

JULY 28, 2017

# SEC Issues Landmark Report on Blockchain Fundraising: Initial Coin Offerings “May Be” Securities Offerings

Authors: [Zain Rizvi](#) and J. Alexander Moore

This week the U.S. Securities and Exchange Commission (SEC) published an [investigative report](#)<sup>1</sup> confirming what many in the blockchain industry had long anticipated: depending on the facts, the offer and sale of blockchain tokens pursuant to an initial coin offering (ICO) “may be” subject to U.S. securities laws. In particular, the SEC identified the ICO of the Decentralized Autonomous Organization (known as The DAO), which had raised upwards of US\$150 million in May 2016, as a securities offering that was not compliant with U.S. securities laws.

Although ultimately the SEC decided not to pursue charges against any of the promoters of The DAO, the SEC published its report to caution those using distributed ledger or blockchain-enabled means for capital raising to consider whether the tokens or coins they propose to sell are securities and, if so, to take appropriate steps to comply with U.S. securities laws.

The SEC’s view that many ICOs constitute securities offerings will have far-reaching implications for blockchain businesses and ICOs. In its report, the SEC confirms that an offer and sale of virtual tokens must be registered with the SEC if the underlying tokens are considered a security unless a valid exemption applies. The SEC cautioned that those participating in unregistered offerings may attract liability for violating securities laws. In addition, the SEC noted that exchanges providing for trading in these securities must register with the SEC unless they are exempt under securities laws.

The SEC did not issue a blanket statement classifying all blockchain tokens offered in ICOs as securities, implying that, in the right circumstances, other ICOs could be conducted without triggering securities law obligations. In addition, the SEC’s report omitted any discussion indicating that other high-profile ICOs, such as the Ethereum token sale that raised US\$18 million in 2014, constituted securities offerings. Given the specificity of the SEC’s ruling and the unique nature of The DAO, it remains unclear to what extent legitimate ICOs – whose primary objective is to distribute blockchain tokens that serve a functional purpose (as opposed to representing an interest in a common endeavour) – will be affected.

The SEC report notes that if tokens from a crowdsale are considered securities, the trading of such tokens in the secondary market would also be subject to securities law restrictions and any exchange providing a marketplace for such tokens would be required to be registered with the SEC. These restrictions and regulatory burdens would significantly impede the transferability of these tokens to a degree that would be incompatible with the purpose and function of these decentralized platforms, effectively frustrating the intended operation of most blockchain applications.

## What Is an ICO?

Initial coin offerings, also known as token sales or ICOs, are a relatively new fundraising phenomenon conducted by organizations using blockchain technology, the distributed ledger system that serves as the foundation for digital currencies such as Bitcoin and Ethereum. Unlike more traditional capital-raising techniques, ICOs are generally used to crowdfund the development and ongoing operations of decentralized platforms through a sale of digital cryptographic “tokens” or “coins” before the project’s development or release.

In addition to raising capital, an ICO also provides a means for organizations developing decentralized platforms to distribute tokens to parties interested in accessing the platform, thereby increasing the participation necessary for the network to properly function. At the same time, the ICO also creates interest in the proposed venture and incentivizes the platform’s continued development. In this way, an

ICO is analogous to a company offering a product or service it has developed, or is in the process of developing, to its customers and using the funds received to finance its operations.

### **Who Participates in an ICO?**

Early engagement in ICOs was contained mostly in the cryptocurrency community, the assumption being that a certain level of experience and understanding of the use and intricacies of cryptographic tokens was required in order to participate. In recent ICOs, greater participation from individual and institutional investors seeking investment returns has resulted in increased price volatility in ICOs and growing attention from the financial media and investing public. As bitcoin and other cryptocurrencies have become more accessible (e.g., via local bitcoin ATMs and mobile applications), technical expertise is no longer a barrier to participation in an ICO. As a result, ICOs have exploded in popularity<sup>2</sup>, with recent examples of successful campaigns from companies such as Bancor and Tezos, which respectively raised over US\$150 million and US\$232 million through their token sales.

Given the increased frequency of ICOs and the large amounts of capital being raised, some regulators have questioned whether ICOs comply with securities law. The Ontario Securities Commission (OSC) has cautioned blockchain businesses to consider whether their products may be subject to Ontario securities laws<sup>3</sup>. In contrast, Greg Medcraft, current chairman of the Australian Securities and Investments Commission, has stated that cryptocurrency-type ICOs likely fall outside the purview of securities regulators<sup>4</sup>.

### **The Case of The DAO**

In its report, the SEC describes its investigation of The DAO, which was touted as a new type of organization that automated governance and decision making using blockchain technology rather than conventional corporate structures. Essentially a collection of contracts executed on the Ethereum blockchain, The DAO was intended to be an investor-directed, venture capital-like vehicle for funding Ethereum-based projects. Through its May 2016 ICO, The DAO raised funds (for use in support of projects) by selling DAO tokens in exchange for ether (the cryptocurrency token used on the Ethereum blockchain) worth approximately US\$150 million. Purchasers of DAO tokens through its ICO would receive a return on their investment in the form of a share in the earnings from the projects The DAO supported.

The SEC concluded that the tokens issued in The DAO ICO were securities, confirming that securities laws apply to virtual organizations using distributed ledger technologies. In its report, the SEC applied the well-established “investment contract” test set out in *SEC v. W.J. Howey Co.*, concluding that The DAO tokens were securities under that test. Under *Howey*, an instrument constitutes an investment contract if it involves an *investment in a common venture premised on a reasonable expectation of profits derived solely from the efforts of a promoter or a third party*.

In the case of The DAO, token holders clearly provided value with the expectation of earning returns on their investment, based exclusively on the efforts of the curators of The DAO who would hold ultimate discretion to submit proposals to investors and would also provide significant managerial efforts after The DAO’s launch. The SEC emphasized the control that the curators had over the proposals submitted to The DAO and the fact that The DAO’s founders were responsible for actively overseeing and safeguarding its operation. This type of centralization is a clear distinguishing feature of The DAO compared to other truly decentralized blockchain systems. In its report, the SEC has not taken the position that other high-profile ICOs, such as the Ethereum token sale, constituted securities offerings.

The DAO token holders themselves, while afforded voting rights, did not have meaningful control over the enterprise, with voting rights akin to those of a corporate shareholder in the eyes of the SEC. The SEC found that, effectively, the tokens that formed part of The DAO’s ICO served no functional purpose other than to act as a distribution of equity-like rights in an organization under the guise of a blockchain token.

### **Caution to Canadian Blockchain Industry**

To date, the OSC has not published guidance on the characteristics of an ICO token that would be considered a security under Ontario securities laws. However, in the March 2017 news release referred to earlier, the OSC cautioned that organizations using such technology

may need to comply with securities law requirements. In addition, the OSC stated that “[p]roducts or other assets that are tracked and traded as part of a distributed ledger may be securities, even if they do not represent shares of a company or ownership of an entity.”

Canadian blockchain companies intending to sell digital tokens need to be mindful of not only Canadian rules but also the laws of all jurisdictions where tokens may be sold. The size of the U.S. market and the high level of interest from U.S. investors in ICOs around the world mean that blockchain ventures originating in Canada are likely to involve significant participation from the United States. In its report, the SEC confirms that parties that offer and sell digital tokens that are considered securities to persons in the United States must register with the SEC, signalling that the SEC will claim jurisdiction in such circumstances.

## Conclusion

Although the SEC report should be received positively by blockchain ventures since the SEC has not categorically declared that all sales of digital tokens are securities offerings, unfortunately neither the SEC nor Canadian regulators have yet provided any detailed guidance on when and in what circumstances they would view token sales as securities offerings. Accordingly, blockchain ventures will need to carefully consider whether contemplated token sales will be considered securities offerings by securities regulators.

<sup>1</sup>See press release containing link to the report: <https://www.sec.gov/news/press-release/2017-131>.

<sup>2</sup>Bankers Ditch Fat Salaries to Chase Digital Currency Riches: <https://www.bloomberg.com/news/articles/2017-07-25/bankers-ditch-fat-salaries-to-chase-digital-currency-riches>.

<sup>3</sup>OSC News release, March 8, 2017: <https://www.osc.ca/en/news-events/news/osc-highlights-potential-securities-law-requirements-businesses>.

<sup>4</sup>Australia's Security Watchdog 'unlikely' to Regulate ICOs: <https://www.coindesk.com/asic-on-blockchain-australias-securities-watchdog-unlikely-to-regulate-icos/>.

Key Contacts: [Robert S. Murphy](#), [Brian Kujavsky](#) and [Jeffrey Nadler](#)