DAO AND THE ART OF SECURITIES REGULATION: SEC CLARIFIES THAT DIGITAL TOKENS MAY BE "SECURITIES"

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U.S. Investment Management Alert

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The rapid rise of distributed ledger technology and the spate of recent initial coin offerings ("ICOs") have focused attention on whether, and in what circumstances, virtual currencies and digital tokens may be securities whose offer and sale are subject to the registration requirements of the United States securities laws. The U.S. Securities and Exchange Commission (the "SEC") has given a partial answer to its view on this question.

On July 25, 2017, the SEC issued an investigative report (the "Report"), which concluded that distributed ledger tokens issued by a "virtual" organization known as "The DAO" ("DAO Tokens") constituted securities for purposes of United States federal securities laws.[1] The Report stated that whether an offer or sale of distributed ledger tokens constitutes an offer or sale of securities depends on the facts and circumstances. In concert with the Report, the SEC also delivered an investor bulletin to educate investors on blockchain, cryptocurrencies, and the risk of fraud in ICOs.[2]

BACKGROUND ON THE DAO

The name of The DAO is an acronym for "decentralized autonomous organization," i.e., a virtual organization embodied in computer code and executed on a distributed ledger or blockchain. The stated purpose of such virtual organizations is to use smart contracts and distributed ledger technology to solve organizational governance and decision-making issues. The DAO was created by Slock.it, a German corporation, which is a for-profit entity that funds projects with assets acquired through the sale of DAO Tokens to investors.[3] An investor could participate in The DAO by contributing Ether, a virtual currency used on the Etherium Blockchain, to The DAO in exchange for DAO Tokens. A DAO Token vested certain limited voting and ownership rights in the holder. According to promotional materials, which were widely distributed by Slock.it, The DAO would earn profits by funding projects that would provide DAO Token holders a return on investment. The DAO was managed by Slock.it and its founders and certain other individual "curators" of The DAO.

Investors made investments in The DAO using pseudonyms (referred to as "pseudonymity"). There were no limitations placed on the number of DAO Tokens offered for sale or the number of purchasers of DAO Tokens, nor was there a required level of sophistication or wealth for such purchasers, which are typically required for private offerings of securities in the United States. DAO Token holders were not restricted from reselling DAO

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Tokens and could sell their DAO Tokens in a variety of ways, including on a platform provided by Slock.it. At the time the offering closed, The DAO had raised approximately an equivalent of US$150 million in Ether.

The DAO's code exhibited vulnerabilities in June 2016 when an unknown individual or group (the "Attacker") diverted approximately one-third of the total Ether raised by The DAO to an Etherium Blockchain address controlled by the Attacker. To fix the problem, Slock.it's founders endorsed a "hard fork" to the Etherium protocol, in effect reversing the Attacker's transfer. Such a "hard fork" is controversial in the cryptocurrency community because a critical characteristic of a distributed ledger is its immutability.

SEC ANALYSIS OF DAO TOKENS

The Report analyzed whether DAO Tokens constituted an "investment contract" (and thus a security) under Section 2(a)(1) of the U.S. Securities Act of 1933, as amended (the "Securities Act"), and Section 3(a)(1) of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"). Pursuant to the Howey test adopted by the Supreme Court, a transaction is a security if there is an investment contract involving 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.[4]

The Report concluded that DAO Tokens are an investment contract and therefore securities. It stated that the use of Ether to purchase DAO Tokens was a type of contribution of value sufficient to create an investment contract and investors contributed Ether to The DAO with reasonable expectation of profits from others' managerial efforts. In a detailed analysis of the active management of The DAO, the SEC concluded that Slock.it and its founders and The DAO's curators were essential to the performance of an investment in DAO Tokens. The SEC noted that the clearance process provided by The DAO did not provide token holders with sufficient information to make informed voting decisions. The SEC also noted that the pseudonymity and dispersion of holders of DAO Tokens made it difficult for them to join together to effect change or to exercise meaningful control.

The Report also made particular note that The DAO has been described as a "crowdfunding contract." However, the Report cautioned that The DAO would not have met the requirements of the Regulation Crowdfunding exemption because, among other things, it was not a broker-dealer or a funding portal registered with the SEC and the Financial Industry Regulatory Authority, Inc. ("FINRA").

Although the SEC concluded that The DAO may have engaged in an unregistered offering of securities in violation of Section 5 of the Securities Act, it declined to bring an enforcement action and instead issued its investigative report, which amounts to an advisory opinion. In a press release issued concurrently with the Report, the SEC stated that it "welcome[s] and encourage[s] the appropriate use of technology to facilitate capital formation and provide investors with new investment opportunities." SEC Chairman Jay Clayton noted that "[t]he SEC is studying the effects of distributed ledger and other innovative technologies and encourages market participants to engage with [the SEC]. We seek to foster innovative and beneficial ways to raise capital, while

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ensuring—first and foremost—that investors and our markets are protected."[5]

TAKEAWAYS

Generally, there are three kinds of securities offerings and sales in the market: registered, exempt, and illegal. While the Report does not identify all token offerings as securities offerings, the Report serves as a stark warning to sponsors and intermediaries to consult with securities counsel in structuring such offerings and facilitating secondary transactions. It also serves as a warning to anyone who purchases digital tokens, as his or her subsequent resale of a digital token that is an unregistered security not subject to a valid exemption could itself be a violation of the securities laws.

Sponsors of token offerings and those who participate in the offerings should consider the following:

- **Facts and Circumstances** – The SEC will look closely at the facts and circumstances of a token offering under applicable statutes and precedent to determine whether a token constitutes a "security," starting with the Howey analysis noted above. In addition, among other considerations, the SEC may look to (i) whether digital tokens associated with a specific enterprise create a commonality of interests between the purchaser and the enterprise, thus creating an investment contract and (ii) the vesting of voting or other ownership rights in such tokens similar to those rights associated with traditional equity investments.[6]
- **Securities Act Considerations** – If tokens are deemed securities, the offer and sale of the tokens would likely need either to be registered under the Securities Act or qualify for an exemption from registration. If the token offering is exempt from registration under the Securities Act, the offering would, for example, need to be made to accredited investors; the tokens would be subject to limitations on resales or transfers; and general solicitation may be prohibited. Regardless of whether the offering is registered or exempt, careful consideration should be given to ensure that prospective investors receive sufficient disclosure about the offering, including the associated risks. The SEC also indicated in the Report that those who participate in the resale of such tokens would need to comply with the Securities Act as well.
- **Offering Considerations** – If a token offering is subject to registration in the United States, then the tokens sold pursuant to such offering may need to be on an exchange registered under the Exchange Act or exempt therefrom. Potentially, an offering could fall within the Regulation Crowdfunding exemption, although as noted above The DAO would not have qualified for this exemption.
- **Investment Advisory Considerations** – A sponsor may be deemed an investment adviser under the purview of the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), and possibly subject to registration with the SEC or with one or more states as such. Even if the sponsor is an investment adviser but is exempt from registration, the sponsor nonetheless would be subject to certain aspects of the Advisers Act, including the anti-fraud rule.[7] Registration under the Advisers Act entails various disclosure and compliance requirements, which increases operation costs.
- **Investment Company Act Considerations** – The U.S. Investment Company Act of 1940, as amended (the "ICA"), also could come into play. Investment company registration and ongoing structural requirements are highly complex and time consuming. Given the regulatory hurdles associated with

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investment company registration, a company in the blockchain industry that is an investment company would likely need to rely on an exemption from registration under the ICA, which would limit the number of United States investors due to eligibility requirements and other limitations under the securities laws.[8]

- **Broker-Dealer Considerations** – If tokens are deemed securities, intermediaries such as token exchanges and promoters would likely need to comply with broker-dealer registration requirements, especially if a platform used to make such offering relies on Regulation Crowdfunding. Even in the absence of a token platform's needing to register as a national exchange, persons or platforms facilitating the purchase or sale of tokens in a token offering may be subject to broker- or dealer-registration requirements.

While the Report addressed only federal securities laws, sponsors of token offerings should also be mindful of the following:

- **Anti-Money Laundering** – A sponsor of a token offering or a token exchange could have obligations under the U.S. Bank Secrecy Act, as amended (the "BSA"), which requires all entities meeting its definition of "financial institution" to assist the United States government to detect and prevent money laundering.[9] The BSA also could affect the sponsor of a token offering or token exchange indirectly to the extent it relies on banks, exchanges, or other financial institutions for clearing, settlement, custody, or other functions.
- **Commodity Issues** – The Commodity Futures Trading Commission has taken the view that Bitcoin and other digital currencies are "exempt commodities" (as defined in the U.S. Commodity Exchange Act, as amended ("CEA")) that are subject to its jurisdiction.[10] This can have implications for whether sponsors or other participants in token offerings may be required to register as commodity pool operators or commodity trading advisors with the National Futures Association and whether investors in such tokens must be "eligible contract participants" as defined in the CEA.
- **Cybersecurity** – Cybersecurity breaches pose risks of reputational harm and financial loss. In addition, a sponsor of a token offering or a token exchange may have obligations under cybersecurity regulations pursuant to the U.S. Gramm-Leach-Bliley Act, as amended, and various state laws. The SEC and FINRA also expect broker-dealers to maintain cybersecurity policies and procedures under existing privacy related regulations.
- **Taxation Considerations** – Although unclear under current law, DAO Tokens may be treated as interests in an unincorporated association (or partnership) for tax purposes, giving rise to various reporting and tax return filing obligations. In addition, the transferability or resale of the tokens may cause any such tax entity to be treated as a "publicly traded partnership," which may be tax inefficient.
- **Extraterritorial Considerations** – Securities laws of non-United States jurisdictions may be applicable and could limit or otherwise affect token offerings.

The Report, along with the accompanying press release and investor bulletin, are clearly designed to send a message to the sponsors and other participants in the emerging token and blockchain world: the SEC intends carefully to scrutinize this emerging technology-based business as it pertains to securities regulation.[11] The investor bulletin is intended to inform potential token purchasers of the risks they face when investing in

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unregistered offerings. By not bringing an enforcement action or making formal findings of violations in the Report, it would appear that the SEC is seeking to provide guidance to this nascent technology while still issuing a warning to sponsors and participants. While the SEC may not have brought an enforcement action, it remains to be seen what private rights of action may be raised by investors in The DAO, purchases of DAO Tokens in secondary transactions, or investors in other "virtual" organizations. Those involved in any aspect of the issuance, sale, or distribution of virtual currencies and digital tokens should carefully consider the application of the United States securities laws, as failure to comply with the securities laws may result in civil penalties, which may include investor rescission rights and monetary penalties, and criminal penalties.

Notes:

1. The Report is available at https://www.sec.gov/litigation/investreport/34-81207.pdf.

2. The investor bulletin is available at https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings.

3. In theory, there was no limitation on the types of projects that could be proposed. For example, proposed "projects" could include, among other items, projects that would culminate in the creation of products or services that DAO Token holders could use or charge others for using.

4. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); see SEC v. Edwards, 540 U.S. 389, 393 (2004); *see also* United Housing Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975).

5. The press release is available at https://www.sec.gov/news/press-release/2017-131.

6. By analogy, the SEC may also seek to apply the "family resemblance" test, which on its face relates to the question of whether a note is a security but may also apply to aspects of a digital token. The family resemblance factors are: (1) "the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]"; (2) "the 'plan of distribution' of the instrument," including an assessment of whether "there is common trading" of the instrument "for speculation or investment"; (3) "the reasonable expectations of the investing public"; and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the investment, thereby rendering application of the Securities Acts unnecessary." *See* Reves v. Ernst & Young, 494 U.S. 56, 66-67 (1990).

7. The Report did not analyze the question whether anyone associated with The DAO was an investment adviser under Section 202(a)(11) of the Advisers Act, in part because The DAO had not commenced its business operations funding projects.

8. The Report also did not analyze the question whether anyone associated with The DAO was an "investment company" under Section 3(a) of the ICA, in part because The DAO had not commenced its business operations funding projects.

9. On July 26, 2017, the Financial Crimes Enforcement Network, working in coordination with the United States Attorney's Office for the Northern District of California, assessed a penalty against BTC-e a/k/a Canton Business Corporation, an internet-based foreign-located money transmitter that exchanges virtual currencies, and Alexander Vinnik, one of its operators, for violations of the BSA. The assessment is available at https://www.fincen.gov/sites/default/files/enforcement_action/2017-07-26/Assessment%20for%20BTCeVinnik%20FINAL%20SignDate%2007.26.17.pdf.

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10. *See* In the Matter of Coinflip, Inc., (CFTC, September 17, 2015) http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf (stating that Bitcoin and other virtual currencies are encompassed in the definition of and properly defined as commodities under the CEA).

11. It is worth noting that while the SEC deemed DAO Tokens to be securities, it did not go so far as to declare any broad category of virtual currencies or digital offerings to be securities. For example, the Report mentions Ether but does not indicate a view as to whether it views Ether as a security. This could be viewed as an implicit acknowledgement by the SEC that some virtual currencies or digital offerings are not securities.

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