Client Alert

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SEC Warns Initial Coin Offerings May Be Subject to US Federal Securities Laws

In 2017, over $1.3 billion has been raised by start-ups through Initial Coin Offerings ("ICOs"), a relatively new form of financing technique in which a company (typically one operating in the digital currency space) seeking to raise seed money makes a "token" available for sale, and the token gives the purchaser some future right in the business or other benefit. Amidst much anticipation, on July 25, 2017, the Securities and Exchange Commission ("SEC") released a Report of Investigation ("Report") under Section 21(a) of the Securities Exchange Act of 1934 ("Exchange Act") warning the market that "tokens" issued in ICOs may be "securities" such that the full breadth of the US federal securities laws may apply to their offer and sale. The Report and a simultaneously released Investor Bulletin offer guidance and serve as a notice to the market that the SEC will be policing this new financing technique.[1]

The Report

The Report is the result of an SEC investigation into whether an organization called The DAO violated US federal securities laws based on its 2016 ICO of DAO Tokens valued at approximately $150 million. The DAO was an example of a decentralized autonomous organization or a virtual organization that exists based on smart contracts executed on a distributed ledger or blockchain. The German company that created The DAO, Slock.it, automated its corporate governance structures and purported to give DAO Token holders decision-making power over the business without a traditional corporate hierarchy.

During the offering period and in exchange for the cryptocurrency "Ether," the general public could purchase DAO Tokens, which provided the holder certain voting and ownership rights. The DAO used the Ether generated in the ICO to fund projects that would provide DAO Token holders a return on their investment. The DAO Token holders had the right to vote on certain corporate governance matters of The DAO, including which projects to fund and when to make distributions of profits to DAO Token holders. After the ICO, DAO Token holders could trade their DAO Tokens on online platforms supporting secondary market transactions. The Report acknowledged that, although The DAO referred to itself as a "crowdfunding contract," it did not qualify as such under Regulation Crowdfunding and neither the ICO nor the trading platforms in the secondary market were registered with the SEC.

Tokens as Securities

The SEC applied well-established federal law to the facts and circumstances of The DAO's ICO and DAO Tokens and found that DAO Tokens were securities under the Securities Act of 1933 ("Securities Act") and the Exchange Act. Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange act include "investment contracts" in the definition of a security. In *SEC v. W.J. Howey*, the US Supreme Court defined an investment contract as (i) an investment of money; (ii) in a common enterprise; (iii) with a reasonable expectation of profits; (iv) to be derived from the entrepreneurial or managerial efforts of

[1] The complete text of the Report is available at http://www.sec.gov/litigation/investreport/34-81207.pdf and the Investor Bulletin is available at https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings.

others.[2] In the Report, the SEC emphasized that case law supports the analysis of form over substance and that emphasis should be placed on the economic realities of the transaction, not the name of the transaction. The SEC quickly dispensed with the first three prongs of the *Howey* test and found that when DAO Token holders invested Ether in The DAO, they were investing money in a common enterprise with the reasonable expectation of profits.

The majority of the SEC's analysis focused on whether DAO Token holders' voting rights on corporate governance matters and investment decisions negated the fourth prong of the *Howey* test. Ultimately, the SEC concluded that the *Howey* test was met because the efforts of Slock.it were essential to the enterprise and DAO Token holders' voting rights were limited. Slock.it created The DAO, maintained its coding and website, marketed the ICO and chose individuals to screen investment opportunities so only the best projects were presented to DAO Token holders for a vote. Additionally, DAO Token holders did not have meaningful control over The DAO because their voting rights were limited to pre-selected projects and the rules of the voting structure incentivized voting in favor of proposals. Furthermore, because the DAO Token holders were so widely dispersed and anonymous, there was no way for DAO Token holders to join together to exercise meaningful control. The SEC determined that the voting rights of DAO Token holders were more like corporate shareholders than partners in a partnership structure.

Although the SEC declined to bring any formal action against The DAO or Slock.it, the Report draws a line in the sand for holders of similar tokens. The market is now on official notice that US federal securities laws apply to the offer and sale of tokens that qualify as securities, including securities issued as tokens on blockchains in ICOs in exchange for cryptocurrencies. Without a valid exemption from registration, both the issuer and those who participate in the unregistered offer and sale of digital securities are violating US federal securities laws.

Token Exchanges Must Register

Taking the analysis a step further, the SEC also concluded that the online platforms supporting the secondary market for DAO Tokens were in violation of Section 5 of the Exchange Act for failing to register as a national securities exchange. Section 3(a)(1) of the Exchange Act defines exchange broadly to include any organization or group which provides a market place for bringing together purchasers and sellers of securities or otherwise provides the generally understood functions performed by a stock exchange. Exchange Act Rule 3b-16(a) further clarifies that an organization must register as a national exchange if it (i) brings together orders for securities of multiple buyers and sellers and (ii) uses established, non-discretionary methods under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade. The SEC concluded that the platforms that traded DAO Tokens in the secondary market satisfied the test to be considered national exchanges without meeting any available exemptions.

Important Takeaways

Some ICOs Must Register with the SEC. The SEC's message is clear that ICOs issuing tokens that meet the *Howey* test must either register the offering with the SEC or structure the ICO to satisfy an exemption from registration. In the press release that accompanied the Report, Stephanie Avakian, Co-Director of the SEC's Enforcement Division, noted that, "the innovative technology behind these virtual transactions does not exempt securities offerings and trading platforms from the regulatory framework designed to protect investors and the integrity of the markets." Jay Clayton, SEC Chairman, stressed that the SEC's intent is not to stop the evolution of blockchain securities, but rather to "foster innovative and beneficial ways to raise capital, while ensuring – first and foremost – that investors and our markets are protected." Presumably, an ICO in which the token provides the purchaser to the future right to receive a good or service, as opposed to some economic return in the enterprise, would not be deemed a security.

[2] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

Impact on Secondary Token Exchanges. The secondary market for blockchain securities must now evaluate which of the tokens traded on their exchanges may qualify as securities. Exchanges that trade in cryptocurrencies, like Bitcoin and Ether, are not implicated by the conclusions in the Report, though registration with other regulators, such as the Commodity Futures Trading Commission ("CFTC"), may be required. Rather, exchanges providing a market for investment securities in the form of tokens or coins must now take inventory and implement structures to ensure only non-security tokens are being traded. Alternatively, secondary markets interested in trading token securities should attempt to qualify as an alternative trading system and file a Form ATS with the SEC to be exempt from liability as an unregistered national securities exchange.

Distinction Between Cryptocurrencies and Digital Securities. The SEC distinguished between Ether as a cryptocurrency and DAO Tokens as securities in its Report. Though not the focus of the Report, this conclusion is important as regulators from across federal agencies grapple with how and when to regulate the crypto-economy supported by blockchains and distributed ledgers.

Regulatory Framework Is Taking Shape. The Report is the SEC's first official guidance on the booming ICO market, and the SEC's Distributed Ledger Technology Working Group will continue to contribute to the regulatory discourse on cryptocurrencies and digital securities issued on blockchains. While other federal agencies have previously asserted jurisdiction over certain aspects of the growing digital economy, the market lacks a clear regulatory framework that is still taking shape. For example, in 2015 the CFTC classified Bitcoin and other digital currencies as "commodities" covered by the Commodity Exchange Act,[3] and has subsequently brought several enforcement cases against parties involved in the sale of digital currency. The Financial Crimes Enforcement Agency has also issued guidance stating that digital currency is considered currency and exchanges will be considered exchanges under the Bank Secrecy Act. As the investors continue to trade in cryptocurrencies and blockchain securities and the size of the digital market continues to grow, the regulatory landscape will continue to evolve.

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[3] A detailed analysis of the CFTC's ruling is available here https://www.hunton.com/images/content/2/3/v2/2325/cftc-defines-bitcoin-and-digital-currencies-as-commodities.pdf.