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Beyond *Howey*: Is stability a security? The evolving digital asset framework

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To date, much of the conversation on digital assets[1] with respect to the U.S. federal securities laws has focused on whether digital assets are "investment contracts" under the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). However, not all digital assets are created equal, and whether something is a security for purposes of the federal securities laws is not exclusively answered by the "*Howey* test."

The starting point is the broad definition of a "security" under the federal securities laws when considering whether the characteristics of a particular digital asset may fall within the definition of a security, before focusing on court cases or exclusively on the investment contract analysis.

Recently, a number of digital assets have been introduced into the market that purport to offer stable value or protect against fluctuations in their price, commonly referred to as "stablecoins." By design, stablecoins do not appreciate in value, which should foreclose the "expectation of profits" element of the *Howey* test.

Along those lines, the staff at the U.S. Securities and Exchange Commission ("SEC"), Division of Corporation Finance, recently granted no-action relief that it will not recommend enforcement action for two different digital assets offered or sold without registration under the federal securities laws — conditioned, in part, on the fact that the tokens will have a fixed price.

Yet, the market needs to still consider whether certain digital assets, including stablecoins, fall under the broad definition of a security that is beyond investment contracts, and extends to "notes" under the test set forth in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), or an interest in a pooled investment vehicle such as a private or exchange-traded fund.

BACKGROUND

All securities offered and sold in the United States must be registered with the SEC or qualify for an exemption from the registration requirements. But what is a security? The Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") (together, the "Securities Acts") provide nearly identical definitions.[2]

What is a security?

As defined by the Securities Act,[3] the term "security" means:

> "Any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

As the Supreme Court has noted, the definition of a "security" under the Securities Acts is "quite broad ... and includes both instruments whose names alone carry well-settled meaning" such as a stock or bond, "as well as instruments of more variable character that were necessarily designated by more descriptive terms, such as an 'investment contract.'"[4]

The Supreme Court interprets such "instruments of more variable character" expansively, stating that "Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called."[5]

Indeed, since the SEC released the DAO Report in 2017, the Commission has clearly indicated that digital assets may be securities within the definition of the Securities Acts.[6]

The ICO boom and 'Crypto Winter'

Although the first digital asset sales (commonly known as initial coin offerings or ICOs) date back to 2013, the market for these digital assets exploded between 2017 and 2018. According to data

from Coindesk, ICOs raised nearly $5.5 billion in 2017 and $16.7 billion in 2018 on a global basis.[7]

Most digital assets sold through ICOs were designed to have some function related to the use-cases being developed by their issuers, generally as a form of use-specific currency.

During that time, companies conducting ICOs unsurprisingly attracted SEC attention. Knowing that certain digital asset issuers were overlooking the *Howey* test (and therefore not registering such sales or relying on an available exemption), the SEC stepped in to remind market participants that digital assets may be investment contracts, and therefore securities, subject to the Securities Acts. In releasing the DAO Report, the SEC pointed businesses and technologists to the 1946 Supreme Court case, *SEC v. W.J. Howey Co.*, and set the tone for digital asset sale discussions in the years that followed.

To date, market participants and legal advisors have predominantly focused their attention on whether a particular token sale meets the *Howey* test for determining if a transaction or scheme is an investment contract: Whether there is an investment of money in a common enterprise with an expectation of profits derived from the managerial efforts of others.

Depending on the facts and circumstances of these stablecoin models, there is a chance they may be securities.

This comes as no surprise, as the SEC focuses consistently on the investment contract analysis for determining whether a token sale is a securities offering, including through a number of settled enforcement actions and federal court complaints alleging unregistered securities offerings in violation of the Securities Act.

The increased SEC enforcement activity and awareness that certain digital assets may be securities contributed to the reduction in ICO activity and downturn in digital asset prices referred to as "Crypto Winter." The downturn lasted from winter 2018 through spring 2019, when the SEC's Strategic Hub for Innovation and Financial Technology ("FinHub") published the "Framework for 'Investment Contract' Analysis of Digital Assets" (the "Framework").[8]

The Framework sets forth FinHub staff's views on how specific factors related to a hypothetical digital asset issuance may impact the investment contract analysis under *Howey*.

The Framework also builds on the June 2018 speech by Director of the SEC's Division of Corporation Finance, William Hinman. The speech makes the point that assets or instruments which are not themselves securities (such as orange groves, certificates of deposits and warehouse receipts — or software, for example) may be offered as part of a program that is an investment contract.

The same statement also highlights that these assets or instruments are not themselves securities, therefore suggesting that they can be distributed without an investment contract under certain circumstances. Notably, the Framework did not address any Supreme Court cases beyond *Howey* and its progeny, and did not consider the broader definition of a security under the Securities Acts.

What we're seeing

Digital assets merely reflect data recorded on a blockchain — the technology itself places no constraints on what that data represents or may be used for. Accordingly, while using blockchain technology to issue and sell digital assets may be a "new paradigm" of raising capital, as mentioned in the DAO Report, it is by no means the only application of blockchain technology that may be subject to the Securities Acts.

Blockchain technology may be used to "tokenize" instruments that are expressly included within the definition of a security under the Securities Acts. For example, Overstock.com, Inc. has publicly issued digital stock (preferred shares) that are recorded using blockchain technology and several private companies and funds have issued private shares represented as digital assets. Outside the U.S., bonds have been created, issued, and transferred using blockchain technology.

In other cases, digital assets may not be securities, including those described in Section III below. Yet others may be designed to function as more novel instruments, including stablecoins that are not marketed based on the opportunity for profit. Are such instruments nonetheless securities within the broad definition under the Securities Acts?

BEYOND *HOWEY*

Stablecoins

As usage of blockchain and digital networks grows, so too does the demand for digital assets with a purportedly stable value to protect against the price volatility common to many digital assets. Financial innovators have developed a number of mechanisms to issue tokens that are intended to maintain a fixed price, generally referred to as stablecoins. Earlier this year, blockchain wallet and data provider Blockchain.com released a comprehensive state-of-the-market report on stablecoins, identifying over 50 live and pre-launch stablecoins.[9]

Types of stablecoins

The European Central Bank ("ECB") recently published a paper that discusses various ways stablecoins may seek to maintain a stable value (and whether such mechanisms are likely to be successful).[10]

Generally, stablecoins seek to maintain a fixed value by either:

(1) Being collateralized, by off-chain assets (such as sovereign currency or gold held in custody by banks), or on-chain assets (such as other digital assets), with an implied or explicit commitment to full redeemability;[11] or

(2) Managing supply (akin to central bank monetary policy), which is programmed algorithmically, or relies on market arbitrage activity from program participants (similar to how shares in exchange traded funds ("ETFs") may be created and redeemed to align the ETF share price with the ETF's net asset value ("NAV")).

Both the Blockchain.com and ECB reports indicate that the more innovative a stablecoin structure is (including the more "decentralized" it is), the less likely such stablecoin will be able to maintain a stable value.

However, the variety of mechanisms used to maintain a stable value (including new technological innovations not yet considered) also means that stablecoins present challenges for regulatory categorization.

Outside the U.S., for example, the UK Financial Conduct Authority ("FCA") noted that depending on the various structures, rights and arrangements employed, stablecoins may be derivatives, units in a collective investment scheme, debt securities, e-money, other types of specified investments, or fall outside of the FCA's jurisdiction.[12] And it is perhaps telling of the need to consider whether stablecoins are securities that the Blockchain.com report features a section on gaining investment exposure to stablecoins.

Other analytical frameworks

Reves

Although a stablecoin may fail the *Howey* test, it may nevertheless meet the broad definition of a security under the Securities Acts under certain circumstances.[13] Therefore, when evaluating whether a particular stablecoin is a security however, participants should consider applicable analytical frameworks beyond the *Howey* test.

In 1990, the Supreme Court adopted the "Family Resemblance Test" to determine whether variable rate promissory notes were "notes" that met the definition of a security under the Securities Acts. Noting that the definition of security expressly includes "notes," but that courts have also identified types of notes that are not securities, the Supreme Court in *Reves* stated that notes are presumed to be securities unless they bear a "family resemblance" to the judicially crafted list of categories of instrument that are not securities.

To apply the Family Resemblance Test, courts will evaluate an instrument based on four factors, none of which is dispositive:

- The motivations of buyer and seller (*i.e.*, whether the seller seeks to raise capital and whether the byer is primarily interested in profit);
- The plan of distribution (*i.e.*, whether there is common trading that allows for speculation);
- The expectations of the investing public (*i.e.*, whether the public would reasonably believe the instruments to be securities); and
- The existence of an alternative regulatory scheme reduces the risk of the instrument.

Certain collateralized stablecoins that can be redeemed for other assets (or indeed other crypto-lending models) may appear to resemble notes, in that the purchaser expects repayment in exchange for surrendering the digital asset. Depending on the facts and circumstances of these stablecoin models, there is a chance they may be securities under *Reves*.

> The SEC staff has many more requests for no-action relief in the queue.

Supply control models

In order to replicate "monetary policy," some algorithmic stablecoins rely on a system of digital assets that provide economic incentives, with the effect expanding or contracting the supply of the stablecoin.

More recently, stablecoins are being developed that seek to use market forces and arbitrage as a mechanism for providing stable value. In this model, the issuer would create a basket of assets, such a global currencies, held in reserve. The value of the stablecoin would be linked to the asset basket but would not be redeemable for or receive payments based on the value of the basket. Rather, authorized market participants could transact with the reserve using the stable-value token to take advantage of arbitrage opportunities, with the effect of expanding or contracting the available supply of the stablecoin.

In certain models, the stablecoin would not entitle holders to an equity interest (or other types of interest) in the asset reserve. Nonetheless, the value of the stablecoin theoretically depends on the value of the asset reserve and the activities

of the network participants in managing that reserve. Furthermore, depending on how the asset reserve is funded, such a reserve may be considered akin to a pooled investment vehicle.[14]

Whether a stablecoin that is linked to the value of a pooled investment vehicle is a security under the Securities Acts, or a commodity derivative subject to the Commodities Exchange Act, will depend on the particulars of each stablecoin structure. The potential integration between a security in a pooled investment vehicle and a related stablecoin was recently raised in the House of Representatives Financial Services Committee Hearing on SEC oversight.[15]

OPEN QUESTIONS

Digitization is not securitization

It is important to remind market participants that digitization is not securitization. The form of recordkeeping for ownership of an instrument, whether paper or electronic (including distributed ledger technology), does not bear on whether the instrument itself is a security. As the ECB report notes, a bank using blockchain to record transfers of commercial bank money on its books "neither change[s] the nature of said money nor [has] particular implications for the economy."

The SEC was quick to put the industry on notice that many, if not all, ICOs are securities offerings, likely contributing to "crypto winter." More recently however, perhaps signaling a thaw, the Commission has made clear that not every distribution of digital assets is a securities offering.

SEC no-action letters

The SEC's Division of Corporation Finance issued two no-action letters indicating the Division would not recommend enforcement action to the Commission if the relevant digital assets are offered and sold without registration under the Securities Acts. Similar to stablecoins, each token is intended to have a fixed price.

The first no-action letter was issued on April 3, 2019 to TurnKey Jet, Inc. ("TurnKey Jet.")[16] TurnKey Jet provides air charter services, and proposed to offer blockchain tokens to facilitate air service charters among users, brokers, and carriers. Relief was conditioned, in part, on the token being sold at a fixed price of $1 through the life of the program.

The token represents an obligation by the issuer to provide services at a value of $1, and it is exchangeable only among participants registered to use the program. Although it seems clear that the token was not a security under the *Howey* test, the no-action letter highlighted that not every token sale is a securities offering.

Still, the TurnKey Jet letter requesting relief also addressed *Reves*, since the token represents an obligation of the issuer. According to the incoming letter, the token effectively represents an open-account debt (as in prepayment for services) which is one of the judicially crafted categories instruments that are not securities under *Reves*.

In doing so, TurnKey Jet also referenced previous SEC no-action letters where staff "provided a favorable no-action response to a request arguing that certain loans and notes were not securities, because, among other things, the terms of the loans and notes provided no possibility of profit or capital appreciation and they were not marketed to the public as investments."

The second no-action letter was issued to Pocketful of Quarters, Inc. ("PoQ") on July 25, 2019.[17] PoQ is a video gaming platform designed to allow players to carry over "in-game currencies" from one game to another. The PoQ token essentially acts as "universal currency" of participating video games.[18] Players can purchase the token from PoQ at a fixed price, and then redeem those tokens to game developers for various in-game purchases. Approved game developers are then able to "cash out" the tokens they received for Ether.[19] The ability of certain third parties to monetize their activity in connection with the program represents a significant expansion in the fact pattern from the SEC staff's condition relief in TurnKey Jet.

Added functionality and potential relief?

The SEC staff has many more requests for no-action relief in the queue. Will it continue to build on the previous no-action letters, and provide clarity that the presence of certain features of stablecoins are unlikely to make a digital asset a security, or will it move beyond stable value instruments?

In particular, clarity involving the following features may be helpful to the industry:

- In each of the previous no-action letters, the digital assets at issue could not be transferred to wallets external to the relevant platform (a "closed system"). Can there be a token that is freely transferrable outside the platform that is not a security?

- In TurnKey Jet, the value of tokens are fixed at one USD per token. In PoQ, certain users are able to exchange tokens for ETH, but "at predetermined exchange rates." Can a digital asset have a floating value based on supply and demand, either within a closed system or as a freely transferrable asset, that is not a security?

- In each of the no-action letters, the digital assets at issue function as an application-specific currency or medium of exchange. Will we see a no-action letter addressing a universal, open system payments use case?
- Similarly, will we see a no-action letter addressing a stablecoin, whether that asset seeks to maintain its value by adjusting supply or through asset backed reserves?
- In the PoQ no-action letter, we saw a security token used for fundraising on the platform, but not as the actual token being considered for relief. Will we see a no-action letter that considers a security token issued pursuant to the Securities Act that may no longer be a security once the network is fully functional or decentralized?

CONCLUSION

The test for whether a contract, scheme or transaction is an investment contract under *Howey* is intentionally broad and requires an analysis of the specific facts and circumstances that does not lend itself to bright line rules. Yet, the definition of security under the Securities Acts is much broader and should not be overlooked.

A security includes other types of instruments and arrangements, with additional judicial interpretive frameworks to be considered as applied to digital assets. As innovators continue to develop new use cases and novel structures for digital asset systems, market participants should remember to broadly consider the applicability of the definition of security under the Securities Acts rather than focusing exclusively on the *Howey* test.

This is not to say that every digital asset is a security, as borne out by recent no-action relief from the SEC's Division of Corporation Finance. As the scope of the federal securities law are brought into focus, innovative technology providers that receive guidance on the applicable legal and regulatory frameworks may yet thrive.

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NOTES

[1] The SEC has broadly uses the term "digital assets" to include cryptocurrencies, coins, and tokens. *See* SEC, 2019 Examination Priorities (Dec. 20, 2018), (https://bit.ly/2D372Pe).

[2] The U.S. Supreme Court has stated that the definitions of "security" under the Securities Act and the Exchange Act are treated as being the same, despite some technical differences. *SEC v. Edwards*, 540 U.S. 398 (2004) (citing *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990)).

[3] 15 U.S.C.A. § 77b(a)(1)

[4] *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) at 686 (internal citations omitted).

[5] *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990)

[6] On July 25, 2017, the SEC Division of Enforcement issued a report of investigation under Section 21(a) of the Exchange Act (the "DAO Report)" to demonstrate the application of the federal securities law to the "new paradigm" of using "distributed ledger or blockchain technology to facilitate capital raising and/or investment." The DAO Report concluded that the digital assets sold by an entity called The DAO were securities as defined under the Securities Acts by analyzing whether the offer and sale of the DAO tokens constituted "investment contracts."

[7] https://bit.ly/2MAIEbg

[8] SEC, Strategic Hub for Innovation and Financial Technology, Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019), (https://bit.ly/2HXfEdZ)

[9] https://bit.ly/2Rdxmv3

[10] Dirk Bullmann, Jonas Klemm and Andrea Pinna, *In search for stability in crypto-assets: are stablecoins the solution?*, ECB Occasional Paper No. 230 (August 2019), (https://bit.ly/2MDuF4q)

[11] "Off-chain" refers to value outside of a blockchain. "On-chain" refers to value existing solely on a blockchain.

[12] Policy Statement PS19/22: Guidance on Cryptoassets, Financial Conduct Authority (July 2019), (https://bit.ly/2T1orhJ).

[13] Testifying before the House of Representatives Committee on Financial Services, SEC Chairman Clayton, referring to digital assets, stated, "a statement such as if it doesn't produce a return, it's not a security, I think — I think that's a bit of an oversimplification." Oversight of the Securities and Exchange Commission: Wall Street's Cop on the Beat (Sept. 24, 2019), (https://bit.ly/2mi9E5L)

[14] This article does not consider the applicability of the Investment Company Act that may be relevant to some of these models.

[15] *See* questions to Chairman Clayton from Rep. Green D-TX . Oversight of the Securities and Exchange Commission: Wall Street's Cop on the Beat (Sept. 24, 2019), (https://bit.ly/2mi9E5L)

[16] TurnKey Jet, Inc., SEC No-Action Letter (Apr. 3, 2019), (https://bit.ly/2YOeel3)

[17] Pocketful of Quarters, Inc., SEC No-Action Letter (Jul. 25, 2019), (https://bit.ly/2YjYH14)

[18] The Pocketful of Quarters incoming letter mentions the company issued a second blockchain token, not the subject of the letter, as a security.

[19] Ether is a digital asset used in the operation of the Ethereum network. In his June 2018 speech, the SEC's Director of Corporation Finance William Hinman stated his view that "current offers and sales of Ether are not securities transactions."

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