

SEC's No-Action Letters Confer Utility Token Guidance

By Anthony Tu-Sekine and Kyle Swan (August 22, 2019)

It has been more than two years since the U.S. Securities and Exchange Commission issued its DAO report,[1] which warned that tokens and coins sold in initial coin offerings may be securities subject to federal securities laws. But one of the key problems exposed by the DAO report remains: how to offer a token so that it is not a security.

Industry participants have grappled with this issue without much guidance from the SEC to provide confidence that their token offerings will not run afoul of federal securities laws. A recent no-action letter issued by the SEC's Division of Corporation Finance to Pocketful of Quarters Inc. on July 25, and a no-action letter issued to Turnkey Jet Inc. on April 3 provide some clarity.[2]

These no-action letters represent two of the most authoritative SEC actions regarding tokens not related to fraud since the DAO report and the June action brought against Kik Interactive Inc. for conducting an unregistered offering of securities.[3] In light of these no-action letters and other recent developments,[4] a path forward for token offerings is beginning to emerge.

The TKJ and PoQ No-Action Letters

The TKJ and PoQ no-action letters address the issuance and trading of tokens that are not securities. Practitioners previously understood that such tokens, generally referred to as utility tokens, could be offered without triggering the registration requirements of Section 5 of the Securities Act of 1933. But the SEC's 2017 cease-and-desist order against Munchee Inc., which planned to sell \$15 million in digital tokens to develop an app,[5] alerted market participants that a utility token offering could easily result in the offering of unregistered securities if done in a way that created an investment contract.[6]

These no-action letters arrived shortly after the publication of the SEC's framework for investment contract analysis of digital assets. The TKJ and PoQ no-action letters represent some of the first demonstrations of the framework's analysis in action, and their restrictions on the token functionality, transferability and marketing are consistent with factors espoused by the framework.

The no-action letters provide helpful guidance for utility token issuers that want to avoid creating an investment contract. However, helpful as the no-action letters may be for utility token issuers, they leave the industry wanting. Critics of the TKJ no-action letter characterize it as addressing a fact pattern that would not raise any concern that an investment contract could have been created,[7] and the PoQ no-action letter similarly includes certain requirements that could be seen as unnecessary to conclude that the offering of the tokens is not an offering of securities. The offering of tokens that are securities and tokens that may be securities present challenges unaddressed by the no-action letters for which industry participants are left clamoring for further regulatory guidance.



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Problems Solved?

The TKJ and PoQ no-action letters are helpful for companies with business models that require the issuance, distribution and trading of utility tokens. However, a number of potentially significant unresolved issues remain for issuers that need to issue their tokens either in accordance with the registration requirements of Section 5 of the Securities Act in the case of security tokens, or in a manner that does not require registration in the case of utility tokens.

Registration Under the Securities Exchange Act of 1934

If certain thresholds are met in an offering of equity securities, the issuer will have to register the securities under the Exchange Act and become a reporting company, which not only will impose significant costs and efforts, but for some token models might require significant modifications. The SEC staff has required registration in its settled orders with issuers that have issued tokens in unregistered initial coin offerings, like Gladius Network LLC, Paragon Coin Inc. and CarrierEQ Inc.[8] This registration process can be both costly and lengthy for prospective issuers, and may discourage many from attempting such an offering.

The Transient-Security Mystery

The SEC staff has indicated that it is possible for a token to be offered as a security, but subsequently lose its security status and become a nonsecurity.[9] It is unclear on what legal basis this argument rests. Generally speaking, an instrument that is a security does not become a nonsecurity — though a restricted security may become a nonrestricted security — and there do not seem to be many useful examples one can look to for reference.

One theory is that when a token that is not a security is offered in a way that creates a separate investment contract, the investment contract adheres to the token like a wrapper, which then separates from the token once the investment contract becomes freely tradeable, such as when the safe harbor requirements of Rule 144 promulgated under the Securities Act are met, or when the token is registered for resale under the Securities Act. The SEC staff has hinted that the transition from security to nonsecurity may depend on the level of decentralization of the token, but until the SEC issues a safe-harbor rule or courts have the opportunity to speak on the subject, it is difficult for issuers and their counsel to rely on this approach.

Trading

If tokens are securities, they can only be traded on an exchange if that exchange meets certain requirements, such as registration as a national securities exchange under the Exchange Act, or as an alternative trading system. Until such exchanges and systems become widely available, liquidity for tokens will be limited, which may hinder more widespread use of security tokens.

International Offerings

If an issuer that has offered its utility tokens in the U.S. in an offering that does not create a separate investment contract decides to offer the tokens in an offering that does not involve any nexus to the U.S. (i.e., an offering outside the U.S. that is not subject to U.S. securities laws) but in a manner that would have resulted in the creation of an investment contract

had the same type of offering taken place in the U.S., what is the status of the tokens offered outside the U.S.? Must they be segregated from the pool of tokens that are held and traded in the U.S.?

No guidance released by the SEC or its staff has addressed issues relating to the treatment of these dual domestic and international token offerings, and existing guidance for cross-border securities offerings is only applicable if one presumes that all tokens — including the utility tokens in the U.S. — are securities.

Although questions remain regarding the treatment of token offerings under a variety of circumstances, the no-action letters represent important progress toward clarity. Market participants are hopeful that the SEC and its staff will continue to release substantive guidance that will provide answers to the ambiguities currently affecting the industry.

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[1] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Securities Act Release No. 81207(July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

[2] TurnKey Jet Inc. (April 3, 2019), available at <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm>; Pocketful of Quarters Inc. (July 25, 2019), available at <https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1>.

[3] The SEC issued guidelines (see SEC Framework for “Investment Contract” Analysis of Digital Assets (2019), available at <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>, and additional insights were provided through a number of speeches (see, e.g., William Hinman, Director, SEC Division of Corporation Finance, Digital Asset Transaction: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), available at <https://www.sec.gov/news/speech/speech-hinman-061418>) (Hinman Remarks), but neither the framework nor the Hinman Remarks represented formal SEC actions. A copy of the complaint against Kik Interactive Inc. can be found at U.S. Securities and Exchange Commission v. Kik Interactive Inc., Case No. 19-cv-5244, S.D.N.Y. June 4, 2019, available at <https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf>.

[4] In July 2019, the SEC qualified offerings of tokens that are securities made by Blockstack PBC and YouNow Inc. under Regulation A under the Securities Act. These offerings were the first-ever token offerings qualified by the SEC under Regulation A, representing an important step forward in the SEC’s willingness to engage with token issuers. Reg. A offerings are limited to \$50 million in any 12-month period.

[5] In the Matter of Munchee Inc., Rel. No. 33-10445 (December 11, 2017).

[6] Investment contracts are securities under U.S. securities laws. While the term is not defined in the Securities Act, courts have developed a number of tests to determine whether

an investment contract exists in SEC v. W.J. Howey Co., 328 U.S. 293 (1946) and its progeny.

[7] Commissioner Hester Peirce, How We Howey, Remarks given at Securities Enforcement Forum, East Palo Alto, California (May 9, 2019), available at <https://www.sec.gov/news/speech/peirce-how-we-howey-050919>.

[8] See In the Matter of Gladius Network LLC, Rel. No. 33-10608 (Feb. 20, 2019); In the Matter of Paragon Coin Inc., Rel. No. 33-10574 (Nov. 16, 2018) (Gladius Order); and In the Matter of CarrierEQ Inc., D/B/A AirFox, Rel. No. 33-10575 (Nov. 16, 2018).

[9] This concept was first proposed in the Hinman Remarks, where Hinman indicated that Ether tokens may have been a security when offered, but are not a security now, and then included in an official action by the SEC in the Gladius Order, which acknowledged a token offered as a security could become a nonsecurity by providing for Gladius to give notice to the SEC staff should it determine, at some point, that its token is no longer a security.