

# SEC Framework and No-Action Letter Provide Guidance on Analyzing Whether a Digital Asset is a Security

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After much speculation and anticipation, on April 3, 2019, the U.S. Securities and Exchange Commission (the “SEC”) released a “Framework for ‘Investment Contract’ Analysis of Digital Assets,”<sup>1</sup> (the “Framework”) to assist market participants in analyzing whether a digital asset is a security. Along with the release of the Framework, the SEC also released its first no-action letter publicly agreeing with the view that the digital asset described therein is not a security.<sup>2</sup>

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While the SEC has made known its views on digital assets such as cryptocurrencies, blockchain tokens and initial coin offerings (“ICOs”) in the past through enforcement actions, published reports and speeches by both Chair Clayton and Division of Corporation Finance Director Hinman, the Framework attempts to provide a straightforward overview of the SEC’s analysis when considering whether a digital asset is a security and thus subject to SEC regulation. Unsurprisingly, the Framework largely walks through the *Howey* factors for identifying an investment contract (and thus a security) set forth as “the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.”<sup>3</sup> The full text of the Framework can be found [here](#).

Although a welcome step by the SEC to continue to clarify its position on digital assets, the Framework largely reiterates what market participants already understood to be the relevant factors for determining whether a digital asset is a security and continues to leave questions unanswered. Of note, while the analysis applies to the question of whether an asset is a security under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, the Framework does not appear to directly address questions that have been an issue for registered investment companies and registered

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<sup>1</sup> SEC, “Framework for ‘Investment Contract’ Analysis of Digital Assets” (Apr. 3, 2019), available at [https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#\\_edn1](https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn1).

<sup>2</sup> TurnKey Jet, Inc., SEC No-Action Letter, 2019 WL 1471132 (Apr. 3, 2019).

<sup>3</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (“*Howey*”).

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investment advisers seeking to invest in digital assets, including how digital assets may be maintained under appropriate custody arrangements.<sup>4</sup>

## THE FRAMEWORK

Very little of the Framework is devoted to a review of the “investment of money” or “common enterprise” prongs of *Howey* as the SEC states that these factors will be satisfied in nearly all cases. Instead, the Framework is largely focused on the “efforts of others” and “reasonable expectation of profits” prongs.

### **Howey: The Efforts of Others Prong**

When looking at the efforts of others prong of *Howey*, the Framework focuses on two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an “Active Participant” (“AP”)? The Framework broadly defines an AP as “a promoter, sponsor, or other third party [that] provides essential managerial efforts” to a project or enterprise.
- Do these essential managerial efforts affect the failure or success of the enterprise, as opposed to efforts that are more ministerial in nature?

The Framework lays out a series of factors intended to help determine the extent to which a purchaser of a digital asset is relying on an AP’s efforts. Importantly, these factors include whether:

- the digital asset or network is still in development and whether the network is sufficiently decentralized such that essential tasks or responsibilities still remain with an AP;
- the AP controls the creation or issuance of the digital assets or takes actions to support liquidity and/or a market price, and a purchaser would expect the AP to promote its own interests and enhance the value of the network or digital asset; and
- the AP has a central role in deciding governance or other key aspects of the digital asset or has a continuing managerial role with respect to the relevant platform or network.

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<sup>4</sup> See [Engaging on Non-DVP Custodial Practices and Digital Assets](#), March 12, 2019; Staff Letter: Engaging on Non-DVP Custodial Practices and Digital Assets, March 12, 2019.

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**Howey: The Reasonable Expectation of Profits Prong**

Similar to the “efforts of others” prong of *Howey*, the Framework lays out key factors intended to help determine whether investors in a digital asset have a “reasonable expectation of profits,” including:

- the potential for actual financial returns, such as the asset holders having a direct interest in the enterprise’s income or profits or the AP’s benefitting from holding the same class of assets as are sold;
- marketability of the asset, such as where there is, or there is expected to develop, a secondary market for the digital asset, and marketing efforts by the AP, such as where the digital asset is offered to a broad audience (rather than targeted at potential users of the related platform) and/or marketed as likely to appreciate in value; and
- evidence of purchaser expectations of profitability, including where the purchase price does not correlate with the market price of the goods or services that can be acquired using the digital asset; where quantities purchased are too many (or too few) to make use of the asset in the manner that would be expected of a typical consumer; or where the funds raised are in excess of those necessary for establishing a functioning network or platform.

The Framework states that in evaluating both sets of factors, one must take into consideration the economic realities of the transaction and evaluate if the digital asset serves primarily a consumptive rather than investment purpose but notes that price appreciation arising solely from external market forces is not “profit” under *Howey*.

**When Is a Security No Longer a Security?**

Significantly, in its discussion of both of the above *Howey* prongs, the Framework also makes clear that a digital asset can shed its “security” tag over time and discusses factors to be considered when reevaluating if a digital asset that was a security when initially issued or sold may no longer be a security. The factors relevant to such an evaluation are largely the same as those that apply to the initial evaluation of whether a digital asset is a security at creation, with the SEC observing whether the factors are still relevant given the passage of time and evolution of the platform, or have shifted so significantly that the protections of the U.S. federal securities laws need no longer apply.

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## THE TKJ NO-ACTION LETTER

Along with its new Framework, the SEC published a first-of-its-kind no-action letter based on the guidelines of the Framework, in which the SEC confirmed that it would not recommend enforcement against TurnKey Jet, Inc. (“TKJ”) as a result of its proposed token issuance and TKJ’s view that its tokens are not securities. TKJ, an air charter service provider, plans to develop a token platform on which tokens will be issued and sold for the purpose of using such tokens to pay for air charter services.

In concurring with TKJ in its view that the TKJ tokens are not securities, the SEC emphasized the following facts, which track to many of the factors emphasized under the Framework:

- TKJ will not use any funds from token sales to develop the underlying TKJ platform, network or app, each of which will be fully developed and operational at the time any tokens are sold.
- The tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold.
- TKJ will restrict transfers of tokens to so-called “TKJ Wallets” only and not to wallets external to the platform.
- TKJ will sell tokens at a price of one USD per token throughout the life of the token program, and each token will represent a TKJ obligation to supply air charter services at a value of one USD per token.
- If TKJ offers to repurchase tokens, it will only do so at a discount to the face value of the tokens (one USD per token) that the holder seeks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the tokens.
- The token is marketed in a manner that emphasizes the functionality of the token and not the potential for the increase in the market value of the token.

As a general matter, no-action letters are applicable only to the recipients and are not binding on courts. Given the very particular set of facts behind the TKJ tokens, it will be interesting to see the extent to which this no-action letter will be followed or expanded by future token sale fact patterns.

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## CONCLUSION & OPEN QUESTIONS

While largely reiterating prior guidance, the Framework provides a helpful overview of the SEC's views on when a digital asset is a security and how to properly analyze the prongs of *Howey* with respect to digital assets. Notably, the Framework facilitates the ability to reevaluate whether an asset that was a security when initially issued or sold may no longer be a security.

The Framework also leaves certain important questions unanswered, including, for example, whether digital assets distributed by means of a so-called "Airdrop"<sup>5</sup> are securities under the Framework, and the extent to which the Framework is meant to interact with digital assets that were issued or otherwise operate on platforms that are primarily overseas. We look forward to hearing more from the SEC on these and other open questions relevant to digital assets. Pending further guidance, market participants should expect the SEC to reference the Framework in future enforcement actions and all potential token issuers should carefully evaluate a proposed issuance against the Framework beforehand.

As with all guidance of this type, the SEC notes that the factors identified in the Framework are not intended to be exhaustive in evaluating whether a digital asset is a security. Further, no single factor is determinative, and the SEC leaves us with the expectation that the analysis of digital assets will continue to evolve over time.

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Please do not hesitate to contact us with any questions.

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<sup>5</sup> An "Airdrop" is commonly known as a process by which digital assets relating to a blockchain network are provided, without consideration, to holders of an unrelated existing digital asset or participants on an existing network or platform. Generally, an Airdrop functions as a free giveaway of a digital asset as a one-time incentive for participants to use the digital asset on a new platform.



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