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SEC Confirms Certain ICOs Are Securities Offerings; Regulators Renew Focus on Cryptocurrencies

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Participants and observers in cryptocurrency markets have long expected input from the SEC on the question of whether offerings of cryptocurrencies would be subject to the federal securities laws. On July 25, the US Securities and Exchange Commission (SEC) issued a Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 of its investigation of an offering of digital tokens by "The DAO," an unincorporated virtual organization. The Report makes clear the SEC's view that the traditional securities law analysis applies to new technologies, noting that "the federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using US dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology."

Background

Over a one-month period in 2016, The DAO offered and sold approximately 1.15 billion DAO tokens in exchange for a total of approximately 12 million Ether (ETH), a virtual currency used on the Ethereum Blockchain. At the time the offering closed, the total ETH raised by The DAO was valued at approximately $150 million in US dollars. Investors could hold the tokens as an investment with certain voting and ownership rights or could sell them on web-based secondary market platforms.

The tokens were promoted and sold through a website that described The DAO's purpose as being "[t]o blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code." The website also represented that The DAO's source code had been reviewed by "one of the world's leading security audit companies" and "no stone was left unturned during those five whole days of security analysis." According to promotional materials, The DAO would earn profits by funding projects that would provide DAO token holders a return on their investment. Token holders would receive "rewards" and then vote to either use the rewards to fund new projects or to distribute the ETH to token holders.

There were no limitations placed on the number of DAO tokens offered for sale, the number of purchasers of tokens, the level of sophistication of purchasers or their ability to resell the tokens.

The DAO represented that the tokens would be available for secondary market trading after the offering period, and a number of platforms posted notices on their own websites and through social media to say that they would support secondary market trading of the tokens. In addition to secondary market trading on the platforms, the tokens were to be freely transferable on the Ethereum Blockchain and token holders would be able to redeem their tokens for ETH through a process referred to as a DAO entity "split," which the SEC described in its Report as a "complicated, multi-week (approximately 46-day)" process.

Following the offering, between May and September 2016, the tokens were sold on a number of different platforms, which used electronic systems that allowed their customers to post orders for the tokens anonymously. In June 2016, an unknown individual or group was able to exploit a flaw in The DAO's code to steal approximately one-third of The DAO's assets. The DAO took steps to revise the Ethereum protocol going forward so that token holders could exchange their tokens for ETH and avoid loss of their investments.

Following an investigation of whether The DAO and related parties had violated the federal securities laws in connection with the offer and sale of DAO tokens, the SEC determined it would not pursue enforcement action based on the conduct and activities known to it at the time it completed its investigation. Instead, the SEC issued the Report, setting out its views as to application of the federal securities laws to DAO tokens.

What Is an ICO?

An ICO, or initial coin offering, is the sale of virtual coins or tokens, often as a means of capital raising by startup companies that are involved in blockchain technology. Depending on the terms of the offering, purchasers may use virtual currencies (such as Bitcoin or Ether) or fiat currency to purchase the coins or tokens.

Securities Law Analysis

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 include a broad definition of the term "security" that encompasses a variety of instruments, including an "investment contract." The facts and circumstances test set forth by the US Supreme Court in *SEC v. W.J. Howey Co.* has long been applied to determine whether a particular instrument should be considered an "investment contract" and therefore a "security" for purposes of the Securities Act. The elements to be considered in the application of the *Howey* test are whether the purchasers of the instrument: (i) invested money or valuable goods or services; (ii) were investing in a common enterprise; (iii) with a reasonable expectation of earning profits; (iv) that were to be derived from the efforts of others.

The Report provides a detailed analysis of the facts and circumstances of the DAO offering and applies the *Howey* test to determine that the DAO tokens were "investment contracts" and therefore subject to the federal securities laws.

The SEC easily found that three of the elements were met—that the payments by purchasers in Ether would be considered an investment of money, and that the investors in The DAO were investing in a common enterprise and had a reasonable expectation of profit in light of the stated

objective of The DAO, which was to fund projects in exchange for a return on investment, and token holders would share in potential profits. The SEC discussed in detail the application of the fourth element of the test—the requirement that the investors have an expectation that the profits would be derived from the efforts of others. Key to this part of the analysis was the significant reliance The DAO investors placed on the managerial and entrepreneurial efforts of the founders and curators. The SEC also noted in this respect that DAO token holders had only limited voting rights and access to information.

Seen through the lens of the *Howey* test, it is not surprising that the SEC found a security to exist in the DAO offering. However, the SEC did not state in the Report that all tokens will be considered securities—rather, the SEC stressed the importance of a detailed analysis of the facts and circumstances of the particular offering. While not free from doubt, the new clarity on the SEC's view of the appropriate analysis to be applied may make it easier for token issuers to structure their offerings to avoid characterization as a security. For example, tokens that are linked to the use of a particular product or service, which are not marketed for their investment potential but rather are intended to be used as a medium of exchange, would not seem likely to satisfy the "expectation of profits" element of the test.

Conversely, if, based on the *Howey* analysis, it is likely that a token may be considered a security, issuers of such tokens may wish to consider structuring the offering to fit within an exemption from the Securities Act registration requirements. For example, Regulation D likely would be available if the issuer were willing to limit purchasers of the tokens to accredited investors and meet the other requirements of the safe harbor, including taking "reasonable steps to verify" that all ultimate purchasers of the tokens are accredited investors if general solicitation is used in offering the tokens. It is important to keep in mind, however, that acknowledgment that a particular token is a security may have other significant regulatory consequences.

Concurrently with the SEC's issuance of the Report, the SEC's Divisions of Corporation Finance and Enforcement issued a public statement about the Report. In it, the Divisions reiterated the SEC's position that the DAO tokens were securities and, without citing the case, affirming the application of the *Howey* test to the new technologies by noting that a "hallmark of a security is an investment of money or value in a business or operation where the investor has a reasonable expectation of profits based on the efforts of others." The Divisions stressed the need for those who are involved in these transactions to carefully consider whether they are creating an investment arrangement that constitutes a security, and encouraged market participants to consult with securities counsel and the Divisions' staff for assistance in analyzing the application of the federal securities laws.

Consequences of an Illegal Securities Offering

Under the federal securities laws, any offer and sale of securities must be registered under the Securities Act or conducted under an applicable exemption from registration. An ICO that involves an offering of securities and was not planned in advance to meet the requirements of an exemption from registration would likely be an illegal offering, as it would not have been registered with the SEC and is not likely to have met the conditions of the relevant exemption.

The consequences of an illegal offering include potential civil or criminal liability for the issuer of the securities or for the individuals responsible for promoting the offering. The purchasers of the securities also have the right under the Securities Act to force the seller to rescind the transaction and repurchase the securities at their original purchase price, plus interest. In addition, as discussed below, if securities are offered, the activities of exchanges and other intermediaries would also come under scrutiny.

Issues for Exchanges and Intermediaries

The Report also stressed the need for compliance with the requirements under the Exchange Act for registration of exchanges that effect transactions in securities. Section 5 of the Exchange Act makes it unlawful for any exchange to effect a transaction in a security unless the exchange is registered with the SEC or exempt from registration. Section 3(a)(1) and Rule 3b-16, collectively, define an "exchange" functionally as any organization or group that (1) brings together the orders of multiple buyers and sellers of securities; and (2) uses established, non-discretionary methods to effect a trade. There are various exemptions from exchange registration, the most common of which is for alternative trading systems (ATSs). ATSs— many of which are so-called dark pools—operate as registered broker-dealers and pursuant to specific requirements set forth in Regulation ATS of the Exchange Act.

In the Report, the SEC concludes that various platforms that traded DAO tokens met the definition of an "exchange" under the Exchange Act and did not appear to have a valid exemption from registration. As a result, had the Division of Enforcement determined that it would recommend that the SEC pursue an enforcement action against the platforms, the SEC would have alleged violations of Section 5 of the Exchange Act, and could have pursued a cease and desist order, disgorgement and/or penalties.

Investment Company Act Issues

The Report did not address whether The DAO was an investment company as defined in the Investment Company Act of 1940 because The DAO did not commence its business operations funding projects. However, prospective ICO issuers, as well as funds or other organizations that invest in ICOs, need to analyze not only the application of the Securities Act to the offering but also the application of the Investment Company Act to their organizations. Generally, an investment company is defined as an issuer of securities that is "engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire "investment securities" having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis." If particular tokens are considered securities, an organization that holds a significant amount of tokens may be deemed an investment company and therefore be subject to SEC regulation.

Other Regulatory Concerns

The issuance of the Report answers the question of whether the SEC is willing to assert jurisdiction over ICOs. Clearly the answer is in the affirmative. However, this leaves many significant questions unanswered, including the interaction between the various regulators that may have a stake in

these offerings.

For example, the trading of virtual currencies and derivative instruments linked to those currencies may implicate the jurisdiction of the Commodity Futures Trading Commission (CFTC). In a September 2015 enforcement action, the CFTC officially declared that “Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities” (*In re Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (Sept. 17, 2015)). Acting CFTC Chairman J. Christopher Giancarlo has spoken extensively regarding how the CFTC and other regulators can encourage innovation in and address issues arising from financial technology. In May 2017, the CFTC launched LabCFTC, an initiative designed to “promot[e] responsible FinTech innovation to improve the quality, resiliency, and competitiveness of the markets the CFTC oversees,” make the CFTC more accessible to market innovators, and foster the CFTC's understanding of new market technologies.

In addition, in July 2017, the CFTC granted LedgerX, LLC, formal registration as a swap execution facility (SEF) and as a derivatives clearing organization (DCO)—the first CFTC approval of a platform for the trading and clearing of virtual currency derivatives. The approvals authorize LedgerX to list and clear fully collateralized, physically settled derivative contracts for virtual currencies. LedgerX, which initially plans to list and clear Bitcoin options, will require participants to provide it with acceptable collateral—i.e., US dollars and Bitcoin—to cover the maximum potential loss of a contract before a trade can be executed. Nevertheless, the CFTC cautioned that its LedgerX approval “does not constitute or imply a Commission endorsement of the use of digital currency generally, or Bitcoin specifically.”

Conclusion

Market participants will continue to need to proceed with caution in structuring offers and sales of tokens, and should consider carefully the factors considered in the SEC's Report and the SEC's analysis and conclusions based on those factors. In particular, and as noted in the Divisions' statements, it will be important for market participants to consult with experienced counsel in considering transactions involving tokens and other virtual currency.

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