

SEC Warns That ICOs and Other Internet Token Sales May Be Securities Offerings Subject to Federal Securities Laws

July 27, 2017 – Governance & Compliance Insider
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On Tuesday, July 25, as many practitioners probably expected, the SEC issued a warning that offers and sales of digital assets (virtual coins or tokens) by organizations using blockchain or distributed ledger technology (often referred to, among other things, as Initial Coin Offerings (“ICOs”) or Token Sales) are subject to the requirements of the federal securities laws. Depending on the offering, investors may use an established currency (e.g., U.S. dollars) or virtual currency (e.g., Bitcoin or Ether) to buy the virtual coins or tokens being offered. After they are issued, the virtual coins or tokens may be resold to others in a secondary market on virtual currency exchanges or other platforms.

A blockchain or distributed ledger is an electronic ledger, or list of entries, maintained by participants in a computer network who use cryptography to process and verify transactions on the ledger, providing comfort to users and potential users that entries are secure. Examples of blockchains are Bitcoin and Ethereum, which are used to create and track transactions in the tokens known as Bitcoin and Ether, respectively.

ICOs have captured significant attention recently as several enterprises, often start-up or development stage businesses, have attracted substantial investments through internet-based offerings, in some cases generating proceeds in the tens and hundreds of millions of dollars. Promoters of ICOs may tell investors that their investments will fund development of a digital platform, software, or similar projects and that the virtual tokens or coins offered may be used to access the platform, use the software, or otherwise participate in the project. Additionally, promoters and issuers may lead potential investors to expect a return on their investment or to participate in a share of the profits expected from the project. The SEC warned that, depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities under U.S. law. If so, the offer and sale of these virtual coins or tokens in an ICO are subject to U.S. federal securities laws. Furthermore, promoters and issuers participating in unregistered ICOs may be liable for securities law violations, and any exchange providing for trading in these virtual coins or tokens may need to register as a securities exchange with the SEC.

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The SEC's warning was made in a Report of Investigation stemming from an Enforcement Division inquiry into whether an organization known as "The DAO" violated federal securities laws with unregistered offers and sales of "DAO Tokens" in exchange for the Ether virtual currency. By the time the offering by The DAO closed, The DAO had raised Ether valued at approximately US\$150 million.

The DAO has been described as a "crowdfunding contract," but it 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 FINRA.

In its report, the SEC concluded that the tokens offered and sold by The DAO were securities offered and sold in the United States and therefore subject to the U.S. federal securities laws. Under the circumstances, however, the SEC decided not to bring charges or make findings of violations, but rather to caution industry and market participants to be cognizant that U.S. federal securities laws apply to anyone who offers and sells securities in the United States, whether the issuer is a traditional company or a decentralized autonomous organization and regardless of whether purchases are made using U.S. dollars or virtual currencies. Moreover, the report confirms that the use of distributed ledger technology does not affect the determination whether virtual coins or tokens are securities.

The SEC's Office of Investor Education and Advocacy also issued an investor bulletin to provide information to investors about ICOs. The bulletin explains that new technologies may be used to perpetrate investment schemes that don't comply with federal securities laws and highlights several red flags of investment fraud.