

## SEC: Certain Initial Coin Offerings Are Securities Offerings

***SEC's investigative report sends clear message that virtual transactions using innovative technologies are subject to the application of securities laws.***

### Introduction

On July 25, 2017, the US Securities and Exchange Commission (SEC) issued a Section 21(a) report (Report)<sup>1</sup> under the Securities Exchange Act of 1934 (Exchange Act) to publish its investigation of whether The Decentralized Autonomous Organization (The DAO) violated the US federal securities laws. In the Report, the SEC, for the first time, addressed whether digital coins or tokens offered and sold in an initial coin offering (ICO) using distributed ledger technology may be securities. The Report also analyzed and demonstrated the application of federal securities laws to the particular facts and circumstances of The DAO's offer and sale of the tokens (DAO Tokens).

The SEC stated in the Report that it knows that virtual organizations and associated individuals and entities are increasingly using distributed technology to offer and sell coins or tokens to raise capital. Furthermore, the SEC said that it issued the Report to stress that US federal securities law may apply to these activities regardless of the form of the organization or technology used to effect the offer or sale. In the Report, the SEC considers the particular facts and circumstances of the offer and sale of the DAO Tokens to demonstrate the application of the existing federal securities to this new market paradigm.

### Background and SEC's Determinations

The DAO is a virtual organization embodied in computer code and executed on a distributed ledger or blockchain. It was created by its founders with the objective of operating as a for-profit entity that would offer and sell DAO Tokens to investors in exchange for "Ether," a virtual cryptocurrency component of the ethereum platform, which would then be used to fund projects on a majority vote of DAO Token holders. The DAO would earn profits from these projects, which would provide DAO Token holders a return on their investment. DAO Token holders could also re-sell DAO Tokens on a number of web-based platforms that supported secondary market trading in the DAO Tokens.

Based on its investigation and analysis, the SEC determined that:

- In applying the test established by the US Supreme Court case *SEC v. W.J. Howey Co.*, the DAO Tokens were securities under the Securities Act of 1933 (Securities Act) and the Exchange Act, because they represented an investment of money in a common enterprise with the expectation of profits to be derived from the efforts of others.

- The DAO, an unincorporated virtual organization, was an "issuer" of securities, and information about the DAO was crucial to the DAO Token holders' investment decision.
- Because DAO Tokens were securities, The DAO must register the offer and sale of DAO Tokens under Section 5 of the Securities Act, unless a valid exemption applied. In addition, participants in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5 of the Securities Act. The Report does not specifically find that there was no valid exemption; however, it appears to be the case.
- The platforms that traded DAO Tokens in the secondary market appear to meet the definition of an "exchange" under Section 3(a)(1) of the Exchange Act, and thus must register as national securities exchanges under Section 5 of the Exchange Act or operate pursuant to an exemption from registration (such as under Regulation ATS).

The SEC has determined not to pursue an enforcement action in The DAO matter at this time. However, the agency cautions those who would use distributed ledger technology for fundraising to take appropriate steps to ensure compliance with the federal securities laws. The Report does not indicate whether the SEC will pursue enforcement action against issuers and participants in other token or coin offerings or platforms that provide facilities for secondary market trading in coins that are securities in the future. However, market participants may reasonably expect future enforcement action in this area. In addition, purchasers in an offering of token securities that were neither properly registered nor exempt from registration under the Securities Act may pursue civil actions to rescind the transactions.

The Report does not analyze the question of whether The DAO was an investment company as defined under Section 3(a) of the Investment Company Act of 1940 (the 40 Act). However, the Report clarifies that those who would use virtual organizations should consider the requirements of the Investment Company Act. For example, to the extent The DAO operated like a fund that would finance and hold interests in other projects that were securities, the DAO would likely fall within the definition of an investment company and would be required to register as such or use an available exemption.

## **What Does the Report Mean to Market Participants?**

The SEC has sent a clear message that innovative technologies and virtual transactions are not exempt from the application of securities laws. Market participants who are considering using an ICO to raise funds should carefully analyze the particular facts and circumstances under the existing regulatory framework to determine whether the tokens may be securities. In particular, they should take into account various rights attributed to the tokens and the economic realities underlying the transaction structure.

If the tokens in an offering are securities, the token's issuer — whether it is a virtual organization or otherwise — will need to either register the offering or rely on an exemption from registration, such as a private placement or the crowdfunding exemption under the Jumpstart Our Business Startups (JOBS) Act, just like other securities issuers. In addition, other aspects of the federal securities laws may apply. For example, intermediaries in offerings of token securities will likely need to be registered as broker-dealers.

Those who provide facilities for secondary markets trading in tokens that are securities may also fall within the definition of an exchange, and would thus need to register as a national securities exchange or as a broker-dealer and alternative trading system under Regulation ATS. In addition, persons or systems that perform the function of an intermediary in making payments or deliveries in connection with transactions in tokens that are securities or act as a custodian of tokens that are securities may also fall

within the definition of a clearing agency, and would need to comply with the applicable Exchange Act registration requirement. Such persons may also fall within the coverage of various money transfer laws.

The Report is the US securities regulator's first statement regarding the nascent ICO market. Other global regulators will likely take note of the SEC's statements and consider the application of local laws to these activities. Accordingly, as the technology underlying ICOs enables tokens to be offered on a global basis, market participants should consider seeking counsel in each jurisdiction in which they anticipate engaging in these sorts of activities.

For completed ICOs, market participants should consider taking appropriate steps to remediate securities law violations to the extent that the offered tokens were securities offered in a transaction that was unregistered or not otherwise exempt from registration. Similarly, trading platforms that have been providing facilities for bringing together buyers and sellers of tokens that are securities should also consider taking appropriate steps necessary to comply with the Exchange Act registration requirement.

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**Endnotes**

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<sup>1</sup> The Report is available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.