided only limited guidance as to how to sell an unregistered digital asset or conduct an ICO without risking an SEC enforcement action.

Before the Framework, the most robust SEC analysis of when a digital asset was a security was published in July 2017, when the SEC released a Report of Investigation on an offering of digital tokens by an entity called The DAO.[4] In this report, the SEC analyzed The DAO's digital tokens under the test established in *SEC v. Howey*, which holds that an asset is an investment contract, and therefore a security, when there is (1) an investment of money (2) in a common enterprise (3) with the reasonable expectation of profits derived from the efforts of others.[5] The SEC concluded that The DAO tokens were securities under the *Howey* test, noting that holders of The DAO's digital tokens had limited control over The DAO and stood to receive a share from the profits of The DAO's enterprises.[6]

For more than two years following the release of The DAO Report, the SEC largely only took action against digital asset ventures that it accused of actually defrauding purchasers, such as two ICOs that purported to be backed by real estate and diamonds.[7] In December 2017, however, the SEC began taking action against digital asset ventures that it did not allege attempted to mislead customers.[8] The SEC's expanded focus included digital asset ventures where the only apparent wrongdoing was failing to register their ICOs as security offerings, even where those ventures did not offer digital asset holders a share of the ventures' profits.[9] The cryptocurrency venture Paragon Coin Inc., represented by Schulte Roth & Zabel before the SEC's Enforcement Division, was the subject of one such action.[10] Paragon had to pay a civil money penalty but was given the opportunity to pursue registration of its digital assets as a class of securities, which appears, based on the Framework, to be the way of the future for many digital asset ventures.[11]

In the wake of the SEC actions targeting cryptocurrency ventures where the only wrongdoing was failing to register their digital assets, there was significant uncertainty in the digital asset industry as to how to design a digital asset that would not run afoul of the SEC's prohibition of the sale of unregistered securities. Many believe that this regulatory uncertainty has

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had a chilling effect on the digital asset industry.[12] The amount raised through ICOs, for instance, has dropped significantly in the past year.[13] Now, with its publication of the Framework, the SEC has attempted to address this uncertainty with the most robust presentation yet of its perspective as to when a digital asset is a security.

The Framework

As with The DAO Report, the Framework centers on the *Howey* test.[14] The SEC quickly disposes of the first two prongs of the test, stating that the sale of a digital asset typically is an investment of money in a common enterprise, so the majority of the Framework concerns when the sale of a digital asset satisfies the final *Howey* test element of a reasonable expectation of profits from the efforts of others.[15] The SEC lists a myriad of characteristics to consider in analyzing this element of the *Howey* test, with the Framework broken down into subsections on (1) reliance on the efforts of others, (2) reasonable expectation of profits and (3) other considerations.[16]

Some key takeaways from the "Reliance on the Efforts of Others" subsection are that the more important and involved the promoter, sponsor, or other third party (defined by the Framework as an "Active Participant") in the continuing success of the underlying venture, the greater the likelihood that the digital asset holder is relying on the efforts of others.[17] To reduce the chances that a digital asset holder will be relying on the efforts of others, tasks, responsibilities, and decision making should be performed by a decentralized network, not an Active Participant.[18] Where the Active Participant can profit from the appreciation of the digital asset, by distributing the digital asset to itself, or by owning the intellectual property affiliated with the digital asset, the Framework states that a digital asset purchaser would reasonably expect the Active Participant to be putting in effort to enhance the value of the digital asset or affiliated network.[19] Many of these specified considerations are beyond those typically considered when analyzing an asset under the *Howey* test. Regarding reevaluating digital assets previously sold as securities, the Framework states that it should be considered whether the Active Participant is still important to the digital asset's value, or whether the Active Participant no longer impacts the enterprise's success.[20]

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The Framework goes on to state in the "Reasonable Expectation of Profits" subsection that the expectation of profits is more reasonable where the digital asset is able to appreciate and is transferable through a secondary market, or is expected to be in the future. [21] The Framework further states that there is a more reasonable expectation of profits when the digital asset is offered to a wider swath of potential purchasers rather than those that are expected to actually use the asset's functionality, where the digital asset is offered or purchased in quantities larger or smaller than what a purchaser would reasonably need to take advantage of the asset's functionality, and where the Active Participant raised more funds than what may be needed to establish the digital asset or associated platform.[22] These listed considerations again suggest that the SEC's Framework goes beyond the traditional *Howey* analysis. Regarding reevaluating digital assets previously sold as securities, the Framework includes as considerations whether the Active Participant's involvement is still key, the stability of the digital asset value at a level correlated to the functionality offered, the trading volume of the digital asset, and whether the digital asset can be used for its intended functionality.[23]

The "Other Relevant Considerations" subsection distills much of the Framework and states that the chances of a digital asset being a security decrease when the digital asset and any affiliated platform are fully developed and operational, where holders of the digital asset can use it for its intended functionality immediately, where the digital asset's creation and structure focuses on user functionality rather than feeding value speculation, and where the prospects for the digital asset appreciating are limited.[24] Marketing of the digital asset should be consistent with these factors to minimize the chance that the digital asset is a security.[25]

The end of the Framework provides a concrete example where a digital asset would not constitute a security: In a pre-existing retail business, where the business markets a non-transferrable digital asset to its existing customer base, and that digital asset can be immediately used in that retail business upon receipt to purchase products at prices commensurate to the prices for those items in real currency, that digital asset would not be a security in the eyes of the SEC.[26] The retail venture in this example is substantially different from the vast majority of digital asset ventures. The example also emphasizes the Framework's position that, to help ensure a digital asset is not a security, the digital

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asset must be sold in the context of an already established and operational venture that has functional utility at the time of sale, not sold in the context of a capital raise so as to establish a venture offering utility in the future.

The Framework establishes that whether a venture is fully functional and able to provide utility is not just crucial in the analysis of digital assets going forward, but will also be central in the SEC's reevaluation of digital assets previously sold as securities.[27] It is important to note, however, that the Framework is not a formal set of rules or regulations, that the Commission has not approved its contents, and that it is not binding on the SEC.[28]

TurnKey No-Action Letter

In its first-ever no-action letter for a digital asset, issued in response to a letter by TurnKey, the SEC reiterates the key factors set forth in its Framework: To avoid a possible enforcement action, the platforms for using a digital asset should already be fully developed and operational prior to the digital asset being sold, and the digital asset should have immediate functionality on those platforms at the time of sale.[29]

TurnKey is a private aircraft charter service that has not yet launched a digital token but already operates multiple business jets and has had over 140 customers.[30] TurnKey's proposed token would allow holders to redeem those tokens for air charter services at an exchange rate of one token to one U.S. dollar, and the tokens would be fully backed by an equal amount of U.S. dollars in a U.S. escrow account.[31] Furthermore, TurnKey can only repurchase the tokens for less than one U.S. dollar, and token purchasers would have to agree that they are not acquiring the tokens to resell or distribute them.[32] TurnKey agents and employees will furthermore not mention profits or investment opportunities when selling its tokens.[33] The SEC found the pre-existing nature of TurnKey's business as well as the aspects of TurnKey's plan that would prevent the TurnKey token from being used or perceived as a profit vehicle, particularly noteworthy in deciding that it would not recommend an enforcement action if TurnKey carried out its token sales plan.[34]

The TurnKey No-Action Letter does not address whether TurnKey would be subject to other regulatory regimes for engaging in the described activity, such as federal anti-money laundering ("AML") regulations

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administered by the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") or state money transmitter laws. Under FinCEN guidance, administrators and exchangers of convertible virtual currency are money transmitters and are subject to federal AML regulations such as the requirement to maintain a written AML program and file suspicious activity reports with FinCEN.[35] Additionally, depending on how the service is structured, and the particular facts and circumstances, state money transmission laws may be implicated,[36] or the business could be engaged in federally regulated activity as a "provider" or "seller" of prepaid access.[37]

Many of the digital assets that have already been developed and sold through ICOs also raise additional complications not presented by TurnKey, and it remains unclear whether the structure proposed by TurnKey would even be viable for the majority of cryptocurrency enterprises. Even with TurnKey appearing to be relatively straightforward in satisfying the SEC's Framework, securing this no-action letter took substantial time and effort on the part of TurnKey, with TurnKey's attorney reporting that the process took over 10 months and required an estimated 50 phone calls between counsel and the SEC.[38]

Implications

The Framework finally provides clear guidance on how to design and distribute a digital asset that does not implicate securities laws in the view of the SEC. However, following the guidance essentially prohibits such digital assets from being sold for the purposes of raising capital to fund the development of new ventures or future functionality, the typical reasons that ICOs were conducted in the digital asset industry. To lower the likelihood that the SEC will conclude that a digital asset is a security, the digital asset venture must already be up and running before any digital asset sale. This is without even addressing the large number of other characteristics listed in the Framework that a digital asset venture would have to consider and adhere to so as to minimize the chance that the SEC will consider the asset a security, many of which go beyond the *Howey* test.

What is left, then, when the SEC's Framework is adhered to? TurnKey and the retail business example provided in the SEC's Framework have digital assets operating with close similarities to fiat currency, though with even more restrictions in some respects. These additional restrictions may well

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dissuade some businesses from exploring the creation of digital assets. The Framework has thus provided certainty in the digital asset industry, but it remains to be seen if its publication will thaw the chill that the industry is currently suffering. It also remains to be seen whether courts will agree with the analysis proposed by the SEC's Framework and endorse the considerations it lists, or if the courts will have a different view of when a digital asset is not a security.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *Framework for 'Investment Contract' Analysis of Digital Assets*, U.S. Securities and Exchange Commission (April 3, 2019), *available here*.

[2] TurnKey Jet, Inc., SEC No-Action Letter (April 3, 2019), *available here*.

[3] Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, U.S. Securities and Exchange Commission (Dec. 11, 2017), *available here*.

[4] *See 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*.

[5] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

[6] *Id.*

[7] *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds*, U.S. Securities and Exchange Commission (Sept. 29, 2017), *available here*.

[8] Press Release, *Company Halts ICO After SEC Raises Registration Concerns*, U.S. Securities and Exchange Commission (Dec. 11, 2017), *available here*.

[9] *See In the Matter of Munchee Inc.*, File No. 3-18304 (Dec. 11, 2017).

[10] *See* Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities, U.S. Securities and Exchange Commission (Nov. 16, 2018), *available here*.

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[11] *See* Press Release, *Paragon Reaches Settlement with the U.S. Securities and Exchange Commission*, Paragon Coin Inc. (Nov. 16, 2018), *available here*.

[12] *See* Mike Orcutt, *Blockchain boosters warn that regulatory uncertainty is harming innovation*, The Technology Review (March 8, 2019), *available here*.

[13] *See* Paul Vigna, Raising Money in the Crypto World Has Gotten a Lot Harder, The Wall Street Journal (March 31, 2019), *available here*.

[14] *Framework for 'Investment Contract' Analysis of Digital Assets*, U.S. Securities and Exchange Commission (April 3, 2019), *available here*.

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] Bill Hinman and Valerie Szczepanik, *Statement on "Framework for 'Investment Contract' Analysis of Digital Assets,"* U.S. Securities and Exchange Commission (April 3, 2019), *available here*.

[29] TurnKey Jet, Inc., SEC No-Action Letter (April 3, 2019).

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[30] *See* Letter from James P. Curry to the Division of Corporate Finance (April 2, 2019), *available here*.

[31] *Id*.

[32] *Id*.

[33] *Id*.

[34] TurnKey Jet, Inc., SEC No-Action Letter (April 3, 2019).

[35] FIN-2013-G001, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (March 18, 2013), *available here*.

[36] *See,* e.g., Texas Supervisory Memorandum 1037, Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act (Jan. 2, 2019), *available here*.

[37] 31 C.F.R. §§ 1010.100(ff)(4) and (7).

[38] Brady Dale, *SEC's First Crypto 'No Action' Letter Took 11 Months to Secure*, Coindesk (April 3, 2019) *available here*.

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