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BLOG

FinHUB's Framework for Analyzing Digital Assets: The Only Certainty it Provides is Uncertainty

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On April 3, 2019, the Securities and Exchange Commission's (SEC) Strategic Hub for Innovation and Financial Technology, known as FinHUB, published a "Framework for 'Investment Contract' Analysis of Digital Assets" (Framework), accompanied by a Statement on the Framework by William Hinman, the Director of the SEC's Division of Corporation Finance, and Valerie Szczepanik, the SEC's Senior Advisor for Digital Assets and Innovation.

On the same day, the staff of the SEC's Division of Corporation Finance issued a "no action" letter to TurnKey Jet, Inc. (TKJ), in which it gave assurance to TKJ that it would not recommend that the SEC take any enforcement action against TKJ if TKJ should offer and sell certain utility tokens without registration of such offers and sales under the Securities Act of 1933 and the Securities Exchange Act of 1934. We analyzed that "no action" letter in our blog post dated April 5, 2019.

The laudable purpose of the Framework is to provide "any analytical tool to help market participants assess whether the federal securities law applies to the offer, sale, or resale of a particular digital asset." The Framework summarizes and organizes in a single document various actions taken by the SEC, and various statements made by members of the SEC staff, relating to the status of digital or virtual assets as securities under the federal securities laws, and includes some additional factors to take into consideration when determining whether an instrument that is a "security" at the time of issuance can later morph into a non-security. The Framework contains over 60 factors, spanning approximately nine pages of text, for market participants to ponder.

The Framework can be said to provide certainty to market participants in the sense that it unequivocally embraces the SEC's prior stance[i] that it is necessary to apply the so-called *Howey* test[ii] to a digital or virtual asset, on a case-by-case basis, to determine whether the asset is a security. So, that much is certain.

The problem with this type of "certainty" is that it inevitably leads to uncertainty. Despite whatever guidance the SEC staff may provide on the application of the *Howey* test to digital assets as a general class, that test by its very nature involves an intensive "facts and circumstances" analysis—an analysis that must be applied on a case-by-case basis to every digital asset. And, far from simplifying the application of the *Howey* test to digital assets, the Framework piles on additional, complicated factors that market participants must consider when applying the test.

Further, even if a market participant undertakes a *Howey* analysis in good faith and concludes that a particular digital asset is not a security, that analysis is not binding on and can be readily "second-guessed" by the SEC or a court.

Indeed, quite apart from the validity of whatever conclusion may be reached after analyzing a particular financial instrument in light of the factors set forth in the Framework, the SEC staff cautions that the Framework itself is not binding on the SEC: "This framework represents the views of [FinHUB]… It is not a rule, regulation, or statement of the Commission, and the Commission has neither approved nor disapproved its content."

As SEC Commissioner Hester Pierce explained in a speech delivered on February 8, 2019, to the University of Missouri Law School, the *Howey* test is quite complicated to apply in practice and hardly lends itself to the type of legal certainty that crypto entrepreneurs need to move forward with their projects:

> "The Supreme Court in *Howey* embraced a 'flexible rather than static principle, one that is capable of adaptation'…an unwelcome phrase for people craving clarity. The subsequent application of the Supreme Court's decision has further added to the ambiguity by diluting factors, such as the prong that asks whether the investors were anticipating 'profits to come solely from the efforts of others.'… 'Solely' has gotten dropped in the application of this prong. In the years since *Howey*, many courts have instead focused on whether profits are derived in effect *principally* from the efforts of others. This approach has been formulated by one appellate court as a question of whether 'the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.'…More to the point, the Commission itself determined in 2017 that tokens issued by the DAO, a decentralized organization based on a distributed ledger, were securities despite the fact that token-holders had certain roles within the organization necessary to its operation…"

While acknowledging that applying the *Howey* test in the crypto space "seems generally to make sense," Pierce believes that "we need to tread carefully," in large part because "[t]oken offerings do not always map perfectly onto traditional securities offerings." Accordingly, "it is important for the Commission, in conjunction with Congress and its fellow regulators, to offer something more concrete and carefully considered."[iii] I suspect that Commissioner Pierce would not conclude that the Framework has offered something "concrete."

Still, as even Commissioner Pierce concedes, it is difficult to criticize the SEC's invocation of the *Howey* test in relation to matters crypto. At present, *Howey* appears to be the settled law on this score. At the same time, although she stopped short of calling for an entirely new (non-*Howey*) paradigm for regulating the offer and sale of crypto-assets, Pierce notes that some critics have argued that whether initial coin offerings can fit within the definition of a "securities" offering does not answer the question of whether that is how we should regulate them.[iv] Further, there are those (including members of Congress)[v] who intuitively suspect that there is something different about crypto assets when compared to run-of-the-mill investment contracts and that this difference calls for a new analytical paradigm for determining whether they are securities for purposes of the federal securities laws. These critics of *Howey* can be expected, sooner or later, to unveil an intellectual and legal framework that justifies jettisoning the *Howey* test from the crypto-sphere. Then the SEC will be faced with a decision: will it rise to the challenge of promoting innovation in the financial markets (as it claims it wishes to do) based on a new analytical approach, or will it continue to invoke the *Howey* test, in talismanic fashion, as the be-all and end-all for determining whether or not crypto assets are securities?

[i]*See*, Statement on Digital Asset Securities Issuance and Trading (SEC Divisions of Corporation Finance, Investment Management and Trading and Markets) (November 16, 2018).

[ii]Under the "*Howey* test" (named after a U.S. Supreme Court case – *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)), a financial instrument such as a crypto asset will be considered an "investment contract," and therefore a "security," where there is an investment of money in a common enterprise with an expectation of profit derived from the managerial or entrepreneurial efforts of others.

As a matter of fact, the *Howey* held that an "investment contract" means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits *solely* from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." 328 U.S. at 299-300. [emphasis added]. Subsequent case law, however, has tended to ignore the word "solely," with courts differing on the scope or degree to which investors must rely on the efforts of others in order for there to be a finding that a particular “contract, transaction or scheme” constitutes an “investment contract” and therefore a “security.” The resulting elasticity of the “*Howey* test” has proven to be a powerful tool in the hands of regulators and plaintiffs.

[iii]On the other hand, Piece believes that “[a]mbiguity is not all bad…We might be able to draw clearer lines once we see more blockchain projects mature. Delay in drawing clear lines may actually allow more freedom for the technology to come into its own.” Presumably, given the overall tenor of her remarks, the type of ambiguity Piece has in mind here is not the type of ambiguity arising from a rote application of the *Howey* test.

[iv]Pierce notes that the authors of a forthcoming article in the Columbia Law Review argue that initial coin offerings have certain features that make the traditional regulatory framework applied to initial public offerings of securities “inappropriate.”

[v]*US Legislators Reintroduce Token Taxonomy Act to Exclude Crypto From Securities Laws,* Cointelegraph (April 10, 2019).
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