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SEC Issues Digital Asset No-Action Letter

In a letter issued July 25, 2019, the Staff of the Corporate Finance Division of the Securities and Exchange Commission gave no-action relief to Pocketful of Quarters Inc. in connection with its "Quarters" gaming token, a digital asset that could be purchased by gamers in exchange for ETH (a cryptocurrency also referred to as Ether, which trades on the Ethereum blockchain). The Staff responded to PoQ's fulsome no-action request with a long list of criteria upon which the relief was granted, including:

- PoQ will not use any funds from Quarters sales to build the Quarters Platform, which has been fully developed and will be fully functional and operational immediately upon its launch and before any of the Quarters are sold.
- The Quarters will be immediately usable for their intended purpose (gaming) at the time they are sold.
- PoQ will implement technological and contractual provisions governing the Quarters and the Quarters Platform that restrict the transfer of Quarters to PoQ or to wallets on the Quarters Platform.
- Gamers will be able to transfer Quarters from their wallets only to game developers for gameplay or to participate in esports tournaments.
- Developers will be subject to Know Your Customer/ Anti-Money Laundering checks at account initiation as well as on an ongoing basis.
- Quarters will be made continuously available to gamers in unlimited quantities at a fixed price.
- There will be a correlation between the purchase price of Quarters and the market price of accessing and interacting with participating games.
- PoQ will market and sell Quarters to gamers solely for consumptive use as a means of accessing and interacting with participating games.

The PoQ No-Action Letter follows soon after the SEC's April 2019 release of its "Framework for 'Investment Contract' Analysis of Digital Assets," which applied the U.S. Supreme Court's 1946 decision in *SEC v. W.J. Howey Co.* — a landmark case concerning the analysis of a nontraditional investment structure under the federal securities laws — to the issues raised by the advent of cryptocurrencies and blockchain technology. In *Howey*, the Court created a test that has come to focus on four primary elements to determine that an investment opportunity creates a "security":

- Investment of money
- Expectation of profits

- Common enterprise (generally meaning that the fortunes of the venture and the investors are linked)
- Efforts of the promoter or other third party

Importantly for Pocketful of Quarters, a later Supreme Court case held that an asset purchased for consumption only is likely not a security for these purposes.

Seemingly, the Staff could have based its relief on the last bullet point, or on the first and second bullet points under *Howey*. All three negate the inference that gamers are motivated to buy Quarters on the expectation of profits from the efforts of PoQ's management.

It is unclear whether—and it would be unfortunate if, the Staff will require certain other of the listed criteria as conditions to cryptocurrency no-action relief, inasmuch as they appear included in the PoQ platform to comply with federal regulatory regimes other than the SEC's. For example, the transfer restrictions and KYC/AML requirements appear directed at federal and state money transmission rules, but, even if included for purposes other than compliance with securities law, the transfer restrictions would prevent speculation in the Quarters.

Similarly, the antepenultimate and penultimate bullet points, intended to prevent speculation in Quarters by stabilizing their price, might appear unnecessary to the no-action relief if the Quarters are not securities for the reasons suggested above. Is it the Staff's view that all of these layers are necessary to prevent a crypto instrument from being considered a security? Unfortunately, the much-desired clarity sought in the form of the SEC's Framework was not, in the view of many commentators, as forthcoming as they had hoped, and, as a result, industry participants finding themselves subsequently seeking regulatory certainty appear to be including numerous (and not always clearly required) representations and restrictions, apparently on the theory of "the more the better." See, e.g., the April 3, 2019, TurnKey Jet, Inc. no-action letter and the request to which it responded.

It may be the case that the price stabilization criteria address an issue raised by William Hinman, the director of the Corporate Finance division, who noted last year that a digital asset that is not a security may become one under changed circumstances (and vice versa). It's conceivable, in absence of transfer restrictions, that speculative interest in the Quarters could develop if demand for the games on the platform became sufficiently great. Then, if the purchasers considered that appreciation of Quarters depended on the efforts of third parties, and if the other legs of the *Howey* test were met, the Quarters could become securities, even though they were originally issued solely to access games.

A question then arises as to whose efforts should be the subject of the fourth *Howey* criterion In the usual case, investors rely on the efforts of the management of the issuer of the securities or of their promoter, but if, once having established the platform, PoQ's continuing efforts are limited to ministerial, routine maintenance of the blockchain gaming platform, those efforts alone might not lead to an expectation of profits. Rather, it could be demand for games created through the efforts of developers, who are customers of PoQ, that would result in appreciation in the Quarters. Thus, the fixed issue price and provision for "correlation between the purchase price of Quarters and the market price of accessing and interacting with Participating Games" would (assuming no transfer restrictions) be necessary to prevent speculation in the Quarters.

On the other hand, Mr. Hinman suggested that when the managerial or entrepreneurial efforts surrounding a blockchain are sufficiently decentralized, the token residing on the blockchain will not constitute a security, citing Bitcoin as an example. If the expectation of profits from the PoQ platform were to

derive from the separate, decentralized efforts of a multitude of developers, then the fixed issue price and "stabilization" algorithm would seem unnecessary to prevent the Quarters' being securities. It might be the case, however, that PoQ's efforts regarding its platform will never be limited to what could be considered ministerial, so that PoQ's centralized efforts would be considered the basis for anticipated profits, in which case the price stabilization features would be essential to keeping the tokens from becoming securities.

The style of the Staff's no-action response is typical, but its mere listing of criteria, without explanation why each is included, leaves open — indeed, raises — many more questions than it answers. If the SEC considers all the criteria that it listed as necessary to its position, the PoQ No-Action Letter may be more beneficial for developers of blockchain assets designed to reward frequent customers, incentivize a survey, or provide an electronic means to track an advertisement rather than for a more typical cryptocurrency token designed to raise funding to build out an electronic network or create a nontraditional payment system. Given the relationship between ETH and the Quarters, however, it should be noted that Quarters could become more or less valuable vis-à-vis fiat currencies (such as the U.S. dollar) as the market value of ETH fluctuates.

Watch This Space

The SEC's guru on matters relating to crypto, Commissioner Hester Pierce, delivered a speech ("Renegade Pandas: Opportunities for Cross Border Cooperation in Regulation of Digital Assets") at the Singapore University of Social Sciences on July 30, 2019, and mentioned the PoQ No-Action Letter and other recent developments in the digital asset space. Ranging from contemplative discussions of trends in innovation theory to specific analysis of SEC enforcement priorities and the Commission's historical perspectives on cross-border government regulation, interestingly, the remarks included the idea that a safe harbor for digital assets may be on the horizon at the SEC. Commissioner Pierce's speech includes the standard disclaimer that her remarks are not representative of the position of the SEC or its Staff on any particular issue, but, in citing the "square peg, round hole" nature of the SEC's financial statement and enterprise disclosure rules to a cryptocurrency project, Commissioner Pierce may have foreshadowed the shape of how such rules might be adapted to better meet the SEC's mission of protecting investors without shackling the renegade pandas that have broken loose in the financial markets following the introduction of blockchain technology.

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