

SEC Report on ICOs and Token Sales – “If It Sounds Too Good to be True...”

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August 10, 2017

On July 25, 2017, the SEC issued an investigative report to advise those who have used or may consider using a virtual organization or capital raising entity that uses distributed ledger or blockchain technology to facilitate capital raising that these activities are subject to U.S. federal securities laws. The SEC also released an investor bulletin to educate and caution potential investors about this new and growing type of capital raising.

Although the SEC determined not to pursue an enforcement action in the instant case, the report concluded that the tokens at issue in the investigation were securities and that, therefore, the offering and sale of the tokens was subject to U.S. federal securities laws. This report confirms that the SEC will look to the facts and circumstances of transactions to determine whether they constitute offerings of securities subject to U.S. federal securities laws. As such, it has broad implications for market participants that assumed sales of digital assets by “virtual” organizations (such as “Initial Coin Offerings” or “Token Sales”) were outside the scope of these laws.

Summary Facts

The SEC’s investigation related to the activities of The DAO, an unincorporated organization, Slock.it UG, a German corporation, and Slock.it’s co-founders and intermediaries in the offer and sale by The DAO of approximately 1.15 billion DAO Tokens in exchange for approximately 12 million Ether (ETH)¹, which were valued at approximately \$150 million at the time the offering closed.

The DAO is a virtual organization embodied in computer code and executed on a distributed ledger or blockchain. Slock.it and its founders created The DOA to raise funds, through the sale of DAO Tokens to investors, to fund future projects. The DAO Tokens were offered to the public without restrictions.² Slock.it’s founders promoted The DAO through media reports, website updates and online forums. Secondary trading of DAO Tokens was also supported by a number of web based platforms.³

Holders of DAO Tokens had certain voting and ownership rights. The holders would also be eligible to receive a return based on the projects funded by The DAO, which would be chosen by a vote of the holders. Proposed projects were vetted by one or more “curators” of The DAO; curators had sole control over what proposals could be submitted to and voted on by holders of DAO Tokens and ultimately funded by The DAO.

A hack occurred at The DAO during the offering period in May 2016 and approximately one-third of the total ETH raised in the offering was moved into an account controlled by the hacker. In response to the hack, Slock.it and its founders took steps designed to restore the DAO Tokens to affected holders.

Analysis

In its review of the offering by The DAO, the SEC concluded that the principles underlying the securities laws apply to virtual organizations or capital raising entities making use of distributed ledger technology. The substance of the transaction and not its novel form is determinative.

The SEC found that DAO Tokens constituted an investment contract in which an investment of money is made in a venture where the investor has a reasonable expectation of profits that would be derived from the efforts of others—the classic definition of a security for purposes of Section 2(a)(1) of the Securities Act. The fact that ETH was the currency used to purchase DAO Tokens, as opposed to cash, was found to satisfy the investment of “money” for this purpose. The efforts of Slock.it, its founders and the curators were seen as

essential managerial efforts affecting the failure or success of the enterprise. The holders of DAO Tokens relied on these parties, as highlighted by the actions taken by Slock.it and its founders in response to the hacking attack.

The SEC concluded that the voting rights provided to holders of DAO Tokens, which included a vote regarding what proposals would be funded, did not provide them with meaningful control over the enterprise. The SEC noted that the ability to vote for proposals was largely perfunctory—as the proposals were subject to clearance by the curators and did not provide sufficient detail with respect to their terms. The facts that the DAO Token holders were widely dispersed, held under pseudonyms and were provided with limited opportunity for communication with other holders also, per the SEC, prevented them from having meaningful control through voting.

The SEC noted that the term “issuer” is broadly defined and includes unincorporated organizations and that case law has upheld a flexible construction of the term to capture novel capital raising transactions. The SEC also cautioned others who participate in an unregistered offer and sales of securities not subject to a valid exemption that they may also be acting in violation of federal securities laws.

Conclusion

The SEC used its investigative report to illustrate the application of the federal securities laws to the emerging virtual markets that are operating worldwide. The analysis of the token offering by The DAO offers a roadmap of the facts and circumstances under which these offerings will be subject to U.S. federal securities laws. Because these types of offerings are expected to continue to proliferate with endless possible variations, it will continue to be a facts and circumstances determination as to the application of these laws in any given circumstance. In addition to warning virtual organizations that the securities law requires the investors receive the information necessary to make an informed investment decision, the SEC provided information directly to potential investors to educate them on the nature of these burgeoning investment opportunities.

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1. ETH is a virtual currency based on the Ethereum Blockchain.
 2. Anyone was eligible to purchase DAO Tokens. There were no limitations on the number of DAO Tokens offered, the number of purchasers or the level of sophistication of the purchasers.
 3. Although the SEC’s primary focus centered on the applicability of the securities laws to the offer and sale of tokens, virtual trading platforms were also cautioned that systems that meet the definition of an exchange under the Exchange Act must operate as a National Exchange or pursuant to an exemption from such registration.

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