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SEC Provides First Guidance on Cryptocurrency, Blockchain and Initial Coin Offerings

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On July 25, the U.S. Securities and Exchange Commission ("SEC") released a Report of Investigation that represents the first major injection of regulatory guidance into the burgeoning cryptocurrency markets. A breakdown of the key takeaways from the SEC's Report and what it means for the cryptocurrency market going forward can be found below:

I. CRYPTOCURRENCY BACKGROUND

Cryptocurrencies, Bitcoin being the first and most prominent, are a recent development best described as digital currency. Bitcoin, Ether, and other cryptocurrencies are powered by blockchain technology, which acts as a public, distributed ledger recording all peer-to-peer transactions in the cryptocurrency. The blockchain system is decentralized and automated. To accomplish this, the blockchain is maintained by a network of communicating nodes running cryptocurrency software. A number of available software applications broadcast transactions to the network, where the nodes validate them, add them to their copy of the ledger, and then broadcast the new addition to the ledger to the other nodes on the network. At certain time intervals, a group of accepted transactions called a block is added to the blockchain and published to all nodes. These new blocks are assembled by "miners"—people or organizations with powerful specialized computers who compete to process transactions and get rewarded with cryptocurrency.

Blockchain technology provides the security, privacy, and decentralization that underlie the recent popularity of cryptocurrencies. The currency is stored exclusively in the blockchain, and requires a private access key to effectuate transactions. All transactions are pseudonymous, tied only to network addresses. The ledger and all transactions are public, but with no real word identity tied to ownership of the cryptocurrency, privacy is accomplished. The blockchain functions without a central authority, with verification and maintenance provided by miners. These features have drawn a lot of attention to blockchain technology and cryptocurrencies, with the SEC finally taking notice.

II. THE SEC'S INVESTIGATION – THE DAO

The SEC's Division of Enforcement opened an investigation into an unincorporated

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organization operating using blockchain technology called The DAO. The DAO, which stands for Decentralized Autonomous Organization, was the brainchild of a group based in Germany. The concept sought to automate organizational governance and decision making, allowing blockchain technology and smart contracts (computerized transaction protocols that execute the terms of a contract) to solve governance issues the designers believed to be inherent in traditional corporations.

The DAO code was deployed on the popular Ethereum blockchain system, marketed as a type of for-profit, crowdfunding entity that would allow individuals to invest in certain projects funded by The DAO. To invest, individuals exchanged the cryptocurrency Ether for DAO Tokens, which gave the holder both the right to vote on which projects to fund and a return on their investment. The DAO gained notoriety after raising the equivalent of $150 million in its month long token offering period. Online platforms quickly started trading in DAO Tokens, creating a secondary market.

Issues cropped up shortly thereafter, with a cyber attack resulting in the loss of one third of The DAO's cryptocurrency. The developers were forced to step in and rewrite the code to reverse this loss and render the stolen cryptocurrency unusable, negatively impacting The DAO's credibility and its decentralized status. Further complaints stemmed from the oversight of operations by individuals known as the "Curators," who were put in place by the developers. The Curators reviewed investment proposals and held considerable power over which proposals went to a token-holder vote. This power would prove quite material in the SEC's investigation.

III. THE RESULTS OF THE SEC'S INVESTIGATION

The investigation focused on The DAO as an example of a recent trend for raising capital known as "Initial Coin Offerings" or "Token Sales" and how these offerings fit into the framework of existing U.S. securities laws. The SEC has regulatory oversight over the offer, sale, purchase, solicitation or other activity involving "securities." The Securities Act defines "securities" to include "an investment contract." The SEC sought to determine whether DAO Tokens constituted an investment contract and therefore came under its regulatory authority.

Securities law has long been indifferent to the name given to an investment, looking instead to the underlying characteristics of what is being offered. The label of "coins" or "tokens" is therefore irrelevant in determining whether an investment is a security. The SEC found that DAO Tokens were indeed securities, basing their decision on the investment contract framework articulated by the Supreme Court in SEC v. W. J. Howey Co. The Howey test defines an investment contract as a transaction whereby one: (1) invests money, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) derived from the managerial efforts of others.

The SEC determined that DAO Tokens met all 4 prongs of the Howey test and were indeed securities. Investors used Ether, a cryptocurrency, to purchase their tokens. This satisfies the first prong, with the SEC noting that "money" need not take the form of cash according to the courts. The DAO was clearly a common enterprise, satisfying the second prong. To satisfy the "expectation of profits" prong, the SEC pointed to marketing materials

distributed by the developers of The DAO that advertised the organization as a for-profit entity with the objective of funding projects in exchange for a return on investment. One of the developers even likened it to buying shares in a company and receiving dividends. The power given to the Curators satisfied the fourth prong and sealed the fate of DAO Tokens. The SEC determined that the voting rights of investors were limited, and that the Curators were essential to the organization. The power of the investors to exert control over projects was limited by the gatekeeping of the Curators and the pseudonymous nature of the investments which limited communication and the formation of voting blocs. The investors' ability to exert meaningful control was almost non-existent, drawing parallels to a typical corporate shareholder. With all four prongs of the Howey test satisfied, DAO Tokens officially became securities in the eyes of the SEC.

IV. CONSEQUENCES

As a security, any offering of coins or tokens like DAO Tokens, requires registration with the SEC (and applicable states) unless an exemption is available. Registration is time consuming and expensive, and once public, an issuer must comply with extensive reporting requirements. The most commonly used exemption from registration requires the offering be limited to "accredited investors" (wealthy individuals and institutions). Even then, depending on the number of investors, an issuer may be subject to reporting requirements. Neither of these options provides the same level of freedom and cost effectiveness as an Initial Coin Offering such as the one employed by The DAO.

In addition to the registration requirement and its resulting obligations, the SEC's determination affects secondary markets as well. Any organization operating as a marketplace for securities, that brings together the orders of multiple buyers and sellers, and uses established, non-discretionary methods under which those orders interact, must register as a national securities exchange under the Exchange Act unless an exemption is met. A common exemption is for alternative trading systems, which must register as broker-dealers and comply with applicable regulations. The SEC's investigation concluded that the platforms set up as secondary markets for DAO Tokens would indeed be subject to these registration requirements, again limiting their level of freedom and cost effectiveness.

V. IMPACT GOING FORWARD

The registration requirements detailed above will likely have a chilling effect on Initial Coin Offerings in the U.S. going forward. This guidance from the SEC will likely force many entities considering ICO's to offer them in the U.S. to accredited investors only, or to offer them outside the U.S. entirely. The good news for cryptocurrency users is that the SEC's Report does not seem to have any effect on the status of cryptocurrency in the traditional sense. Aside from possible impacts on volatility and value resulting from the chilling effect on ICO's, cryptocurrency use will continue to be available when used in the traditional manner as a digital payment system or online currency.

Potential coin or token issuers or purchasers must consider the Howey test and ask "is this a security?" If the coin or token offered is merely a unit of value or access to a blockchain system, the offering should not be deemed a security. If the coin or token purports to offer a return on investment, voting rights, or an ownership stake in an entity or common

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enterprise, the issuer or purchaser should exercise caution. One must always think about whether a particular coin or token offering has a reasonable expectation of profits to be derived from the managerial efforts of others. If the issuer of the coin or token is managed or governed primarily by a promotor, entity founder, or governing body with limited or no voting rights for general holders, a serious risk of running afoul of the SEC exists.

This area of securities law will continue to evolve as blockchain technology and cryptocurrencies gain mainstream acceptance. The SEC and courts use a highly flexible approach to determining what is and isn't a security, one that is capable of adaptation to meet the various schemes devised by issuers who seek investment and promise a return. Without bright line rules, investing in unregistered cryptocurrencies will necessarily involve some degree of risk.

Anyone with questions on the SEC's new cryptocurrency guidance can contact Rich May, P.C. attorneys Thomas Bilodeau, III and David Glod.

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