SULLIVAN & CROMWELL LLP

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Digital Assets as Securities

SEC Corporation Finance Director Lays Out the Staff's Analysis in Assessing Whether Digital Assets Constitute Securities

SUMMARY

On June 14, William Hinman, Director of the Division of Corporation Finance of the SEC, delivered a speech at the Yahoo Finance All Markets Summit in San Francisco, in which he laid out the analysis applied by the SEC staff in assessing whether a digital asset constitutes a security. The speech, which has been published on the SEC's website,[1] provides two sets of non-exhaustive factors (discussed below) to use in assessing the status of a given asset as a security. However, the speech emphasizes that the SEC will continue to focus on the economic substance of transactions to determine when the securities laws are applicable, and where those transactions involve raising capital from investors to fund a venture, the securities laws generally will apply.

Without addressing any other digital asset specifically, Hinman separately confirmed that current offers and sales of ether and bitcoin are not securities transactions. In reaching this conclusion, Hinman focused on the operational and decentralized nature of the underlying networks on which these two digital assets exist.

The Securities and Exchange Commission (the "SEC") has been following and monitoring the development of initial coin offerings ("ICOs") and digital assets closely, giving particular attention to the issue of whether digital assets are securities under the U.S. federal securities laws.[2] To further this effort, Valerie A. Szczepanik was appointed earlier this month to serve as Associate Director of the Division of Corporation Finance and Senior Advisor for Digital Assets and Innovation for Mr. Hinman, as director of the Division.[3]

Hinman's speech at the Yahoo Finance All Markets Summit included observations and comments on the nature of digital assets and digital asset transactions generally, mirroring prior SEC statements that have suggested that a digital asset may, in certain circumstances, not be viewed as a security.[4] Hinman began by stating that the analysis should "focus not on the digital asset itself, but on the circumstances surrounding the digital asset and the manner in which it is sold."

Hinman emphasized several core principles to keep in mind when assessing whether a particular digital asset transaction implicates the securities laws, in each case focusing on the analysis in *Howey*[5]—specifically, whether the value received for the digital asset is invested in a common enterprise with an expectation of profit derived from the efforts of others. Acknowledging that, in many cases, the digital asset itself may not be a security, Hinman noted that when the asset is sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others, the sale involves an investment contract within the meaning of *Howey*. When the network on which the digital asset functions becomes sufficiently decentralized that this expectation no longer exists, the same asset may no longer be treated as a security. Citing the *Gary Plastic*[6] case, as well as *Howey*, as examples, Hinman noted that even an instrument that is not itself a security may become subject to securities regulations depending on how and why it is sold.

Applying this conceptual framework to bitcoin and ether, two of the most prominent virtual currencies in current use, Hinman observed:

> [W]hen I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value. And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.[7]

Hinman provided two sets of factors to consider in assessing whether a digital asset transaction will be subject to the securities laws. In previewing the factors, Hinman noted that the primary issue is "whether a third party . . . drives the expectation of a return" and whether the digital asset functions "more like a consumer item and less like a security." The factors he proposed to assess these two tests are set forth in full in an appendix to this memorandum.

Hinman's remarks concluded by encouraging promoters of digital assets and their counsel to engage in dialogue with the SEC, noting that the Division of Corporation Finance stands prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use.[8] In addition, the speech noted that other divisions at the SEC will guide market participants through other related issues, including those relating to broker-dealers, exchanges, market manipulation, custody and valuation.

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ENDNOTES

1 William Hinman, Dir., SEC Div. of Corp. Fin., Remarks at the Yahoo Finance All Markets Summit: Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018) (the "Speech"), available at https://www.sec.gov/news/speech/speech-hinman-061418.

2 The SEC's "The DAO Report" of July 2017 announced the SEC's view that many tokens are securities but unregistered. In a subsequent enforcement action, the SEC found the mobile phone application developer Munchee, Inc. in violation of securities laws for offering and selling digital tokens which were unregistered securities. For a discussion of the SEC's prior statements and enforcement actions concerning ICOs and tokens, see our memorandum to clients, "Company Halts 'Initial Coin Offering' After SEC Issues Cease-and-Desist Order; SEC Chairman Issues Statement on Blockchain-Based Offerings" (Dec. 13, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Company_Halts_Initial_Coin_Offering_After_SEC_Issues_Cease_and_Desist_Order.pdf.

3 Press Release, SEC, SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation (June 4, 2018), available at https://www.sec.gov/news/press-release/2018-102.

4 For example, using an example of a laundry token, SEC Chairman Clayton has previously remarked that the use of a token can lead it to evolve toward or away from a security, saying that "[j]ust because it's a security today doesn't mean it'll be a security tomorrow, and vice-versa." Nikhilesh De & Mahishan Gnanaseharan, *SEC Chief Touts Benefits of Crypto Regulation*, Coindesk (Apr. 5, 2018), https://www.coindesk.com/sec-chief-not-icos-bad/. To use another example from Chairman Clayton, in December 2017 he indicated his view that a token used to participate in an up and running book-of-the-month club is not a security but that an interest in a "publishing house with the authors, books and distribution networks all to come" is more likely a security. *See* Jay Clayton, Chairman, SEC, Statement on Cryptocurrencies and Initial Public Offerings (Dec. 11, 2017), available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

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

6 *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985).

7 *See* the Speech, *supra* note 1 (footnote omitted).

8 Hinman called out the offering structure Simple Agreement for Future Tokens, or "SAFT", specifically. He warned against applying the opinion expressed in the remarks to a hypothetical SAFT in the abstract. Instead, Hinman encouraged people with questions on a particular SAFT to consult with securities counsel or the SEC directly. The Speech, *supra* note 1, n.15.

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APPENDIX

FACTORS TO ASSESS WHETHER A DIGITAL ASSET TRANSACTION IS A SECURITIES TRANSACTION

Non-exhaustive list of factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security, focusing on the primary consideration of whether a third party drives the expectation of a return

In the speech, Hinman identifies a non-exhaustive list of factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security, focusing on the primary consideration of whether a third party—a person, entity or coordinated group of actors—drives the expectation of a return on the digital asset, which includes:

1. 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?
2. 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 in 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?
3. 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?
4. 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?
5. 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?
6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

Non-exhaustive list of contractual or technical ways to structure digital assets so that they function more like a consumer item and less like a security

Hinman also provides a non-exhaustive list of contractual or technical ways to structure digital assets so that they function more like a consumer item and less like a security, here focusing in large part on the economic substance of the transaction and the relationship between the stated functionality of a digital asset and the actual design, governance, distribution and use of the network and digital asset in question. The factors are:

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?

2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?

3. 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?

4. 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?

5. Is the asset marketed and distributed to potential users or the general public?

6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?

7. Is the application fully functioning or in early stages of development?