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# Is the Party Over? The SEC Investigates Cryptocurrency Offerings

***Benjamin T. Brickner and Trudy-Anne McLeary****

*In a Section 21(a) investigative report and companion investor bulletin, the Securities and Exchange Commission concluded that offers, sales, and resales of cryptocurrency coins and tokens are likely subject to federal securities laws. This article reviews the Commission's analysis and discusses implications for the coin and token ecosystem.*

The U.S. Securities and Exchange Commission (the "Commission" or "SEC") has released an investigative report with important implications for issuers and sponsors of initial coin offerings ("ICOs") and token sales that raise funds for cryptocurrency ventures.[1] Prompted by the recent proliferation of such activity, the report concluded that tokens offered to purchasers in a 2016 token sale were securities regulated by the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[2] As a result, absent an exemption, such offerings must be registered with the Commission, similar to other public offerings.

The press release accompanying the report notably quotes the new Commission chairman and the new heads of the Corporation Finance and Enforcement divisions.[3] This combined statement gives the report unusual weight and makes clear that its contents describe senior officials' current thinking on cryptocurrency regulation. While the Commission declined to take enforcement action at this time, the report and press release convey a clear

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1 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017) [hereinafter "*SEC Report*"], *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf. While the report refers to "initial coin offerings" and "token sales" interchangeably, coins and tokens are distinct digital assets. For purposes of the Commission's securities analysis, however, this distinction is immaterial. For more information about the differences between coins and tokens, *see* Zach LeBeau, "What's the Difference Between an 'ICO' and a 'Token Launch'?," *Medium* (May 11, 2017), https://medium.com/@SingularDTV/whats-the-difference-between-an-ico-and-a-token-launch-7105edbb2112.

2 *SEC Report*, *supra* note 1, at 11–15.

3 Press Release, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-131.

warning to those engaged in similar activities that unregistered sales of cryptocurrency coins and tokens may constitute illegal public offerings of securities.[4]

## THE TOKEN SALE

In 2016, The DAO, an unincorporated association, organized an initial public offering-style transaction in which members of the public were offered digital tokens ("DAO Tokens") in exchange for ether, a cryptocurrency component of the computing platform Ethereum.[5] Similar to bitcoin, ether is a digital asset designed to function as a medium of exchange with no centralized authority governing its production or use. Both ether and the DAO Tokens are represented as units of computer code recorded on a transaction ledger, or blockchain. Cryptocurrency blockchains are stored on diffuse computing networks, making their transaction records readily discoverable and difficult to counterfeit.[6]

The proceeds of the DAO Token sale—approximately $150 million—were intended to finance projects approved by a vote of DAO Token holders. Projects were to consist of investments in "smart contracts," or multiparty agreements encoded on a blockchain. This would have enabled transactions under these agreements to be self-executing, thanks to the technology's inherent verification and enforcement mechanisms. The DAO was designed to direct smart contract profits to DAO Token holders.[7]

Thus, the offering presented participants with the opportunity to share in the earnings from these projects and, importantly, was marketed as such. In June

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[4] The Commission concurrently issued a bulletin educating investors about ICOs and token sales and warning about the risks associated with participating in them. *See* Investor Bulletin: Initial Coin Offerings, SEC Investor Bulletin (July 25, 2017) [hereinafter "*SEC Bulletin*"], *available at* https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings.

[5] The DAO was created by the German technology company Slock.it as a decentralized autonomous organization (hence the name "DAO"). These stateless organizations are governed by self-executing computer protocols known as "smart contracts." Their governing protocols and transaction history are recorded on widely distributed digital ledgers known as blockchains. For more information about decentralized autonomous organizations and how they operate, *see* Ethereum Foundation, Decentralized Autonomous Organization (Aug. 14, 2017), *available at* https://www.ethereum.org/dao.

[6] For a mildly NSFW primer on ether and cryptocurrency in general, *see* Daniel Oberhaus and Jordan Pearson, "Okay, WTF Is Ethereum?," *MOTHERBOARD* (June 16, 2017), *available at* https://motherboard.vice.com/en_us/article/newkqz/okay-wtf-is-ethereum.

[7] For more information about The DAO and how it was intended to operate, *see* Christoph Jentzsch, Decentralized Autonomous Organization to Automate Governance (March 23, 2016)

2016, however, hackers gained control over one-third of the ether raised through the offering, then valued at about $50 million.[8] Only by fundamentally altering the computing platform on which ether is based was The DAO able to regain control of the stolen assets.[9] Following this attack, the Commission launched an investigation into the applicability of the federal securities laws to DAO Tokens and similar offerings, and whether unsuspecting investors were exposed to a high risk of fraud.

## COMMISSION DISCUSSION AND ANALYSIS

While cryptocurrencies, blockchain, and digital tokens are new and rapidly evolving technologies, most federal securities laws have been on the books for decades and were not written with these novel constructs in mind. Nonetheless, the Commission and other regulators are adept at applying existing law to new concepts, as the Commission's report demonstrates.

### When Are Coins and Tokens Securities?

As a general matter, to comply with federal securities laws, a public offering of securities must be made under a registration statement filed with and declared effective by the Commission (unless an exemption is available).[10] In its investigation, the Commission sought to determine whether DAO Tokens and similar instruments constitute securities for purposes of the Securities Act and the Exchange Act. A security is broadly defined to include investment contracts.[11] As explained in the report, an investment contract "is an investment of money in a common enterprise with a reasonable expectation of

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[hereinafter "*The DAO White Paper*"], *available at* https://download.slock.it/public/DAO/WhitePaper.pdf.

[8] *See* Klint Finley, "A $50 Million Hack Just Showed That the DAO Was All Too Human," *Wired* (June 18, 2016), https://www.wired.com/2016/06/50-million-hack-just-showed-dao-human/.

[9] In cryptocurrency parlance, ether holders voted to implement a "hard fork" in the blockchain that invalidated certain prior transactions and enabled The DAO to recover the stolen assets. Due to the distributed nature of the technology, however, the hard fork—essentially a software update—could not be imposed on all ether holders. Refusal by some to go along with the hard fork gave rise to a new cryptocurrency. These rival currencies (ether and classic ether) coexist with a shared history until the hard fork, but now record their transactions on separate blockchains. See Vitalik Buterin, "Hard Fork Completed," *Ethereum Blog* (July 20, 2016), https://blog.ethereum.org/2016/07/20/hard-fork-completed/.

[10] *See* 15 U.S.C. § 77e.

[11] *See* 15 U.S.C. § 77b(a)(1) (Securities Act) and 15 U.S.C. § 78c(a)(10) (Exchange Act).

profits to be derived from the entrepreneurial or managerial efforts of others."[12] The Commission applied the classic test for a "security" under federal law, established by the U.S. Supreme Court in *SEC v. W. J. Howey Co.*, a 1946 decision that articulated a three-part analysis.[13]

The Commission found that DAO Tokens met all three prongs of the *Howey* test for identifying investment contracts and, therefore, constituted securities. Specifically, the Commission's analysis concluded that DAO Token holders (1) invested money (2) with a reasonable expectation of gaining profits (3) that were derived from the efforts of The DAO.[14] The investment-of-money prong was satisfied by token holders' exchange of the digital currency ether. The expectation-of-profits prong was satisfied by how the offer was marketed. Statements made by promoters, on The DAO website and in a white paper, marketed the offering as an investment opportunity.[15]

After easily concluding the first two prongs were met, the Commission discussed at greater length whether the offering depended on the efforts of others. Here the Commission framed the "central issue" as whether the efforts made by those other than the participants were "undeniably significant" and "essential managerial efforts which affect the failure or success of the enterprise." The Commission noted that the creators of The DAO "held themselves out to investors as experts in Ethereum," the blockchain protocol on which The DAO operates. Moreover, they informed participants that they had selected key personnel to manage the enterprise "based on their expertise and credentials."[16]

**Implications for ICOs and Token Sales**

The Commission provided extensive analysis of the third *Howey* prong, examining marketing factors specific to The DAO, suggesting that other platforms could be structured to avoid the inference that the profits were derived from the efforts of others, thereby avoiding the conclusion that securities were offered. For example, the Commission noted that DAO Token holders' voting rights "did not provide them with meaningful control over the enterprise." The Commission observed that the ability to vote for contracts was "largely perfunctory" and that token holders were "widely dispersed and limited in their ability to communicate with each other." Moreover, promoters

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[12] *SEC Report*, *supra* note 1, at 11.

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

[14] *SEC Report*, *supra* note 1, at 11–15.

[15] *See The DAO White Paper*, *supra* note 7.

[16] *SEC Report*, *supra* note 1, at 12–13.

administered The DAO's website, effectively controlling the information available to token holders about the offering.[17]

The Commission proceeded to describe and examine these features at length. This emphasis is notable and suggests that technological innovation could provide token holders with voting rights, communication abilities and/or information access sufficient to reach a different conclusion under *Howey*'s third prong. Implementing such a platform could be difficult, especially where holders are numerous, because effective voting control and internal communication may not be practical. Nonetheless, the Commission's detailed discussion on these points, and the issues it identified in The DAO's offering, raise intriguing questions about how a different approach might navigate the securities law landscape more effectively.

Similarly, the Commission might have reached a different conclusion if the DAO Tokens had an immediate practical use, such as exchangeability for currently available products or services. If purchasers had acquired tokens as assets to be spent rather than held for speculative purposes, the tokens would have more closely resembled units of exchange than securities. This suggests another possible path for token promoters to avoid application of federal securities laws: by emphasizing the tokens' practical utility and not marketing them on the basis of investment potential.

**Additional Considerations**

The report also noted that The DAO offering would not fall under the Jumpstart Our Business Startups (JOBS) Act's crowdfunding exemption because The DAO did not meet certain threshold criteria, such as being registered with the Commission and the Financial Industry Regulatory Authority as a broker-dealer or funding portal.[18] The DAO also raised more than the $1 million annual cap applicable to exempt crowdfunding issuers.[19]

The Commission's report does not assert that all coins and tokens necessarily constitute securities, nor that all ICOs and token sales are "offerings," but does emphasize the broad application of securities laws "regardless [of] whether the issuing entity is a traditional company or a decentralized autonomous organization" and "regardless [of] whether those securities are purchased using U.S. dollars or virtual currencies."[20] The Commission's investor bulletin further

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[17] *SEC Report*, *supra* note 1, at 13–15.

[18] *SEC Report*, *supra* note 1, at 4 n.11.

[19] *See* 15 U.S.C. § 77d(a)(6).

[20] *SEC Report*, *supra* note 1, at 17–18.

explains that "depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities," such that their offer and sale would be subject to securities regulation.[21]

Until now, ICOs and token sales have been organized on the theory that the coins and tokens being issued are *currency* and therefore exempt from securities regulation. The Commission rejected this argument, likely because purchasers of coins and tokens buy them with intent to invest, not to hold legal tender. Perhaps due to the novelty of the transactions involved and apparent good faith intentions of the participants, the Commission decided not to pursue an enforcement action against The DAO.[22] But it is clear that future ICOs and token sales will be closely scrutinized, and their sponsors are unlikely to receive a similar free pass.

**KEY TAKEAWAYS**

- **Coins and Tokens May Be Securities.** Although the Commission's report is directly applicable only to DAO Tokens, it effectively puts other issuers on notice that all cryptocurrency coin and token sales are potentially subject to securities regulation. In particular, coins or tokens that meet the *Howey* test as applied in the Commission's analysis are particularly likely to be regulated, as their offering would be deemed an investment contract.
- **Other Securities Laws May Also Apply.** The Commission's report does not consider whether The DAO's activities render it an "investment company" for purposes of the Investment Company Act of 1940 or an "investment adviser" for purposes of the Investment Advisers Act of 1940, which generally require investment companies and investment advisers to register with the Commission. Given the broad definition of "securities" under these acts, and the Commission's conclusion that cryptocurrency coins and tokens may constitute securities, issuers should carefully consider the applicability of these acts to their activities, and the obligations thus entailed.[23]
- **Alternative Approaches May Be Available.** The Commission's report raises the question of whether alternative approaches could be developed to avoid the third prong of the *Howey* test. Although significant

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[21] *SEC Bulletin*, *supra* note 4.

[22] *SEC Report*, *supra* note 1, at 1.

[23] *See* 15 U.S.C. § 80a–3(a)(1) (Investment Company Act) and 15 U.S.C. § 80b–2(a)(11) (Investment Advisers Act).

caution is in order, the Commission's analysis may offer hope to market participants who innovate to carefully address the concerns articulated in the report. As the Commission noted, "[w]hether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction."[24]

- **Other Market Participants Are Also Affected.** ICO and token sale service providers that handle coins and tokens should consider whether their activities require registration with the Commission in some capacity, including as national securities exchanges, broker-dealers, alternative trading systems or clearing agencies. Platforms that traded DAO Tokens on the secondary market arguably satisfied the definition of "exchange" under Section 3(a)(1) of the Exchange Act, thus requiring them to register, unless an exemption was available.[25]
- **The Penalties for Violations Are Substantial.** Promoters of illegal, unregistered offerings face substantial civil and criminal liability.[26] In addition, purchasers of securities in such offerings have a statutory right of rescission, requiring sponsors to repurchase the securities at their original purchase price, with interest.[27] The indirect consequences of an enforcement action are also significant. Those found to have violated securities laws will find it difficult to establish banking relationships, obtain regulatory licenses and raise conventional capital.
- **Remedial Action May Be Advisable.** Those who have already completed ICOs or token sales should consider whether they have violated any securities laws and take steps to remediate any continuing violations. Similarly, trading platforms, intermediaries and other service providers that have previously handled coins or tokens should consider whether they are required to register with the Commission and take steps to do so.
- **Future Participants Should Proceed With Caution.** The Commission's message is clear: Coin and token issuers and brokers must tread carefully and fully consider the regulatory implications of offerings prior to launch. If the coins or tokens being offered are securities, registration with the Commission will be required, unless an exemption

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[24] *SEC Report*, *supra* note 1, at 17–18.

[25] *See* 15 U.S.C. § 78c(a)(1).

[26] *See* 15 U.S.C. §§ 77l and 77x.

[27] *See* 15 U.S.C. § 77l.

is available, such as in private placements to accredited investors under Regulation D and foreign offerings to overseas investors under Regulation S.[28]

## CONCLUSION

The Commission's detailed legal and factual analysis of the DAO Token sale suggests that it is closely monitoring cryptocurrency activities. The Commission observes that "virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital."[29]

We expect the Commission will continue to examine the applicability of securities law to each iteration of coin and token sales as these forms of raising capital evolve. Issuers considering an ICO or token sale and other participants in the coin and token ecosystem should consult securities law and digital finance experts, including competent legal counsel, before undertaking such activities.

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[28] *See* 17 C.F.R. §§ 230.500–508 (Regulation D) and 17 C.F.R. §§ 230.901–905. Securities issued in exempt foreign offerings must also include transfer restrictions and other features that effectively prevent participation by U.S. persons. *See* 17 C.F.R. § 230.905.

[29] *SEC Report*, *supra* note 1, at 10.