

SEC Clarifies How to Tell When a Token is a Security – A New Framework

WRITTEN BY

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On April 3, 2019, the Securities and Exchange Commission’s Division of Corporation Finance (the “SEC”) issued a Statement^[1] with a “Framework for ‘Investment Contract’ Analysis of Digital Assets” (the “Framework”) for the application of U.S. federal securities laws to blockchain and distributed ledger technologies.^[2] The SEC also issued a no-action letter indicating that the digital asset described in the request will not be considered a security and may be offered and sold without registration under the U.S. federal securities laws.^[3] While the Framework itself is not a formal rule, it represents the first significant attempt by the SEC to outline its current approach to determining whether a digital asset is a security and goes beyond its prior statements that the *Howey* test for investment contracts should be applied to sales or offerings of digital tokens, coins, or other assets.

In the Framework, the SEC reiterates that a digital asset is an investment contract “when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.” It goes on to observe that for most sales or offerings of digital assets, the investment of money and common enterprise prongs of the *Howey* test are almost always met.

As expected, the “reasonable expectation of profits derived from the efforts of others” is the central focus of the SEC’s analysis described in the Framework. The Framework indicates that the SEC will generally find a “reliance on the efforts of others” if the blockchain has any feature that is centrally controlled by the entity offering or selling the digital asset (or by a group of third parties affiliated with that entity). Only actual distributed or decentralized ledgers will not be considered to rely on the efforts of others.

Regarding expectation of profits, the SEC states that either distributions or gain on the sale of the digital asset in a secondary market are sufficient to meet this criteria; however, it mentions that price appreciation “resulting *solely* from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered ‘profit’ under the *Howey* test.”

Companies that issue digital assets should be cognizant of the Framework to ensure that the digital assets do not trip any of the securities laws.

[1] Announcement is available at <https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets>

[2] The Framework can be viewed at <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>

[3] A copy of the *TurnKey Jet, Inc.* No-Action Letter can be found at:
<https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm>

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