SEC focuses on initial coin offerings: tokens may be securities under federal securities laws

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Abstract

Purpose – *To explain the recent determination by the US Securities and Exchange Commission (SEC) with respect to so-called "token sales" or "initial coin offerings" (ICOs) that some tokens may be securities under federal securities laws and to address other recent actions by the SEC with respect to ICOs.*

Design/methodology/approach – *Reviews the SEC's determination that some tokens issued in an ICO may be securities under federal securities laws as outlined by the SEC's Division of Enforcement in a "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO." Provides overview of SEC Investor Alert, Investor Bulletin, and recent comments and actions of the Staff regarding investment in ICOs and provides guidance to those interested in participating in an ICO as an investor or issuer.*

Findings – *These actions by the SEC make it clear that the SEC is closely monitoring the market for ICOs, and that it wants potential investors and issuers to be aware that it is watching and may take action if it believes the securities laws have been violated.*

Originality/value – *Practical overview of recent developments and guidance from experienced securities and financial services lawyers.*

Keywords *Digital assets, US Securities and Exchange Commission (SEC), Cryptocurrency, Initial coin offerings (ICOs), Token sales, Virtual currency*

Paper type *Technical paper*

On July 25, 2017, the SEC's Division of Enforcement issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (DAO Report). This report indicates that "The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain." The DAO Report concludes that the digital tokens, which were issued for the purpose of raising funds for projects, may be deemed to be securities under the federal securities laws. According to the SEC, such securities must be registered with the Commission or eligible for an exemption from the registration requirements. The same day, the SEC's Office of Investor Education and Advocacy issued an Investor Bulletin, addressing the topic of ICOs more generally. Concurrently, the SEC's Divisions of Corporation Finance and Enforcement released a joint statement supporting the DAO Report and Investor Bulletin. In their statement, the Divisions noted that "the issue of whether a particular investment opportunity involves the offer or sale of a security – regardless of the terminology or technology used in the transaction – depends on the facts and circumstances, including the economic realities and structure of the enterprise."

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Investor bulletin

The Investor Bulletin observes that, "[d]epending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities. If they are securities, the offer and sale of these virtual coins or tokens in an ICO are subject to the federal securities laws." The Investor Bulletin also highlights the risks of ICO investing and provides guidance for potential investors. Among other risks, the Investor Bulletin highlights that, due to the nature of virtual currencies and digital tokens, investors may be subject to cybersecurity risk and loss resulting from hacking. Additionally, while some tokens may afford investors with rights under the federal securities laws, the SEC may have difficulty enforcing these rights on account of the difficulty in tracing and freezing assets due to the international nature and lack of central authority or custodian with respect to virtual currencies and digital tokens.

DAO report

In the DAO Report, the SEC analyzed certain aspects of "The DAO," including how the entity was created, funded and run. The DAO was formed as a for-profit entity in order to "create and hold" assets by selling tokens (DAO Tokens) to investors in exchange for "ether" (the native cryptocurrency of the Ethereum blockchain), with the proceeds of such sales being used to fund "projects" intended to generate profits. "In addition, DAO Token holders could monetize their investment in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms [. . .] that supported secondary trading in the DAO Tokens." After the sale of approximately $150 million in DAO Tokens to investors, The DAO suffered a hack and lost approximately one third of the ether raised.

In determining whether a violation of the federal securities laws had occurred, the SEC considered as a "threshold question whether DAO Tokens are "securities'" within the meaning of such laws. This DAO Report notes that "[a]ll securities offered and sold in the USA must be registered with the Commission or must qualify for an exemption from the registration requirements," and applies these principles to "a new paradigm – virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities." The DAO Report goes on to state that "[t]he automation of certain functions through this technology, "smart contracts," or computer code, does not remove conduct from the purview of the USA federal securities laws" and "[t]hese requirements apply to those who offer and sell securities in the USA, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using USA dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology." Accordingly, based on facts and circumstances particular to The DAO, as set forth below, the SEC concluded that the DAO Tokens are securities within the meaning of the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act)[1].

In reaching this conclusion, the SEC applied the *Howey* test of an "investment contract" in analyzing the DAO Tokens' nature. In *SEC v. W.J. Howey Co.* and its progeny, the USA Supreme Court defined an investment contract as "an investment of money in a common enterprise with profits to come solely from the efforts of others[2]". The SEC used the following factors of the *Howey* test to determine that DAO Tokens are securities:

> *Investment of Money.* An investment of "money" need not take the form of cash[3]. The SEC found that investors made the type of "contribution of value" that can create an investment contract by using ether to make their investments, and DAO Tokens were received in exchange for ether.

Reasonable Expectation of Profit. The second prong of the *Howey* test looks at whether investors who purchased an instrument had a reasonable expectation of profit from that enterprise. The SEC found that investors reasonably expected a return on their investments through a share of potential profits from projects to be undertaken by The DAO – a common enterprise – given that they were repeatedly informed in marketing materials that The DAO's objective was to fund projects in exchange for a return on investment.

Derived from the Managerial Efforts of Others. The third prong of the *Howey* test examines whether the profits of an instrument are derived from the managerial efforts of others. In making this determination, the SEC queried whether the efforts of others were the "undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise[4]". The SEC "safeguarding investor funds, and determining whether proposed contracts should be put for a vote" which in turn led potential investors "to believe that they could be relied on to provide the significant managerial effort required to make The DAO a success." The SEC also found that the management provided active oversight of The DAO in responding to the hack. Further, the SEC found that investors' voting rights did not provide them "with meaningful control over the enterprise" because DAO Token holders' ability to vote for contracts was mostly perfunctory and DAO Token holders were widely dispersed and limited in their ability to communicate with one another.

Based on its finding that the DAO Tokens qualify as securities, the SEC concluded the following:

The DAO, as issuer, was required to register the offer and sale of DAO Tokens under the Securities Act. Absent a valid exemption, the registration, disclosure, reporting and other aspects of the securities laws applied to the offer, sale and subsequent trading of such tokens.

Any platform offering secondary market trading of DAO Tokens must register with the SEC as a national securities exchange under the Exchange Act (or operate within a recognized exemption).

Although the conclusion in the DAO Report was the result of a fact-based inquiry, the SEC described its views with respect to ICOs in terms of general applicability, indicating the SEC's intention to implement these views broadly in the future. Under the SEC's analysis of the Howey test, not all tokens are securities, and potential issuers should consider the expectations of potential investors and the rights afforded in connection with an ICO under such test. While the SEC decided not to pursue enforcement in the matter of The DAO, the DAO Report is a reminder that all offerings of tokens within the USA must be conducted in accordance with the federal securities laws or fall within an exemption. The DAO Report also raises a serious concern that, absent an exemption, platforms that operate as USA exchanges to trade such tokens may need to register as a national securities exchange or alternative trading system. Furthermore, any person who receives compensation from the sale of tokens may need to register as a broker-dealer, and any person who provides investment advice with respect to a token sale may need to register as an investment adviser. Further, the DAO Report warns "[t]hose who would use virtual organizations" to review their obligations under the Investment Company of 1940 Act. The DAO Report did not consider such obligations in this case because The DAO did not begin its planned investment operations.

SEC Warns Investors and Takes Action Against Issuers Involved in and/or Promoting ICOs

Investor alert

On August 28, 2017, the SEC published an Investor Alert "warning investors about potential scams involving stock of companies claiming to be related to, or asserting

they are engaging in, [ICOs].” The Investor Alert warns that potential scammers may use the lure of new and unfamiliar technology to convince investors to participate in what may be scams, “includ[ing] “pump-and-dump” and market manipulation schemes” in connection with publicly traded companies trying to take advantage of the hype associated with these new technologies. The Investor Alert acknowledges that ICOs themselves may be “fair and lawful investment opportunities,” while cautioning that publicly traded companies may try to use an ICO “to affect the price of the company’s common stock”.

According to the Investor Alert, the SEC recently halted trading in the securities of four issuers “who made claims regarding their investments in ICOs or touted coin/token related news.” The Investor Alert states that “[c]ircumstances that might lead to a trading suspension include:

> A lack of current, accurate or adequate information about the company – for example, when a company has not filed any periodic reports for an extended period;
>
> Questions about the accuracy of publicly available information, including in company press releases and reports, about the company’s current operational status and financial condition; or
>
> Questions about trading in the stock, including trading by insiders, potential market manipulation, and the ability to clear and settle transactions in the stock.”

In addition to halting trading in the securities of issuers, at least one start-up in the process of raising money through an ICO has reported that it was contacted by the SEC. According to the website for blockchain-based company Protostarr: the company was contacted by the SEC on August 24, 2017, regarding its ongoing ICO to raise money for a decentralized application; and after consultation with legal counsel, the company determined to “cease further operations” and refund to the ICO participants all ether that had been raised (Protostarr.io, 2017).

Statement by enforcement co-director

Since the publication of the Investor Alert, Steven Peikin, Co-Director of the SEC’s Enforcement Division, reportedly stated, in connection with ongoing investigations into potential fraudulent activities by companies in the blockchain and digital currency space, that some of these companies “are really just trying to steal people’s money.” Mr. Peikin went on to state: “As with any kind of newsworthy event, roaches kind of crawl out of the woodwork and try to scam money off investors[5]”.

Conclusion

These comments from the SEC staff, as well as the release of the investor alert shortly following the investor bulletin and DAO report, suggests that the SEC is closely monitoring the market for ICOs, and that it wants potential investors and issuers to be aware that it is watching and may take action if it believes the securities laws have been violated[6]. potential issuers and investors should also take into account the implications of state securities laws on a state-by-state basis when considering whether to raise Capital or invest, respectively, via an ICO. Issuers and publicly traded companies should also be aware that the commodity futures trading commission has asserted jurisdiction over digital currencies as “commodities,” and has anti-fraud and anti-manipulation authority over spot and forward transactions involving these products, including ICOs[7].

Notes

1. Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act include "investment contracts" within the definition of "security."
2. *SEC v. W.J. Howey Co.*, 328 US 293, 301 (1946); see also *SEC v. Edwards*, 540 US 389, 393 (2004).
3. *SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121 at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of a virtual currency meets the "investment of money" component of the *Howey* test)
4. Citing *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).
5. *See* SEC Chief Says Cyber Crime Risks Are Substantial, Systemic, *New York Times* (Sept. 5, 2017).
6. Although beyond the scope of this *OnPoint*, various state and federal agencies have weighed in on the status and treatment of virtual currencies. Additionally, foreign jurisdictions including China, Singapore, Hong Kong and Canada have recently released their own guidance with respect to how ICOs are treated under each jurisdiction's respective securities laws.
7. *See In the Matter of Coinflip, Inc.*, *et al.*, Comm. Fut. L. Rep. (CCH) 33,538, (Sep. 17, 2015).

Reference

Protostarr.io (2017), available at: https://protostarr.io/press-releases/protostarr-shutting-down/ (accessed 5 September 2017).

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