

Is an initial coin offering a sale of securities?



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Following industry-wide speculation and posturing, the Securities and Exchange Commission (SEC) has released its “[Framework for ‘Investment Contract’ Analysis of Digital Assets](#),” which the SEC will use to determine if an initial coin offering (ICO) constitutes a securities offering. Though the SEC declined to establish a specific test applicable to every ICOs, the framework contains a lengthy list of factors to consider when making this determination. Ultimately, the SEC left open the possibility of offering a non-security ICO, and the factors listed in the framework will help future ICO offerees navigate the complex securitization determination.

When considering the framework and its component, it is important to acknowledge that the framework has not fundamentally altered the SEC’s approach; the framework still relies on the “investment contract” test outlined in *SEC v. Howey*, i.e., the traditional method employed by the SEC in determining whether a security exists.

Under *Howey*, an “investment contract” (i.e., security) exists if there is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. The framework clearly establishes that the vast majority of ICOs satisfy the first two prongs of the *Howey* test: purchasers of an ICO are making an investment of money, and the blockchain network constitutes a common enterprise.

Therefore, the determining factor in the framework’s analysis concerns the third prong, the reasonable

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expectation of profits from the efforts of others. As established in the framework, the SEC considers this prong satisfied when an active participant (any promotor, sponsor, or other third party (or affiliated group of third parties)) involved in the ICO “provide essential managerial efforts that affect the success of the enterprise,” because the purchaser of a token in an ICO would be expected to receive profits (i.e., an increase in the value of the token) from the managerial work of the active participant. The term “token” refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called “virtual currencies,” “coins,” and other “digital assets.” The SEC view this test as objective, focusing solely on the transaction itself and the manner in which the ICO’s tokens are offered and sold.

Unfortunately, the SEC did not set forth a specific test for determining whether any active participants are providing essential managerial efforts. Instead, the SEC provide 65 distinct factors that it considers in performing this analysis. The framework does not contain an indication of the relative importance of any of the factors, but the following, non-inclusive factors merit further discussion:

- **Active participant involvement:** The SEC indicates that the following factors weigh in favor of an ICO being considered a security offering:
 - Active participants determine who will receive additional tokens and the necessary conditions.
 - Investors reasonably expect the active participant’s efforts will result in an in the increase value of the token, creating a return on investment.
 - Active participants, implicitly or explicitly, promise the creation or support of a digital marketplace for the underlying token, including by controlling the creation of additional tokens or taking any action to support a market price (e.g., buybacks or burns).
 - Active participants develop, improve operations of, or promote the underlying blockchain network or owning or controlling ownership of the intellectual property rights of the underlying blockchain.
 - Active participants retain ability to realize capital appreciation in the token (e.g., retaining a stake in the tokens).
 - Active participants benefit from their efforts by holding the same class of tokens as those distributed to the public.
 - Active participants retain managerial responsibilities such as determining compensation for network participants, making managerial level business decisions, or distributing tokens to other active participants as compensation for employment.
 - Active participants monetize the value of the token, particularly if the token has limited utility or functionality.
- **Token characteristics:** The following token characteristics are relevant in determining if a security exists:
 - The token can be immediately used to make payments or act as a substitute for fiat currency (which would not support qualifying the token as a security).
 - The token gives the investors rights to income or profits or gain on the value of the token (which would support qualifying the token as a security).
 - The token is tradable through a secondary market (which would support qualifying the token as a security).
 - The token is marketed and sold as transferable (which would support qualifying the token as a security).

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- **Marketing characteristics:** The following ICO marketing characteristics are relevant in determining if a security exists:
 - The token is marketed as an investment.
 - The distributors of the token intend to use the ICO revenue to develop the token's underlying blockchain network.
 - The token gives the investors rights to income or profits or gain on the value of the token (which would support qualifying the token as a security).
 - The token is tradable through a secondary market (which would support qualifying the token as a security).
 - The token is marketed and sold as transferable (which would support qualifying the token as a security).

The framework contains numerous additional factors, and the above is merely a subset of the factors themselves.

In addition, the framework has a process whereby the SEC could “reevaluate at the time of later offers or sales” a token sold a security during an ICO. If, after this reevaluation, the SEC determines that the token does not meet the *Howey* test, then the token would not qualify as a security during the post-ICO sale or any subsequent sales thereafter. The SEC will consider the following factors in determining if a reevaluation is necessary or desirable:

1. Investors no longer consider active participant development of the underlying network as necessary for continued profits (e.g., the operation of the bitcoin network and changes in the value of bitcoin based on speculative investment absent underlying changes to the network).
2. The value of the token is directly and stably correlated to the value of the good/service provided to holders of the token.
3. The volume of trading of the token corresponds to the demand for the good/service provided to holders of the token.
4. Holders can use the token to acquire the intended good/service available to holders of the token.
5. The economic benefit of holding a token is incidental to the right to use the token to acquire the intended good/service available to holders of the token.
6. No active participant has access to material, non-public or inside information.

Should the SEC determine that, using the above factors, the holders of a token no longer reasonably expect that any profits generated from holding the token will be derived from the efforts of others, the token would no longer qualify as a security, and its subsequent sale would be exempt from any security offering requirements.

Using the framework, the SEC has issued a no-action letter to TurnKey Jet, Inc. (TKJ), which had intended to offer a non-transferrable token that was pegged to the US dollar, usable only in a marketplace established by the company, and redeemable at a discount (that is, the company would redeem tokens for less than the \$1 per token). By using this particular structure, the SEC determined that TKJ had created a virtual currency that could only be used to purchase goods or services from TKJ (i.e., an existing platform) and could not be sold at a profit. As a result, the SEC determined the TKJ token did not meet the third prong of the *Howey* test, meaning the TKJ tokens did not qualify as securities, and TKJ is now free to sell the tokens without SEC oversight or filing requirements.

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In publishing the framework, the SEC provided some long-awaited guidance to developers and investors that want to participate in an unregistered ICO and seek SEC guidance or pre-approval. With that said, the objective, fact intensive nature of the test outlined in the Framework means the process of determining whether an ICO must register with the SEC requires a well-planned and thorough review of the terms of the ICO itself, the underlying blockchain network, and the structure of the offering, a daunting task for even the most experienced investors. Fortunately, an attorney with the relevant experience and knowhow can guide potential participants through the associated pitfalls.

Please contact a McDonald Hopkins attorney listed below to see how we can help you and your business navigate the shifting landscapes of an ICO.



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Team member bio