CARLTON FIELDS

The SEC Addresses Initial Coin Offerings

BLOCKCHAIN AND DIGITAL CURRENCY | BUSINESS TRANSACTIONS | SECURITIES AND DERIVATIVE LITIGATION | SECURITIES TRANSACTIONS AND COMPLIANCE | TECHNOLOGY | SEPTEMBER 26, 2017

Richard A. Denmon

Matthew E. Kohen

On July 25, 2017, the Securities and Exchange Commission (SEC) issued a Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 (Report) [1] and an Investor Bulletin: Initial Coin Offerings (Bulletin) [2] finally weighing in on whether virtual coins or digital tokens created and disseminated using distributed ledger or blockchain technology may be "securities" under the federal securities laws.

The answer? Maybe, depending on the facts and circumstances.

Virtual Currencies, Initial Coin Offerings, and Tokens – What are They?

Recently, the sale of blockchain-based tokens through initial coin offerings (ICOs) has become an increasingly popular financing technique used by companies to raise capital to fund the development of a digital platform, software, or other project. The sale of such tokens through ICOs has been made possible through the rapid popularization of blockchain technology, the cryptographically-secured, distributed ledger that underpins virtual currencies such as bitcoin and ethereum.

Although the mechanics of ICOs may vary, one popular method of conducting a token sale is to utilize ethereum's ERC-20 token standard, and issue such tokens through a smart contract deployed to the ethereum blockchain. In this example, individuals may participate in an ICO by sending a certain amount of ether (the token used to transact on the native ethereum blockchain, also known as ETH) to a smart contract. In turn, the smart contract will send a corresponding amount of tokens to the wallet that initiated the transaction. Thus, at the conclusion of the ICO, the company that created the token and deployed the smart contract will likely have received ether in exchange for its own token. Similarly, users who sent ether to the smart contract will typically receive tokens, which may have a number of potential uses.

Tokens purchased through an ICO may be used to, among other things, access the platform, use the software, or otherwise participate in the project. Other tokens may function to confer certain rights on the token holder, such as ownership rights, the right to share in a portion of the organization's profits, or the right to vote on how the organization should conduct itself.

Tokens are generally fungible. After their issuance they may be sent to other persons in a manner similar to the way ether is transacted between users. Leveraging the same benefits of blockchain technology enjoyed by other virtual currencies, token transactions are recorded on the blockchain, which, through the power of complex mathematics and cryptography, functions as a reliable transaction ledger with verifiably accurate entries.

To provide a medium for the exchange of virtual coins or digital tokens after they have been issued, platforms have developed as a secondary market for trading them. These platforms, known as virtual currency exchanges, consist of persons or entities that exchange virtual currency for a fiat currency (e.g., an underlying physical currency, such as dollars), funds, or other virtual currency. The virtual currency exchanges generally receive a fee for these exchange services.

As a result of the infrastructure described above, the use of virtual coins and digital tokens is becoming a popular method to exchange and store value, manage and exercise ownership rights, and administrate other functions. However, depending on the specific attributes of a given token, it may be considered a security under U.S. law, and therefore subject the issuer to applicable laws and regulations.

Are Virtual Coins and Digital Tokens "Securities" Under U.S. Securities Laws?

Investment Contracts are Securities . Under the federal securities laws, a security is defined to include not only the typical types of instruments that everyone understands to be a security (e.g., stocks, bonds, notes, etc.), but also "investment contracts.” [3] In the seminal case of *SEC v. W.J. Howey* [4], the Supreme Court defined an investment contract as:

- an investment of money;
- in a common enterprise;
- with a reasonable expectation of profits;
- to be derived from the entrepreneurial or managerial efforts of others.

The SEC will apply this test to determine whether virtual coin or digital token offerings involve the offer and sale of securities subject to the federal securities laws. The first three prongs of the test generally are easy to apply, especially when the marketing materials or white papers for the offering espouse the benefits of investing in the tokens. However, applying the fourth prong of this test can be problematic and will depend significantly on the specific facts and circumstances of the offering, the function of the token, and the operation of the underlying enterprise.

***The DAO*.** In the Report, the SEC applied this test to the initial offering of tokens by a decentralized autonomous organization known as the DAO, which was created by slock.it, a company existing at the time under German law. The DAO was a virtual organization created by slock.it to raise funds by issuing tokens to be used to fund projects. DAO token holders would share in these projects’ anticipated earnings. Although token holders would have been permitted to vote on potential project funding, a project could not be considered for funding unless a “curator,” an individual initially appointed by slock.it, approved it (projects were to be submitted in the form of a smart contract) and decided it should be considered for approval. In its examination of the DAO offering and investment procedures, the SEC noted:

- The offering of the tokens was promoted by slock.it on a website which described the operations of DAO, its structure and source code, and provided a link through which DAO tokens could be purchased.
- The DAO promotional materials provided that DAO would earn profits by funding projects that would provide DAO token holders with a return on investment (referred to as rewards) and that DAO token holders would then vote to either use the rewards to fund future projects, or distribute ETH to DAO token holders.
- There were no limitations placed on (i) who was eligible to purchase the DAO tokens, (ii) the number of DAO tokens that could be sold in the offering, (iii) the number of purchasers of DAO tokens, (iv) the level of sophistication of the purchasers, or (v) the resale of DAO tokens purchased in the offering.
- As for the resale of DAO tokens in the secondary market, (i) prior to the offering of the DAO tokens, slock.it solicited platforms on its system (including at least one U.S. platform) to support secondary trading DAO tokens; and (ii) during the offering of the DAO tokens, the platforms publicly announced their intention to support such secondary trading.
- The expertise of the DAO creators and the curators was critical in monitoring the operations of the DAO, and the voting rights of DAO token holders were limited, perfunctory, and afforded them no meaningful control over the enterprise.

SEC Analysis of the DAO Token Offering. The SEC noted, “U.S. securities laws may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of organization or technology used to effectuate the particular offer or sale.” When evaluating whether an investment contract exists, the SEC further stated that the definition is to be flexibly construed so as to adapt to various schemes by those who seek to use other people’s money on the promise of profits, and that such analysis should be based on the economic realities and not the form of the underlying transaction.

In its analysis of whether the DAO token offering was an investment contract, the SEC easily determined that the purchase of the DAO tokens satisfied the first three prongs of the *Howey* test. As to the first prong of the test, the SEC explained that an investment of money need not be in the form of cash, but rather must only be an exchange of value. The SEC stated that the purchase of DAO tokens in exchange for ETH is the type of contribution of value that satisfied this prong of the test. Based on the promotional materials and the structure of the enterprise, the SEC also had little difficulty concluding that investors purchasing DAO tokens were involved in a common enterprise and reasonably expected to earn profits through the enterprise. The SEC noted that the promotional materials disseminated by slock.it and its co-founders clearly stated that the DAO was a for profit entity, its objective was to fund projects that would provide a return on investment, all ETH were pooled and available for investment in projects, and holders of DAO tokens would share in potential profits from projects approved by the curators and the DAO token holders. As a result, in the SEC’s view, a reasonable investor would have been motivated, at least partly, by the potential for profits from their ETH investment into the DAO.

Although the SEC provided a more thorough analysis of the fourth prong of the *Howey* test, it ultimately concluded that this prong was satisfied because the purchasers of the tokens were significantly reliant on the efforts of the DAO’s promoters (slock.it and its co-founders) and the curators for making the enterprise and its projects a success, and token holders had only limited voting rights that did not rise to the level of sharing managerial control over the enterprise or its project investments. In particular, the SEC noted that: (a) slock.it selected the curators based on their expertise and credentials to evaluate projects and, in their promotional materials, led investors to believe that they could rely on the curators to provide the significant managerial efforts required to make the DAO a success; (b) the DAO protocols for evaluating and approving a project, including the particulars of token holder votes, had been pre-determined by slock.it and the curators; and (c) the curators have the power to vet and to decide which proposals go to a vote and the vote necessary to approve a proposal. As structured, the DAO founders and the curators were critical in monitoring the operation of the DAO, safeguarding investor funds, and determining the projects to be considered by the DAO. The SEC found that “investors had little choice but to rely on their expertise.” Further, the voting rights afforded investors gave them no ability to meaningfully effect managerial control or investment decisions of the curators. The matters to be voted on by DAO token holders were limited to those approved by the curators (including any proposals to remove a curator), the ability to vote on projects was largely perfunctory, and insufficient information about individual projects was available to DAO token holders for them to make an informed investment decision. Coupled with the fact that investments in the DAO were made by widely dispersed investors using pseudonyms that were continually trading in the secondary markets, the SEC viewed the ownership of DAO tokens as closely aligned with the ownership of a shareholder (with limited input to the operations of the entity) and not an interest that had true managerial control (such as a general partnership).

Based on this analysis and the economic realities of the investment, the SEC concluded that the DAO tokens were securities under the Securities Act and the Exchange Act.

What Does This Mean?

The SEC did not proclaim that all virtual coins and digital tokens offerings involve an offer and sale of “securities.” Rather, it will depend on the specific facts and circumstances and the economic realities of each transaction, generally through the application of the *Howey* test.

Application of U.S. Securities Laws to Offerings. If a transaction involving the sale of blockchain tokens (such as an initial coin offering) is deemed an offer and sale of securities, then the offering must be registered with the SEC or an exemption from registration must be available. Registration involves a lengthy process that requires preparing and filing a detailed disclosure document with the SEC (i.e., a registration statement) that will include the prospectus that must be distributed to investors (i.e., a prospectus) prior to accepting any offers to purchase the tokens. The SEC can be expected to review the filing and provide comments requesting revisions to and support for various statements included in the documents. In addition, organizational documents, agreements relating to the sale of the securities, and various material agreements will need to be publicly filed as exhibits to the registration statement. Alternatively, the offering may be made pursuit to one of the various exemptions from registration under the Securities Act. However, each of these exemptions are subject to specific requirements and limitations that must be followed as a condition to such exemption, including those that may limit the manner of the offering, the purchasers of the securities, and the resale of the securities. Further, even if the offering is exempt from registration under the federal securities laws, it must still comply with applicable state securities laws registration requirements or exemptions therefrom.

One of the hallmarks of the U.S. federal securities laws is that potential investors are to be provided with all material information necessary to make an investment decision. Although the level of the necessary disclosures may in some instances depend on the sophistication of the offerees, it is always unlawful to make any untrue statement of a material fact, or to omit a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading (the so-called anti-fraud provisions). As a result, disclosure documents furnished to potential investors must not contain any material misstatements or material omissions that a reasonable investor would consider important in making his or her investment decision.

Intermediaries. If the tokens are securities, both federal and state securities laws require the intermediaries who offer, transact in, or advise on investments in securities to be licensed or registered. This includes persons or firms: (a) acting as brokers or dealers of the securities being offered; (b) receiving transaction-based compensation for offering and selling securities on behalf of an issuer; and (c) investment advisors providing advice as to whether its clients should invest in the offering or in secondary trading of the securities.

Registration of Secondary Trading Platforms as a National Securities Exchange . Platforms that provide trading facilities for the secondary trading of digital tokens that are deemed securities may be considered an “exchange” under the Exchange Act.[5] If so, they must be registered as a national securities exchange unless they operate under an appropriate exemption. The SEC noted in the Report that the platforms that provided a secondary market for the DAO tokens “provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods” and, as such, appear to have been national securities exchanges subject to registration.

Foreign Based Entities Offering Securities May Still Be Subject to the U.S. Securities Laws. In the Report, the SEC clearly reminded issuers that the U.S. federal securities laws apply to any persons or entities, whether traditional or a decentralized autonomous organization, that offer and sell securities in the United States, regardless of the jurisdiction of origin of the person or entity and whether the securities are being purchased with U.S. dollars or other currencies (including virtual currencies). The purpose of the U.S. securities laws is to provide investors with all of the material information necessary to make informed investment decisions and to provide them with various procedural protections.

These restrictions also apply to the resale of securities. Simply excluding U.S. purchasers from the initial offering of digital tokens deemed to be securities will be insufficient to comply with U.S. federal securities laws. Generally, securities can be sold outside the United States without complying with U.S. federal securities laws only if offered and sold in an offshore transaction (e.g., no offer is made to a person in the United States and the buyer is physically outside of the United States, or the sale is made on certain foreign exchanges or offshore securities markets) where no directed selling efforts are made in the United States (e.g., not designed to condition the U.S. markets). Further, buyers of securities in offshore transactions may not resell the securities in the United States without complying with the registration requirements or an exemption from registration. In essence, the concept is to not allow the securities offered in offshore transactions to leak into (or be reoffered in) the United States without compliance with U.S. federal securities laws.

The fact that slock.it was a German entity and the DAO was an unincorporated Swiss entity did not shield them from the application of the U.S., federal securities laws because the digital tokens were available for purchase by U.S. residents and were trading by at least one secondary exchange platform in the United States.

Application of Other Laws . As previously indicated, the SEC did not state that ***all*** digital tokens are securities. If, under the facts and circumstances, certain digital token offerings do not constitute an investment contract and may not be considered a security, they may still be subject to regulatory oversight by other U.S. agencies. For example, the U.S. Commodity Futures Trading Commission (CFTC) has stated that virtual coins or digital tokens that function as a digital currency created through a mathematical formula and award system, such as Bitcoin, are a commodity and, under applicable law, all offers and sales of any derivatives based on such currencies must comply with the CFTC’s rules and regulations. Further, processors of bitcoins, even if located outside the United States, may be subject to money services business requirements and regulations. These regulations impose a number of licensing and compliance requirements, including the implementation of anti-money laundering programs subject to oversight by the Financial Crimes Enforcement network (FinCen) if they are doing business in the United States (which may be through foreign domain names and websites). Similarly, some states have enacted laws or regulatory regimes that specifically apply to virtual currencies and the individuals and businesses who utilize them.

Parting Thoughts

The development virtual currencies and the increasing popularity of initial coin offerings are relatively new phenomena, and U.S. regulators are only now beginning to consider the regulatory implications of these innovations. In the coming years, such regulators are expected to become more aggressive in their approach. Because of the facts and circumstances analysis required to evaluate each potential digital token offering to determine whether it involves “securities” subject to the U.S. federal securities laws, together with the lack of specific SEC guidance, it will be difficult for companies to offer tokens that blur the line between virtual currency and security. The analysis may involve looking to other areas where the SEC has provided guidance through interpretive releases and no action positions with respect to investment contracts, such as real estate offerings and membership interests, understanding that they may not necessarily have any direct application to digital token offerings. In any event, anyone interested in using this form of financing will need to undertake careful planning and fully understand the nature of the regulatory risks it entails.

---

[1] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: the DAO; Exchange Act Release 34- 81207 (July 25, 2017)

[2] Investor Bulletin: Initial Coin Offerings; Securities and Exchange Commission (July 25, 2017)

[3] Section 2(a)(1) of the Securities Act of 1933 (the Securities Act) and Section 39A)(10) of the Securities Exchange Act of 1934 (the Exchange Act)

[4] *SEC v. W.J. Howey Co* ., 328 US 293, 301 (1946)

[5] See Section 3(a) (1) of the Exchange Act and Rule 3b-16(a) promulgated thereunder. An organization, association, or group of persons will be an “exchange” if they: (a) bring together the orders for securities of multiple buyers and sellers; and (b) use established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.