SEC and Digital Assets

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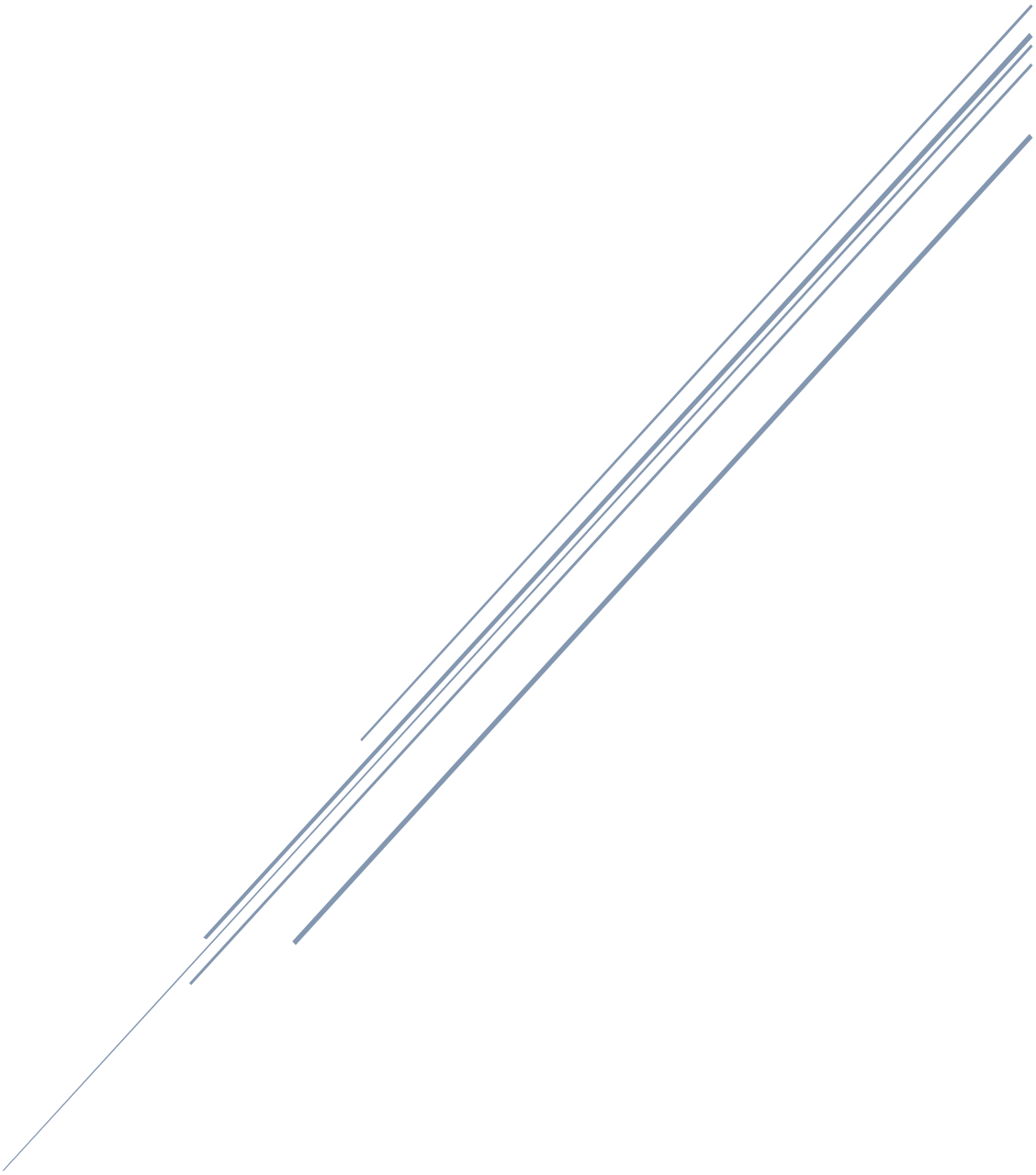

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Introduction

In the United States (“**US**”), the Securities Exchange Commission (“**SEC**”) has made it clear that it will regulate digital assets as long as the underlying asset will amount to a security. On various occasions, SEC has stated that in identifying whether an asset is a security or not, the focus will be on the substance of the transaction and not its form.

Security and SEC

Section 5 of the Securities Act, 1933 renders it unlawful for any person to make use of any means or instrumentalities of interstate commerce to offer or sell a security except that security is registered with the SEC or exempted from registration. Generally, the SEC has regulatory authority over the transactions that are related to digital assets that constitute a security.

The definition of security includes an “investment contract” and the in the case of SEC vs W.J. Howey, the U.S Supreme Court has defined an investment contract as any contract, transaction or scheme involving an investment of money in a common enterprise with the reasonable expectation that profits will be derived from the managerial efforts of the promoter or a third party (known as Howey test). The U.S Supreme Court has stated that this definition embodies a *“flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits”.* Howey test has been a paramount instrument for the SEC to extend its jurisdictions over a period of time as it enables the SEC to identify the underlying nature of the transaction behind any asset which might have been structured differently than a security to avoid the regulatory burden that comes with labelling an asset as a security.

Applicability of Howey Test on Virtual currencies

In the case of SEC v. Trendon T. Shavers and Bitcoin Savings and Trust, Trendon offered interests up to 1% per day until it stopped making profits, investors lost more than 2,60,000 bitcoins. The U.S District Court for the Eastern District of Texas stated the transaction as an investment contract and also said that it was not asked to decide whether "*bitcoin itself is a*

security, or whether the offer, sale, trade or exchange of bitcoins constitutes the offer or sale of securities". In the same case, the court also held bitcoin as money and therefore a security as per the Howey test. A similar view was observed by the courts in SEC v. Blockvest, LLC Reginald Buddy Ringgold, III a/k/a Rasool Abdul Rahim El and Jacob Zowie Thomas Rensel v. Centra Tech, Inc. where the virtual currencies were held as securities.

The DAO Analysis

In July 2017, SEC issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act, 1934 that analyses when an offer or sale of a digital asset will constitute a security and will be subject to the federal securities law. In the report, the digital asset in question was a token created by a German corporation named Slock.it known as Decentralized Autonomous Organization ("**DAO**") which had sold more than 1 billion DAO tokens in exchange of Ether. The money raised from DAO tokens were to be used for various blockchain projects and the returns from that would provide the holders with return on their investment. The SEC applied the Howey test as follows:

1. Investment of money – purchased with Ether;
2. Common enterprise – DAO;
3. Expectation of profit – return on investment from the blockchain projects;
4. Derived from the efforts of others – efforts of Slock.it

As the token fulfilled all the elements of the Howey test, SEC analysed the DAO token to be an investment contract and hence, a security.

Substance over form

In the case of SEC v. C.M. Joiner Leasing Corp., the U.S Supreme Court held that "*the reach of the* (Securities) *Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a security."*

Several federal district courts have held that transactions involving virtual currencies are securities by applying the Howey test and further mentioned that the participants must comply with the securities law if they are not eligible for an exemption.

Further clarification on applicability of Howey test with regards to virtual currencies came with the cease and desist order issued to Munchee Inc. which was a corporation in California with an app which allowed users to review and upload pictures of meals. In order to raise capital, it decided to issue utility tokens with a real use case with its app. Applying the Howey test on the token, SEC found out that even though the token was labelled as utility tokens, the marketing of the tokens to the investors listed several examples of offering hope and expectations of profits to the investors. The SEC also observed that the token was marketed to the people who invest in digital assets and not to the food industry. The SEC held that even if there is practical use of the token, it does not mean that the token cannot constitute a security, as in determining whether an offering constitutes a security or not, the underlying economic realities of the transaction will prevail over how the offering is labelled.

Jay Claton, Chairman of the SEC, in his testimony on Virtual Currencies to the Committee on Banking, Housing, and Urban Affairs, United States Senate talked about the practice of highlighting the utility voucher like characteristics of proposed ICOs by certain participants in order to prevent them from the regulations of securities law. He further stated that "*The rise of these form-based arguments is a disturbing trend that deprives investors of mandatory protections that clearly are required as a result of the structure of the transaction. Merely calling a token a 'utility' token, or structuring it to provide some utility, does not prevent the token from being a security*".

William Hinman, the SEC's Director of the Division of Corporate Finance in his speech on 14th June, 2018 also talked about the applicability of the Howey test in determining the ICOs as a security. He mentioned that a coin or token in itself is not a security and compared it with the orange grooves in the Howey test as they were also not a security. He clearly stated that central to determining whether a security is being sold is how it is being sold and the reasonable expectations of the purchasers.

In October 2019, Telegram Group Inc. which has raised more than 1.7 billion dollars of investment funds was sued by SEC for non-registration for its offer and sales of digital assets called Grams. SEC's motion for preliminary injunction sought to prevent the distribution of Grams to the initial purchasers as it anticipated that after the initial distribution, the initial purchasers would act as underwriters and resell the Grams in a secondary public market.

Denying the allegations, Telegram contended that any such resale would be unrelated to the initial distribution and should be considered separately. As per Telegram, the initial sale to investors was conducted relying on Rule 506(c) of Regulation D under the Securities Act, 1933. And for transactions in Grams after the platform is launched would amount to spot transactions in commodities. Rejecting the Telegram's arguments, the U.S. District Court for the Southern District of New York granted the preliminary injunction after applying the Howey test and held that initial sale and distribution of the Grams and possible subsequent transactions by those early purchasers include a larger scheme to distribute those Grams into a secondary public market and amounts to an investment contract.

Exemption from Howey test

In April 2019, in order to facilitate the participants in understanding whether the U.S federal securities law apply to their transaction, SEC Strategic Hub for Innovation and Financial Technology published a framework for assisting the participants to identify whether the virtual currency is sold as a security under the federal securities law or not. The framework discusses the applicability of the elements of the Howey test with regards to the virtual currencies. Further, the framework also lays down additional factors that the participants can consider which may help in indicating whether the offering has a consumptive intent instead of the investment intent.

At the same time, SEC's Division of Corporation Finance issued its first no-action letter exempting a participant who was offering a pre-paid gift certificate as a part of a membership program for an air charter company as the Howey test requires a reasonable expectation of profit, the no action letter served as the first example of selling a digital asset without registering itself as a security. In July, 2019, another no action letter was issued to Pocketful of Quarters, Inc. providing relief against the registration requirements for issuing digital tokens. The pertinent thing to note in both the no-action letters was that both were issued with significant transfer restrictions.

Recently, on February 6, 2020, Hester M. Pierce, Commissioner on SEC, gave a speech on "Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization" at the International Blockchain Congress describing a draft proposal for safe harbour from the registration requirements under the Securities Act, 1933 as there is a need for clarification on the applicability of federal securities law with regards to the offer and sale of digital assets.

The proposal intends to strike the right balance between fostering innovation and protecting investors' interests. However, at present it is at a very raw stage and will require formal comments of the entire department and also comments from the industry stakeholders.

Conclusion

SEC has made its stance clear on whether a transaction relating to virtual currencies will be considered as a security or not will depend on the substance of the transaction after the applicability of the Howey test. Keeping that in mind, the best way to navigate through federal securities law is to check for the eligibility for an exemption. This substance over form approach by SEC is a clear signal that companies cannot circumvent regulations just by grooming the assets differently.