

## SEC's Investigative Report Raises Difficult Questions for ICO Issuers

### IN SHORT

**The Situation:** The U.S. Securities and Exchange Commission has issued its first public statements regarding the burgeoning market for initial coin offerings.

**The Result:** The SEC's report noted that determining whether a coin or token constitutes a security relates to specific factors, i.e., an investment of money in a common enterprise and with the expectation of profits that are expected to arise substantially from the efforts of a third party.

**Looking Ahead:** Market participants should ensure they understand the applicability of securities law—including the possibility of an exemption—when considering ICO activities.

Against the backdrop of recent growth of initial coin or token offerings ("ICOs"), the U.S. Securities and Exchange Commission ("SEC"), on July 25, 2017, published its first public statements on this fundraising practice. The Investigative Report released by the SEC analyzed a specific offer and sale—the spring 2016 sale of DAO Tokens by a virtual organization, known as The DAO—and stated a warning to market participants who have consummated, or are considering participating in, ICOs: "virtual coins or tokens may be securities and subject to the federal securities laws."

In the case of The DAO's issuance of DAO Tokens, after evaluating the facts and circumstances, the SEC elected not to bring charges but, instead, to use the report to sound a note of caution to the industry and market participants. As a result, market participants in the recent wave of ICOs (including coin or token issuers, those marketing coin offerings, and those maintaining trading platforms for secondary coin trading) may find themselves asking: Is a particular coin or token a security? And if so, what are the consequences?

#### Is a Coin or Token a Security?

As the SEC's Investigative Report notes, whether or not a particular ICO or token issuance involves the offer and sale of a security depends on the specific facts and circumstances, including the economic realities of the transaction. The analysis of whether a coin or token is a security will turn on the presence of a few specific features articulated by the U.S. Supreme Court in *SEC v. W.J. Howey Co.*: an investment of money in a common enterprise and with the expectation of profits that are expected to arise substantially from the efforts of a third party.

Because of the inherent complexity in evaluating these elements, the SEC's statements encourage market participants to consult with securities counsel or the SEC staff for assistance in analyzing the applicability of the federal securities laws. Although beyond the scope of this brief *Commentary*, similar analysis might be required with respect to state securities laws.



In the absence of registration or a valid exemption, the consequences of violating Section 5 of the Securities Act are significant.



#### If an ICO Involved a Security, What Are the Consequences?

Section 5 of the U.S. Securities Act of 1933 ("Securities Act") provides that the offer and sale of securities in the United States requires either registration with the SEC or the availability of an applicable exemption from these registration requirements. In the absence of registration or an exemption, the consequences of violating Section 5 of the Securities Act are significant and may include SEC enforcement actions, including claims for disgorgement and penalties, and investor claims for damages or rescission (at the purchase price, plus interest). In addition, any uncertainty created by the SEC's statements could lead to other potential private litigation. As a result, the first course of action for an issuer of unregistered securities would be to evaluate whether the transaction might qualify for an available exemption—for example, based on the size of the offering or the nature of the participants in the offering.

The SEC's statements do not provide guidance to those who have previously conducted ICOs or issued coins or those facilitating secondary coin markets. However, the SEC's statements encourage market participants analyzing the applicability of the federal securities laws to engage with the SEC staff for assistance. In the absence of subsequent guidance from the SEC, market participants concerned about having participated, or considering participating, in an ICO or token offering that did not address U.S. federal securities laws considerations would be prudent to discuss their particular circumstances with securities counsel.

For further information, we include a few recent press articles reporting on the SEC's Investigative Report from [CNBC](#), [The American Banker](#), [Bloomberg](#), and [The New York Times](#).

#### THREE KEY TAKEAWAYS

1. Participants in recent ICO activity—coin or token issuers, marketers, and trading platform operators—may be unsure as to whether their coins or tokens are considered securities.
2. SEC enforcement actions for engaging in activities involving unregistered securities can be severe. Unlawful activities may also be subject to civil litigation.
3. A recent SEC report encourages ICO market participants wondering about the applicability of federal securities laws to contact the SEC for assistance.

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