

Financial Services

Fintech Alert: SEC Advises That an Unincorporated Virtual Organization That Issued Virtual Currency Engaged in an Unregistered Securities Offering

Action Item: The Securities and Exchange Commission (“SEC”) has provided guidance for digital currency offerings that may run afoul of the U.S. securities laws. Investors, token issuers, and other parties involved in these transactions should be aware of circumstances that may make offerings in the United States subject to regulation by the SEC.

On July 25, 2017, the Securities and Exchange Commission (“SEC”) issued a groundbreaking investigative report relating to blockchain tokens. The report concludes that tokens issued by The DAO are securities under U.S. securities laws. You may be wondering: What is a blockchain token? What is The DAO? Why is the SEC report groundbreaking? We have the answers to these questions and opine on new issues that lie ahead.

Executive Summary: Based on a 1946 Supreme Court case¹ that held the sale of an interest in an orange grove and an agreement by promoters to develop the grove and harvest the oranges for profit constituted an investment contract (and, therefore, a “security” subject to the Securities Act), the SEC has concluded that a 2016 token sale by The DAO, an unincorporated Swiss virtual organization,² constituted an unregistered securities offering. The SEC report provides useful guidance in analyzing whether other offerings may run afoul of U.S. securities laws.

Welcome to the new securities law paradigm.

A Primer on Cryptocurrencies, Blockchain, ICOs, and Virtual Currency Exchanges

Once upon a time, only governments created and issued currencies (often referred to as “fiat currencies”). Now, software developers create virtual currencies that are held in digital wallets. These virtual currencies, sometimes referred to as cryptocurrencies, alternative currencies, digital tokens, or “coins,” are digital stores of value that allow for immediate transactions and borderless fund transfers. Experts estimate that the market capitalization for all cryptocurrencies has surpassed \$100 billion, with that capitalization reflecting gains significantly concentrated in the last few months.³ Whether the rise of cryptocurrencies is another “speculative bubble” like Tulipmania in the Netherlands in the 1600s (one of the first widely reported examples of such a bubble), or more recent bubbles like the .com bubble in the late 1990s or the real estate bubble in the United States in the late 2000s, remains to be seen.

Initial coin offerings (“ICOs”) permit companies, software developers, or others to raise capital from a broad base of sources by offering the sale of cryptocurrencies. ICOs are similar to initial public offerings (“IPOs”), except the purchaser in an ICO receives digital tokens, not shares of ownership in a company. In addition, anyone can invest in an ICO, unlike an IPO where either the sale is registered with the SEC or each U.S. purchaser

must be appropriately qualified. No underwriters are necessary for ICOs, unlike for IPOs because the virtual currency is created almost instantly and sold directly. No syndicates are necessary, eliminating the need for brokers to resell the shares to investors. Finally, while IPOs tend to be one-day events, ICOs can last for almost a month, giving initial investors more time to participate. *The American Banker* estimates that the total amount of money raised so far in ICOs in 2017 may exceed \$700 million.⁴ The most well-known cryptocurrencies are Bitcoin, Ethereum (“Ether”), Ripple, the recently created Bitcoin Cash (created from a “forking” of Bitcoin⁵), and Litecoin. Unlike fiat currencies that are supported by national governments, cryptocurrencies have no reserve or other monetary support system.

The value of digital currencies is derived from the expected value based on the terms that attach to the tokens. For example, the valuation may reflect the anticipated value of the underlying code or function that the capital raise will fund or may reflect the value of having access to the platform provided by the developer. Alternatively, the value may reflect the expected profit to the issuer of the digital currency—which is likely to make the token a security for purposes of the U.S. securities laws.

Blockchain technology is the current software vehicle that permits the existence of cryptocurrency, among numerous other applications, as the cryptocurrency is created and stored on and all transactions are recorded in the blockchain. Blockchain is a digital, decentralized ledger (or list) of all transactions that take place across a peer-to-peer network (P2P) of computers known as nodes, which are connected to the blockchain through the Internet. The ledger is visible to anyone (all nodes) within the network, though differences in access exist between public and private blockchain systems. The ledger permanently records, in “blocks,” the history of exchanges that take place between the peers in the network. All the completed and authenticated transaction blocks are connected and “chained” from the beginning of the chain to the most current block. Hence, the name “blockchain.”

There is no need for a central authority to manage the blockchain, and no party has the power to alter the records once entered. Instead, for public cryptocurrency blockchain systems, encryption techniques are used to control the creation of monetary units and to authenticate the transfer of funds. There is a low risk of fraudulent transactions using blockchain because tampering with the ledger entries would have to occur in all of the many ledgers in the system at the same time. A very small change to the ledger would result in a change to the computing algorithm, raising a red flag of a fraudulent transaction to all

computers on the P2P network. Digital signatures (signed with private keys) safeguard that transactions on the blockchain are from legitimate participants on the P2P network and not from imposters.

The last piece of the puzzle is the virtual-currency exchange or digital-currency exchange (“DCE”) that allows customers to purchase and trade digital currencies for other assets, such as fiat currencies or different digital currencies. Most DCEs also offer wallets to store and maintain digital currency accounts. In the wallet, a customer can check account balances and make transactions with other investors and merchants who accept cryptocurrency as a form of payment.⁶ Coinbase is one of the leading online platforms to buy, sell, and store digital currency. It recently raised \$100 million from outside investors and has a \$1 billion valuation.⁷

The DAO Investigative Report—the SEC Weighs in on a Regulatory Gray Area

The SEC does not often issue a Report on Investigation Pursuant to Section 21(a) of the Securities Exchange Act (an “Investigative Report”). Section 21(a) of the Exchange Act authorizes the SEC to investigate violations of the federal securities laws and, at its discretion, “publish information concerning any such violations.” When the SEC issues an Investigative Report, it does not adjudicate any fact or issue and it does not make a finding of any securities violations. The last time the SEC issued an Investigative Report was in January 2014.⁸

The SEC may issue an Investigative Report rather than bring an enforcement action as litigation can be lengthy, costly, and potentially risky for the SEC. An Investigative Report allows the SEC to quickly alert the market to its views on the application of the securities laws to a particular issue.

In The DAO Investigative Report,⁹ the SEC:

- Describes the relevant legal analysis for determining whether and when a cryptocurrency is a security.
- Articulates views on the activities of virtual-currency exchanges that may require registration as a national securities exchange.
- Warns that unincorporated decentralized autonomous organizations that use blockchain technology to operate as virtual entities could constitute investment companies, and their associates could qualify as investment advisors.
- Expresses support for the appropriate use of technology for innovation as long as such technology and innovation do not run afoul of the securities laws.

The DAO—Factual Background

A German company named Slock.it and its founders created The DAO to raise funds by selling a new cryptocurrency called DAO Tokens to investors. The DAO would then use those assets to fund certain projects. Individuals could propose projects and “Curators” selected by Slock.it assessed and vetted the projects before DAO Token holders could vote on the projects. DAO Token holders would also share in the contemplated revenues from these projects, and could re-sell DAO Tokens on secondary exchanges for a profit.

In a 2016 ICO in which investors were offered DAO Tokens in exchange for Ether, The DAO sold approximately \$1.15 billion DAO Tokens, and The DAO was valued at approximately \$150 million in U.S. dollars when the offering closed. Following the ICO, the DAO tokens were sold on a number of different platforms, which used electronic systems that allowed their customers to post orders for the tokens anonymously. In June 2016, hackers stole one-third of the Ether raised through the ICO (then valued at about \$50 million). The DAO was able to recover most of the stolen assets.

After the attack, the SEC launched an investigation into the applicability of the federal securities laws to DAO Tokens and similar offerings. The SEC determined that it would not pursue enforcement action. Instead, the SEC issued the Investigative Report, setting out its views as to application of the federal securities laws to The DAO, its related parties, and the DAO Tokens.

Securities Law Analysis

The SEC’s application of federal securities law to cryptocurrency is largely based on the Howey test enunciated in the 1946 Supreme Court case *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946). The test has four prongs:

- (1) whether there is an investment of money;
- (2) in a common enterprise;
- (3) with the expectation of profits that are;
- (4) derived from the entrepreneurial or managerial efforts of others.¹⁰

The *Howey* test, according to the Court (and apropos to this discussion), “embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”¹¹ Twenty years later, the Supreme Court reiterated, “[I]n searching for the meaning and scope of the word ‘security’...form should be disregarded for substance and the emphasis should be on economic reality.”¹²

The SEC found that DAO Tokens met all prongs of the *Howey* test and, therefore, constituted a security: (1) the payments by purchasers for DAO Tokens in Ether were considered an investment of money, (2) investors in The DAO were investing in a common enterprise, (3) the investors had the reasonable expectation of profit in light of the stated objective of The DAO to fund projects in exchange for a return on investment in which the token holders would share, and (4) the DAO investors relied on the managerial and entrepreneurial efforts of the founders and curators in deciding which projects to fund as the DAO Token holders had only limited voting rights and access to information.

Here are the key takeaways from The DAO Investigative Report:

- **Traditional securities law analysis applies to new technologies**, “regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology.”
- **DAO Tokens were investment contracts within the definition of a “security”** under the Securities Act of 1933 and the Exchange Act because they met all four prongs of the *Howey* test: (1) an investment of money (2) in a common enterprise (3) with the expectation of profits that are (4) derived from the entrepreneurial or managerial efforts of others.
- **The SEC did not declare that all tokens are necessarily securities**. The SEC highlighted the importance of a thorough analysis of the facts and circumstances of a particular offering before determining whether the cryptocurrencies at issue are securities.
- **Tokens that are used as a medium of exchange for a particular product or service (and not for their investment potential) are likely not securities** because they would fail the third prong (“expectation of profits”) of the *Howey* test.
- **The DAO, an unincorporated decentralized autonomous organization that used blockchain technology to operate as a “virtual” entity, was an issuer of securities**. The DAO Investigative Report notes that an “unincorporated organization” is a “person” that can fall within the relevant definition of “issuer.”

- **The initial coin offering for the DAO Tokens should have been registered with the SEC or conducted in compliance with an exemption under the Securities Act.**
- **The platforms that traded the DAO tokens were securities exchanges and should have registered with the SEC as a broker-dealer or national securities exchange, or operated pursuant to an appropriate exemption, such as an alternative trading system that complies with Regulation ATS.** The platforms “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.”
- **Regulation D may be available if a cryptocurrency issuer is willing to limit purchasers of the tokens to accredited investors and meet the other requirements of the safe harbor.** If coins are sold only to accredited investors, there may be limitations on the ability of investors to resell the coins, especially to non-accredited investors.
- **The DAO offering did not fall under the JOBS Act’s crowdfunding exemption.** The DAO was not registered with the SEC and the Financial Industry Regulatory Authority as a broker-dealer or a funding portal. The DAO also raised more than the \$1 million annual cap applicable to exempt issuers under Regulation CF.
- **Had The DAO commenced its business operations of funding projects, it would have raised questions over The DAO’s status as an “investment company” under the Investment Company Act of 1940 and the status of its associates as “investment advisers” under the Investment Advisers Act of 1940.**
- **The SEC’s Division of Corporate Finance went on record the same day the Investigative Report was issued to “welcome and encourage the appropriate use of technology to facilitate capital formation and provide investors with new investment opportunities.”**

Conclusion

The SEC stressed that “[w]hether or not a particular transaction involves the offer and sale of a security...will depend on facts and circumstances, including the economic realities of the transaction...regardless of whether the issuing entity is a

traditional company or a decentralized autonomous organization that uses blockchain technology to operate as a virtual entity.” While not every cryptocurrency may be deemed a security, one must thoroughly analyze the facts and circumstances of a particular offering using the four-pronged *Howey* test. Counsel can help investors, issuers, and other participants engage in this thoughtful legal analysis of blockchain token sales, trading platforms, and investment company/advisory activities in connection with cryptocurrencies to avoid the potentially harsh consequences of violating federal and state securities law.

1. *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946)
2. A virtual organization is an organization embodied in computer code and executed on a blockchain.
3. CryptoCurrency Market Capitalization, available at <https://coinmarketcap.com/currencies/> (last visited on August 4, 2017); Total market capitalization, available at <https://coinmarketcap.com/charts/> (last visited on August 4, 2017).
4. <https://www.americanbanker.com/news/tezos-raises-232-million-for-new-cryptocurrency-project> (last visited on August 4, 2017)
5. A “fork” is what happens when a blockchain diverges into two different paths forward. Users of the blockchain have to support one choice over the other, with each of the two blockchains having their own ledger and rules. In the case of bitcoin, the fork created a divergence in the bitcoin blockchain resulting in two coins: bitcoin and bitcoin cash. Bitcoin users kept their existing bitcoins, but also received bitcoin cash. If users utilize bitcoin cash, its value will increase and it will compete with bitcoin; if not, it will become valueless.
6. For example, a Netherlands-based startup called Detacoin just announced that it is setting up a blockchain-based system enabling patients to pay for dental care with its Ethereum-based tokens. <https://dentacoin.com/> (last visited on August 7, 2017).
7. See <http://www.cbsnews.com/news/digital-currency-exchange-operator-coinbase-eyes-1-billion-valuation/> (last visited on August 4, 2017).
8. Release No. 71390, January 24, 2014 (investigation into whether the independence of KPMG was impaired when the firm loaned non-manager level tax professionals to certain audit clients).
9. Release No. 81207, July 25, 2017, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO
10. 328 U.S. at 299.
11. *Id.*
12. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

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