JONES DAY

COMMENTARY

JUNE 2018

IN SHORT

The Situation: The Director of the U.S. Securities and Exchange Commission's Division of Corporate Finance, William Hinman, has weighed in on when digital assets will be characterized as securities.

The Result: In reinforcing the core principles set forth in the SEC's recent ICO enforcement actions, Mr. Hinman described important nuances involved in the application of the landmark *Howey* test, highlighted that the application of the *Howey* test may yield a different result in light of changing circumstances over time, and affirmed that current sales of Bitcoin and Ether are not securities transactions.

Looking Ahead: While market participants seeking to determine whether transactions in a particular digital asset involve the sale of a security continue to face a challenging facts-and-circumstances based analysis, Mr. Hinman's remarks provide important insights into certain of the factors that the SEC views as critical to the analysis.

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Although the SEC has consistently noted that whether or not a particular digital asset transaction should be characterized as a securities transaction will depend on the characteristics and use of that particular asset, market participants have highlighted the potential chilling effect of a lack of certainty regarding the outcome of the securities law analysis when applied to particular digital assets. Against this backdrop, William Hinman, the SEC's Director of the Division of Corporation Finance, addressed the Yahoo Finance All Markets Summit: Crypto on June 14, 2018.

> "Mr. Hinman's statements provide useful insights into certain factors that may arise in a particular application of the *Howey* test, which the SEC staff would likely view as critical to the determination of whether a digital asset transaction constitutes a securities transaction."

Key Factors in the Application of the *Howey* Test

At the outset, Mr. Hinman's remarks reinforce the core principles set forth in the SEC's recent statements and enforcement actions relating to initial coin offerings, or ICOs—the U.S. Supreme Court's landmark decision in *SEC v. Howey* continues to apply, requiring a facts-and-circumstances analysis as to whether a particular transaction involves an investment of money in a common enterprise and with the expectation of profits that are expected to arise substantially from the efforts of a third party. Nevertheless, Mr. Hinman's statements provide useful insights into certain factors that may arise in a particular application of the *Howey* test, which the SEC staff would likely view as critical to the determination of whether a digital asset transaction constitutes a securities transaction:

Decentralization*.* Focusing on information asymmetries between investors and promoters as a key impetus of the Securities Act of 1933, Mr. Hinman articulated that sufficient decentralization of a network may lead such information asymmetries to recede, as investors no longer reasonably expect a third party to carry out managerial or entrepreneurial efforts with respect to the network. Over time, therefore, there may be sufficient decentralization of networks and systems such that regulating digital assets that function on these systems as securities may not be required. In this regard, Mr. Hinman affirmed that current offers and sales of Bitcoin and Ether are not securities transactions.

Expectations of Profit*.* Mr. Hinman also expounded on the expectation-of-profit prong of the *Howey* test to emphasize the importance to the *Howey* analysis of evaluating the manner in which a digital asset is sold and the expectations of the purchases in the transaction. Because the Supreme Court has acknowledged that the purchase of an asset for consumption only is likely not a security, it is important to ask the key question: is a particular digital asset "marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?" In this regard, an instrument marketed and sold to the general public rather than to specific users of a network may weigh heavily on the expectation-of-profits prong of the *Howey* analysis.

While market participants seeking to determine whether transactions in a particular digital asset involve the sale of a security continue to face a challenging facts-and-circumstances based analysis, Mr.

Hinman's remarks provide important insights into certain of the factors that the SEC views as critical to the analysis. However, the factors identified in Mr. Hinman's remarks are only illustrative, and the application of the *Howey* analysis to particular facts and circumstances is a challenging and uncertain endeavor. Until further regulatory clarity develops, market participants should discuss their particular circumstances with securities counsel.

Mr. Hinman affirmed the SEC's willingness to assist in making this determination and encouraged market participants to engage with SEC staff: "We are happy to help promoters and their counsel work through these issues. We stand prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use." We expect that pioneering market participants will take up Mr. Hinman's invitation to engage with the SEC staff in effort to crystallize, and formalize, the SEC staff's approach to the characterization of digital asset transactions.

FOUR KEY TAKEAWAYS

1. The U.S. Supreme Court's landmark decision in *SEC v. Howey* continues to apply to initial coin offerings.
2. William Hinman, Director of the U.S. Securities and Exchange Commission's Division of Corporate Finance, has affirmed that current offers and sales of Bitcoin and Ether are not securities transactions.
3. An instrument marketed and sold to the general public rather than to specific users of a network may weigh heavily on the expectation-of-profits prong of the *Howey* analysis.
4. Proactive market participants are likely to reach out to the SEC staff to seek formal interpretive or no-action guidance in order to understand the SEC staff's thinking with regard to digital asset transactions.

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Stephen J. Obie
New York / Washington

Harold K. Gordon
New York

Peter E. Devlin
New York

Mark W. Rasmussen
Dallas

Aanand A. Mehta, an associate in the Cleveland Office, assisted in the preparation of this Commentary.

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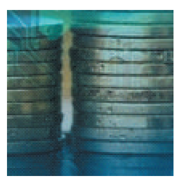

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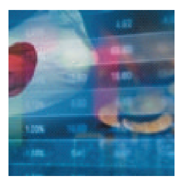

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