SEC Issues Guidance on Initial Coin Offerings

On July 25, 2017, the Securities and Exchange Commission (SEC) Division of Enforcement issued an investigative report on a hot new fundraising phenomenon being used by emerging companies, venture capital funds, and hedge funds finding rules meant for everyday sales of securities may apply to these offerings, too. These so-called initial coin offerings (ICOs) involve the creation of a digital token or coin based on distributed ledger or blockchain technology that are offered to the public in exchange for either fiat currency or virtual currency (such as bitcoin or ether). Investors who acquire these digital coins can use them in the future to buy a product or service that the coin creator plans to offer, or simply sell the coins through a digital currency exchange.

The report stems from an SEC inquiry of a "virtual" organization known as "The DAO" and looked into whether The DAO and associated entities and individuals violated federal securities laws with unregistered offers and sales of DAO Tokens in exchange for ether. The SEC analyzed the DAO Tokens under the so-called Howey[1] test, the core factors of which are: whether purchasers of the instrument contributed money or valuable goods or services; whether purchasers were investing in a common enterprise and reasonably expected to earn profits through that enterprise; and whether the expected profits are to be derived from the efforts of others.

Finding that DAO Tokens allowed the holders to profit from the efforts of others, the SEC found that the DAO Tokens were securities and therefore subject to the federal securities laws. While the SEC exercised its discretion in deciding not to pursue civil penalties and disciplinary action against the relevant parties, or make findings of violations in the report, the SEC took the opportunity to caution the industry and market participants that issuers of distributed ledger or blockchain technology-based securities must register offers and sales of such securities unless a valid exemption applies.

Whether a particular ICO involves the offer or sale of a security — regardless of the terminology or technology used — will depend on the facts and circumstances, including the economic realities of the transaction. In applying the Howey test to determine whether the DAO Tokens were securities, the SEC did not declare that tokens are all necessarily securities, but provided cautionary advice to market participants, observing that "the federal securities laws apply to those who offer and sell securities in the United States, 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."[2]

"The SEC is studying the effects of distributed ledger and other innovative technologies and encourages market participants to engage with us," added SEC Chairman Jay Clayton. "We seek to foster innovative and beneficial ways to raise capital, while ensuring — first and foremost — that investors and our markets are protected."[3]

The SEC's Office of Investor Education and Advocacy also issued an investor bulletin educating investors about ICOs. As discussed in the report, virtual coins or tokens may be securities and subject to the federal securities laws.

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Christopher J. Bellini at (612) 260-9029 or cbellini@cozen.com.

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

[2] SEC Press Release 2017-131, July 25, 2017, "SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities U.S. Securities Laws May

Apply to Offers, Sales, and Trading of Interests in Virtual Organizations"

[3] *Id.*