



## SEC provides further guidance on when digital assets may be deemed securities

By Daniel McAvoy and Brian Becker

On June 14, 2018, William Hinman, Director of the Securities and Exchange Commission's (SEC's) Division of Corporation Finance, provided important but nonbinding guidance on when a digital asset may be deemed a security in his remarks at the Yahoo Finance All Markets Summit in San Francisco, California. Slowly, the SEC has continued to reveal its views on the approaches taken by some crypto and digital asset industry participants—such as the pioneers of the Simple Agreement for Future Tokens (or SAFT), who have attempted to structure digital asset sales in such a way that the digital asset is not a security. As noted by Director Hinman in his remarks, these are still the “early days” of crypto, but with this latest guidance, the SEC has provided more clarity around securities law-compliant digital asset sales. The following is a summary of certain key takeaways from Director Hinman’s remarks and related analysis.

### ***Digital assets that represent a set of rights giving the holder a financial interest in an enterprise are unlikely to fall outside the purview of U.S. securities laws.***

- Referring to the digital asset as a “coin” or “token” will not impact the analysis regarding whether the digital asset is a security. This will be true even if the underlying code or a patent refers to the asset as a currency or presale. The economic substance of the transaction and the asset will guide the legal analysis.
- Although a digital asset may begin its life as a security, it may change its character over time.
  - For instance, a cryptocurrency that starts its life as a currency could subsequently become a commodity. Director Hinman’s remarks still leave unanswered the question of whether a digital asset can be both a security and a commodity at the same time (and thus subject to both SEC and CFTC regulation), as seen with certain hybrid swaps.
  - A digital asset that is initially offered in a securities offering and is no longer connected to an investment in a central enterprise, or is later sold only to be used to purchase a good or service available through the digital asset’s network will likely no longer be considered a digital asset.

***The following factual circumstances surrounding the sale or offering of a digital asset will be important to the analysis under the Howey test regarding whether the digital asset is a security:***

- **Passivity of purchasers.** When purchasers are passive in nature and rely on the efforts of others to increase the value of the purchased digital asset, it is more likely to be a security.
- **Marketing efforts.** Where a wide array of purchasers are solicited irrespective of whether they will in fact use the digital asset being sold for its intended purpose and, instead, are solicited with the proposition of future profit, the digital asset is more likely to be a security.
- **Network maturity.** If a digital asset is being sold at a time when the digital asset's network is largely undeveloped and the offering of the digital asset more closely resembles a bet on the success of the enterprise through the efforts of others than the purchase of something used to exchange for goods or services, the digital asset is more likely to be a security.
- **Network decentralization.** When a digital asset's network becomes sufficiently decentralized (i.e., purchasers of the digital asset would not reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts), the digital asset is less likely to be a security.

***Central to determining whether a digital asset is a security is how the digital asset is being sold and what the purchaser expects when making the decision to purchase the digital asset.***

- While an asset may not be a security under certain circumstances, under different circumstances the same asset may be a security. When a digital asset is sold as part of an investment to non-users for the purpose of developing an enterprise by a person or coordinated group (including "any unincorporated organization") working actively to develop or guide the development of the digital asset's network, the digital asset is almost certainly a security.
- In line with the "Howey" test, any asset, including a digital asset, may be a security if the purchaser is reasonably expecting profits from the managerial efforts of others.

***Generally, the initial funding of a blockchain-based enterprise should be conducted through a more conventional registered or exempt securities offering. Once the digital asset's network has been developed, the digital asset may be sold to those who will use the functionality of the digital asset and its network, although other SEC guidance presents conflicting views.***

- It would be possible that the security-like characteristics of the asset may fade over time such that it is no longer a security at some point in the future.
- It appears that a token is less likely to be viewed as a security if the purchasers are not making an investment in the development of the enterprise.

***Bitcoin and Ether are sufficiently decentralized such that no central third party exists whose efforts are key determining factors in the enterprise, and therefore, the sale and resale of Bitcoin and Ether are not securities transactions.***

- Digital assets that may not otherwise meet the qualifications of a security may be packaged and sold as an investment strategy that can be a security. For example, if Bitcoin were placed in a fund or trust and interests in the fund or trust were sold, the interests would be a security even though the asset in the fund or trust is not.

- A factor in determining whether a cryptocurrency might be a security is whether applying the disclosure regime of federal securities laws would add value to investors.
- While not explicitly stated, it seems that a digital asset that is mined would be less likely to be treated as a security than one that is sold.

***The following factors will be considered, on a non-exclusive basis, in determining whether a digital asset is a security:***

- Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
- Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value of the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
- Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
- Are purchasers “investing”—that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
- Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
- Do persons or entities other than the promoter exercise governance rights or meaningful influence?

***The following features should be considered, on a non-exclusive basis, when attempting to structure digital assets so they function more like a consumer item and less like a security:***

- Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
- Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
- Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
- Are the tokens distributed in ways to meet users’ needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser’s expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as

having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?

- Is the asset marketed and distributed to potential users or the general public?
- Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
- Is the application fully functioning or in early stages of development?

Generally, this is a fairly major step in the SEC's regulation of virtual assets. The SEC has recently made a point of being more transparent than under prior administrations, but this is the closest to transparency we have seen with respect to virtual assets. Of course, there are still many questions left to be answered, and the general frameworks that have been offered mean that almost any virtual asset that isn't a mined asset used purely as general currency falls into the gray area. Still, after Chairman Clayton has stated that the SEC does not intend to adjust U.S. securities laws to better fit virtual asset structures, it is a very positive step that there is real guidance that might help limit securities laws' recent chilling effect on token offerings and blockchain innovation in the U.S. markets.

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