

## **VI. *The SEC and Initial Coin Offerings: How Securities Laws Affect ICOs***

### **A. Introduction**

In the past few years, the increasing popularity of virtual currencies, such as Bitcoin, has sparked online investment opportunities known as Initial Coin Offerings (ICOs).<sup>1</sup> An ICO is an investment tool that capital-raising entities use to offer tokens for money or virtual currency that will fund future projects.<sup>2</sup> By utilizing ICOs, these entities have the capability to raise vast amounts of money in a very short period of time, without geographical restrictions.<sup>3</sup> The tokens investors receive are unique to each ICO, which may have a specific utility attached to them, or the tokens can simply be redeemed for money or virtual currency in the future.<sup>4</sup> Using blockchain technology, the capital-raising entities decentralize the ICO investment process, allowing individuals to purchase these virtual coins or tokens

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<sup>1</sup> See also David Z. Morris, *The Rise of Cryptocurrency Ponzi Schemes*, THE ATLANTIC (May 31, 2017), <https://www.theatlantic.com/technology/archive/2017/05/cryptocurrency-ponzi-schemes/528624/> [<http://perma.cc/E2B9-QKD9>] (“In the last two months alone, more than two dozen companies building are on the ‘blockchain’ technology pioneered by Bitcoin have launched what are known as Initial Coin Offerings to raise operating capital.”).

<sup>2</sup> SEC OFFICE OF INV’R EDUC. AND ADVOCACY, INVESTOR BULLETIN: INITIAL COIN OFFERINGS (2017), [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings) [<http://perma.cc/HX24-UDQU>].

<sup>3</sup> See Arjun Kharpal, *Initial Coin Offerings Have Raised \$1.2 Billion and Now Surpass Early Stage VC Funding*, CNBC (Aug. 9, 2017, 9:17 AM), <https://www.cnbc.com/2017/08/09/initial-coin-offerings-surpass-early-stage-venture-capital-funding.html> [<http://perma.cc/B4ZR-K7DL>] (reporting that \$1.2 billion were spent on ICOs as of July 2017); see also Jonathan Keane, *\$35 Million in 30 Seconds: Token Sale for Internet Browser Brave Sells Out*, COINDESK (May 31, 2017, 1:40 PM), <https://www.coindesk.com/35-million-30-seconds-token-sale-internet-browser-brave-sells/> [<http://perma.cc/U75V-ZP2V>] (noting the Basic Attention Token ICO raised \$35 million within 30 seconds of its ICO).

<sup>4</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, 1 (July 25, 2017) [hereinafter DAO Report] (“The holders of [the] Tokens stood to share in the anticipated earnings . . . as a return on their investment in [the] Tokens.”).

from any location.<sup>5</sup> The Securities and Exchange Commission (SEC) has the authority to regulate securities that reach individuals in the United States, but ICOs and virtual currency in general had not been considered securities.<sup>6</sup> In July 2017, the SEC issued a report that now serves as the basis for how the SEC may regulate ICOs in the future as investment contracts.<sup>7</sup>

This article discusses the potential impact of federal securities laws on ICOs. Sections B and C provide a brief overview of blockchain technology and investment contracts. Section D discusses the SEC Report which serves as the basis of this article, as well as potential interpretations of the report applying to future contexts. Finally, Section E of the paper describes the resulting consequences of the report, such as how the ICO market changed for U.S. investors, and how capital-raising entities may alter the ICO process.

## B. Overview of Blockchain Technology

ICOs generally utilize blockchain technology, a form of record-keeping for online transactions, often described as a type of ledger.<sup>8</sup> Rather than store all of the transactions in a central location, groups utilizing blockchain store the transaction records on the network of systems that enact the transactions, creating a “distributed ledger.”<sup>9</sup> The virtual currency that individuals can pay to invest in an ICO also uses blockchain technology, which is used to receive an ICO token without needing to provide fiat money or credit.<sup>10</sup> Once the

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<sup>5</sup> INVESTOR BULLETIN: INITIAL COIN OFFERINGS, *supra* note 2 (noting ICO transactions take place on the internet, often without a central system storing the information).

<sup>6</sup> 15 U.S.C. § 77b (2012) (listing the class of agreements that constitute a “security”); Jeffrey E. Alberts & Bertrand Fry, *Is Bitcoin a Security?*, 21 B.U. J. SCI. & TECH. L. 1, 10 (2015) (concluding that virtual currencies like Bitcoin are not securities).

<sup>7</sup> DAO Report, *supra* note 4, at 1–2 (finding that the “DAO Tokens are securities,” specifically investment contracts).

<sup>8</sup> *Id.* at 2 (describing blockchain as a decentralized ledger of transactions).

<sup>9</sup> *Id.* at 10 (“The [SEC] is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital.”).

<sup>10</sup> Memorandum from Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, Heather Cruz et al., SEC Issues Guidance on Regulation of Initial Coin Offerings (Aug. 1, 2017) [hereinafter Skadden Memo], <https://www.skadden.com/insights/publications/2017/08/secissuesguidanceonregof->

virtual currency is authenticated on the ledger, an automated “smart contract” is formed, allowing the investor to receive the token.<sup>11</sup> Blockchain experts emphasize that the security of a blockchain transaction can be greater than a centralized server, because all transactions must be verified before being able to effect a new transaction, allowing a high degree of transparency in examining the underlying transactions.<sup>12</sup> While the decentralization of a blockchain can reduce the likelihood of computer hacking, ICOs utilizing blockchain are not immune from hacking, as the security of the blockchain might depend on its underlying computer code.<sup>13</sup>

### C. Overview of Investment Contracts

In 1946, the Supreme Court decided the landmark case of *SEC v. W.J. Howey*, which determined the definition of “investment contract” as applied to federal securities laws.<sup>14</sup> In this case, the contract at issue was a sale of land which would be leased back to the seller, who would then cultivate the land and pass along a portion of

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initialcoinofferings [<http://perma.cc/ZN3Y-WQZF>] (“The idea behind these virtual organizations is to replace traditional organizational decision-making and governance with smart contract computer code on a blockchain.”). *But see* INVESTOR BULLETIN: INITIAL COIN OFFERINGS, *supra* note 2 (“Purchasers may use fiat currency (e.g., U.S. dollars) or virtual currencies to buy these virtual coins or tokens.”).

<sup>11</sup> DAO Report, *supra* note 4, at 3 (noting that the exchange of virtual currency on a blockchain can create an automated contract between the purchaser and seller).

<sup>12</sup> JUAN BATIZ-BENET, JESSE CLAYBURGH, & MARCO SANTORI, COOLEY, THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK 3 (2017) [<http://www.saft-project.com/static/SAFT-Project-Whitepaper.pdf>] [[perma.cc/MM76-623U](http://perma.cc/MM76-623U)] (“On-chain transactions make systemic market risks more transparent to analysts and regulators. Add to that near-instant settlement times, immutable transaction records, network resiliency, and all the other benefits of underlying blockchain architecture.”)

<sup>13</sup> *See* DAO Report, *supra* note 4, at 1 (noting that a hacker “used a flaw in . . . [the ICO’s] code” in order to complete a theft).

<sup>14</sup> 328 U.S. 293, 298–99 (1946) (“[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.”).

the profits back to the land purchaser.<sup>15</sup> The court found that regardless of the nature of the property interest, the offering of an asset for an expected profit could fall within the meaning of an “investment contract.”<sup>16</sup> This case created the determinative standard for an investment contract, which is “a contract, transaction or scheme in which (i) a person invests money in a common enterprise; (ii) with a reasonable expectation of profits; (iii) to be derived from the entrepreneurial or managerial efforts of others.”<sup>17</sup> The test became known as the *Howey* test, utilized to determine if an investment contract exists where individuals invest in projects that would lead to profits from the efforts of others.<sup>18</sup> Because the *Howey* test is a generally applicable test, it can apply to smart contracts created by ICOs, which is how the SEC determined that certain ICOs may be securities.<sup>19</sup>

#### D. The DAO Report

On July 25, 2017, the SEC concluded an investigation into The DAO, which was a “Decentralized Autonomous Organization” operated by Slock.it.<sup>20</sup> Slock.it created an ICO that would fund

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<sup>15</sup> *Id.* at 296 (“The service contract . . . gives *Howey* . . . a leasehold interest and ‘full and complete’ possession of the acreage.”).

<sup>16</sup> *Id.* at 301 (“The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value.”).

<sup>17</sup> Skadden Memo, *supra* note 10 at 2.

<sup>18</sup> *Id.* at 4 (explaining that even in the context of ICOs, “the *Howey* test remains the touchstone for analyzing whether any transaction involves the offer and sale of a statutory security,” taking into account “expectations of the potential token holders and the rights they are afforded in light of the *Howey* test.”).

<sup>19</sup> DAO Report, *supra* note 4, at 11–12 (“Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under *Howey*.”).

<sup>20</sup> *See id.* at 1 (“The [SEC’s] Division of Enforcement (‘Division’) has investigated whether The DAO, an unincorporated organization; Slock.it UG (‘Slock.it’), a German corporation; Slock.it’s co-founders; and intermediaries may have violated the federal securities laws.”).

upcoming projects with virtual currency from investors.<sup>21</sup> Slock.it sold DAO Tokens in its ICO in exchange for Ether (ETH), a virtual currency unit of Ethereum, and no fiat money was used to purchase DAO Tokens.<sup>22</sup> This sale began on April 30, 2016, and ended on May 28, 2016.<sup>23</sup> The DAO sought to alter the way a company could function, effectively using blockchain technology to determine disputes among unrelated individuals.<sup>24</sup> However, a security breach in The DAO blockchain allowed a hacker to take control of the virtual currency belonging to The DAO.<sup>25</sup> The security breach caused The DAO to lose nearly one-third of the total amount invested in the ICO,<sup>26</sup> where the value of the virtual currency at the time of the ICO was “approximately \$150 million.”<sup>27</sup> The SEC conducted a report in the wake of this hack, given the large amount of investments lost before The DAO could fund projects.<sup>28</sup> In its report, the SEC sets out the standard it used to determine that DAO Tokens were securities, as well as how other ICOs may be treated under federal securities laws.<sup>29</sup>

In the report, the SEC declared that DAO Tokens were securities and are therefore subject to SEC regulations; however, the SEC declined to pursue an enforcement action against The DAO for

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<sup>21</sup> *Id.* at 4 (“The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO’s anticipated earnings from the projects it funded.”).

<sup>22</sup> Skadden Memo, *supra* note 10, at 2 n.2 (noting Ethereum was the underlying blockchain for Ether used to make exchanges for DAO Tokens).

<sup>23</sup> DAO Report, *supra* note 4, at 2.

<sup>24</sup> *Id.* at 3 (“As described, a DAO Entity purportedly would supplant traditional mechanisms of corporate governance and management with a blockchain such that contractual terms are ‘formalized, automated and enforced using software.’”).

<sup>25</sup> *Id.* at 9 (“[A]n unknown individual or group . . . began rapidly diverting ETH from The DAO, causing approximately 3.6 million ETH—1/3 of the total ETH raised by The DAO offering—to move from The DAO’s Ethereum Blockchain address to an . . . address controlled by the Attacker . . .”).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 16 (“The DAO sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million ETH, which was valued in USD, at the time, at approximately \$150 million.”).

<sup>28</sup> *Id.* at 1, 3 (“After DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO’s code to steal approximately one-third of The DAO’s assets.”).

<sup>29</sup> *Id.* at 11 (explaining that the *Howey* test for an investment contract indicates DAO Tokens, and similar tokens, are subject to federal securities laws).

violating securities laws.<sup>30</sup> One of the first parts of the *Howey* test addressed in the DAO Report involved whether investors had even invested money as required to be an investment contract.<sup>31</sup> One of the novelties of The DAO ICO, no fiat currency was needed to buy a token, differentiating it from a typical security.<sup>32</sup> The SEC determined that ETH, like Bitcoin<sup>33</sup>, classifies as money to satisfy the first prong of the *Howey* test.<sup>34</sup> For the next factor of the test, the SEC needed to examine the potential for profits, as well as whether it would be reasonable for the investors to expect such profits.<sup>35</sup> The SEC determined that investors reasonably expected to profit from investing in the tokens, relying on the “various promotional materials disseminated by Slock.it and its co-founders inform[ing] investors that The DAO was a for-profit entity” in order to hold that DAO Tokens satisfied the second prong of the *Howey* test.<sup>36</sup> Finally, the SEC examined the efforts of all of the actors involved in the ICO, finding that the investors relied on the efforts of those embarking on the projects and those who would determine which projects would be

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<sup>30</sup> *Id.* at 1 (“Slock.it’s co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.”).

<sup>31</sup> *Id.* at 11 (stating that the first part of the analysis is determining investors provided money, or something else of value, in exchange for the asset).

<sup>32</sup> Skadden Memo, *supra* note 10, at 2 n.2 (noting that Ethereum was the underlying blockchain for the Ether used to make exchanges for DAO Tokens); *see also* SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (applying the investment contract framework to an investment of fiat money).

<sup>33</sup> DAO Report, *supra* note 4, at 11 (claiming that the previous precedent determined that virtual currency, even though it is not fiat money, is still an investment of money under the *Howey* test); *see also* SEC v. Shavers, No. 4:13-CV-416, 2014 WL 4652121 at \*1 (E.D. Tex. Sept. 18, 2014) (examining the role of the SEC’s jurisdiction over bitcoin investments).

<sup>34</sup> DAO Report, *supra* note 4, at 11 (“Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under *Howey*.”).

<sup>35</sup> *Id.* (“Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO’s Ethereum Blockchain address in exchange for DAO Tokens.”).

<sup>36</sup> *Id.* at 12 (“Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts.”).

funded to gain profit.<sup>37</sup> In order to reach this conclusion, the SEC examined several aspects of The DAO's management.<sup>38</sup> First, the SEC determined that the efforts of individuals other than the investors determined the likelihood of success for each token's value, such as the oversight by Slock.it and the unavoidable reality that "[i]nvestors had little choice but to rely on [The DAO's creators' and Curators'] expertise" in the day-to-day management of the investment pool and project voting.<sup>39</sup> Furthermore, the SEC determined that even though the investors had nominal voting rights,<sup>40</sup> these voting rights were not great enough to overcome the great control exhibited by The DAO's creators and Curators.<sup>41</sup> Because the investors relied on the "managerial efforts of others," DAO Tokens met the third prong on the *Howey* test, thus rendering the tokens an investment contract.<sup>42</sup>

### 1. Potential ICO Securities Law Exemption

One of the most straightforward ways for ICOs to avoid regulation under securities laws is to only sell tokens to accredited investors, which creates a Regulation D exemption.<sup>43</sup> Accredited

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<sup>37</sup> *Id.* ("The DAO's investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO's Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO's investors.").

<sup>38</sup> *Id.* at 12–15 (examining the managerial efforts of the capital-raising entity and the voting rights afforded to the investors in order to determine the third prong of the *Howey* test).

<sup>39</sup> *Id.* at 12–13 ("Investors in The DAO reasonably expected Slock.it and its co-founders, and The DAO's Curators, to provide significant managerial efforts after The DAO's launch. The expertise of The DAO's creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a vote. Investors had little choice but to rely on their expertise.").

<sup>40</sup> *Id.* at 14 ("The voting rights . . . did not provide . . . meaningful control over the enterprise, because (1) DAO Token holders' ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.").

<sup>41</sup> *Id.* at 15 ("Their efforts, not those of DAO Token holders, were the 'undeniably significant' ones, essential to the overall success and profitability of any investment into The DAO.").

<sup>42</sup> *Id.* at 12.

<sup>43</sup> 17 C.F.R. § 230.501 (2013) (recognizing an individual who has a net worth greater than \$1 million, or has an annual income greater than \$200,000 over at least a two-year span, is an accredited investor under Regulation D

investors are individuals or entities who are considered sophisticated investors based on net worth, such that the SEC will not apply securities laws to capital-raising entities seeking accredited investors.<sup>44</sup> In order to qualify for this exemption, every investor must be an accredited investor.<sup>45</sup> One such ICO that is likely exempt from SEC securities laws is Filecoin, a capital-raising entity intending to only sell tokens to a class of accredited investors in both the United States and other locations.<sup>46</sup> By knowing the status of each investor, Filecoin can essentially ignore the SEC Report regarding investment contracts because it would qualify for a Regulation D exemption by solely selecting accredited investors for the ICO.<sup>47</sup> Even if Filecoin had been unsuccessful in filtering all unaccredited investors, the exemption still applies if the capital-raising entity exercises reasonable care in determining the investors are all accredited.<sup>48</sup> Going forward, the SEC would likely need to examine the computer code created by the capital-raising entity to determine if that entity utilized reasonable care in filtering accredited and unaccredited investors.<sup>49</sup>

## 2. Importance of the Type of Asset Acquired

While the SEC determined that a token, the value of which depends on the managerial efforts of others, will fall within federal securities laws, there is no specific guidance on tokens that retain

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exemptions); 17 C.F.R. § 230.506 (2013) (stating that securities offered only to accredited investors are generally exempt from federal securities laws).

<sup>44</sup> Laura Shin, *Filecoin ICO, Launching Next Week, Aims to Resolve Token Sale Problems*, FORBES (July 19, 2017, 1:00 PM), <https://www.forbes.com/sites/laurashin/2017/07/19/filecoin-ico-launching-next-week-aims-to-resolve-token-sale-problems/#676b754e384b> [http://perma.cc/3JJL-7CXB] (reporting Filecoin would only allow ICO accredited investor participants, so as to be exempt from securities laws).

<sup>45</sup> 17 C.F.R. § 230.506.

<sup>46</sup> Shin, *supra* note 44 (reporting that Filecoin announced it would determine if an investor is accredited or not before making a token sale, a process that would apply even to individuals living outside the United States).

<sup>47</sup> *Id.* (reporting that Filecoin would focus sales only on accredited investors).

<sup>48</sup> 17 C.F.R. § 230.506 (noting that reasonable efforts are required to determine the status of each investor).

<sup>49</sup> *See id.* (noting that reviewing IRS forms and documents related to net worth dated within three months of the attempted transaction are examples of reasonable steps required to qualify for the exemption if unaccredited investors become investors despite the capital-raising entity's diligence).



separate utility.<sup>50</sup> Some capital-raising entities provide tokens in ICOs that can be used to access a service.<sup>51</sup> The Basic Attention Token, which conducted an ICO in May 2017, sold \$35 million worth of utility tokens within 30 seconds.<sup>52</sup> After the SEC concluded that DAO Tokens were securities due to their status as investment contracts, the entity controlling Basic Attention Token announced that it believed Basic Attention Tokens could not be investment contracts based on their utility to users beyond the potential for profits.<sup>53</sup> Some commentators have indicated tokens like the Basic Attention Token may escape SEC regulation under the *Howey* test because they are not simply profit-raising assets to which the *Howey* test usually applies.<sup>54</sup>

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<sup>50</sup> Skadden Memo, *supra* note 10, at 6 (“The SEC did not address ICOs that offer token holders only the right to access a future service that has not yet been built (so-called ‘access tokens’ or ‘utility tokens’). . . . Even for access tokens and utility tokens, the *Howey* test remains the touchstone for analyzing whether any transaction involves the offer and sale of a statutory security.”).

<sup>51</sup> BATIZ-BENET, CLAYBURGH & SANTORI, *supra* note 12, at 3–4 (“Some [tokens] will act as staking or betting mechanisms, membership rights, or loan collateral. Some will simply act as cryptographic ‘coupons’ redeemable for mundane goods and services . . .”).

<sup>52</sup> Keane, *supra* note 3 (“Brave’s ethereum-based Basic Attention Token (BAT) generated about \$35m and was sold out [in] . . . under 30 seconds.”).

<sup>53</sup> FAQ, BASIC ATTENTION TOKEN (last visited Sept. 23, 2017), [basicattentiontoken.org/faq](http://basicattentiontoken.org/faq) [<http://perma.cc/52R5-DESH>] (explaining that the company offering Basic Attention Tokens does not believe the SEC will regulate the tokens as securities, calling the tokens a “utility token . . . that can also be used as a unit of account between advertisers, publishers, and users in a new, blockchain-based digital advertising and services platform”).

<sup>54</sup> Skadden Memo, *supra* note 10, at 4 (“Even for access tokens and utility tokens, the *Howey* test remains the touchstone for analyzing whether any transaction involves the offer and sale of a statutory security.”); *see also* Legal Update from Dechert LLP, Jeremy Senderowicz et al., SEC Focuses on Initial Coin Offerings: Tokens May Be Securities Under Federal Securities Laws (Sept. 2017), [https://info.dechert.com/10/9294/september-2017/sec-focuses-on-initial-coin-offerings--tokens-may-be-securities-under-federal-securities-laws\(2\).asp](https://info.dechert.com/10/9294/september-2017/sec-focuses-on-initial-coin-offerings--tokens-may-be-securities-under-federal-securities-laws(2).asp) [<http://perma.cc/7565-MQKT>] (“[T]he SEC described its views with respect to ICOs in terms of general applicability, indicating the SEC’s intention to implement these views broadly in the future. Under the SEC’s analysis of the *Howey* test, not all tokens are securities, and potential issuers should consider the expectations of potential investors and the rights afforded in connection with an ICO under such test.”).

### E. Resulting Consequences of the DAO Report

Failure to regulate ICOs under federal securities laws could result in investors having significantly limited rights to recover money lost due to fraudulent activities, as there would be no entity overseeing the transactions and holding the ICO capital-raising entities accountable.<sup>55</sup> If ICOs are considered securities, not only will capital-raising entities open themselves up to liability for violating federal securities laws, but they will also incur substantial costs in complying with securities laws.<sup>56</sup> Such costs include preparing a prospectus, waiting for SEC approval before acting, and ensuring compliance with SEC regulations.<sup>57</sup> After ICOs raised a combined \$400 million in China, the Chinese government declared all future ICOs in the country illegal, decreasing the pool of potential investors.<sup>58</sup> Unless the supply of ICOs decreases because ICOs cannot be sold in China, this development appears to increase the available pool of tokens for investors in the United States and other countries to purchase. Although the SEC has not indicated it will ban ICOs as China has, the SEC's recent trading suspensions of ICO investments indicates that the SEC will likely begin to regulate the ICO industry in potentially an even broader way than the DAO Report suggests.<sup>59</sup>

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<sup>55</sup> Morris, *supra* note 1 (describing fraudulent ICO schemes before the SEC issued the DAO Report).

<sup>56</sup> Memorandum from Davis Polk & Wardwell LLP, SEC Confirms That Some Initial Coin Offerings Are Illegal Unregistered Securities Offerings (July 27, 2017), [https://www.davispolk.com/files/2017-07-27\\_sec\\_confirms\\_that\\_some\\_initial\\_coin\\_offerings\\_are\\_illegal\\_unregistered\\_securities\\_offering\\_s.pdf](https://www.davispolk.com/files/2017-07-27_sec_confirms_that_some_initial_coin_offerings_are_illegal_unregistered_securities_offering_s.pdf) [<http://perma.cc/C67Q-LQ7R>] (“In order to comply with securities laws, the public offering of a token that is a security must be made under a registration statement, including a prospectus . . . . Any false or misleading statements in the prospectus, whether or not intentional, can give rise to liability for the issuer, any seller, any underwriter and their respective control persons, among others”).

<sup>57</sup> *Id.*

<sup>58</sup> See generally Lulu Yilun Chen & Justina Lee, *Bitcoin Tumbles as PBOC Declares Initial Coin Offerings Illegal*, BLOOMBERG (Sept. 4, 2017, 3:17 AM), <https://www.bloomberg.com/news/articles/2017-09-04/china-central-bank-says-initial-coin-offerings-are-illegal> [<http://perma.cc/YA3U-HYJE>].

<sup>59</sup> SEC OFFICE OF INV’R EDUC. AND ADVOCACY, INVESTOR ALERT: PUBLIC COMPANIES MAKING ICO-RELATED CLAIMS (2017), <https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making> [<http://perma.cc/JUM5-YFSD>] (“The SEC recently issued several trading suspensions on the common stock of certain issuers who made

Although the volume of investment in ICOs still remains high after the issuance of the DAO Report, many ICOs have excluded potential investors in the United States due to uncertainty regarding the SEC's jurisdiction.<sup>60</sup> While several groups are encouraging caution for potential investors and capital-raising entities, these warnings have not diminished the demand for ICOs.<sup>61</sup> In the two months following the SEC's release of the DAO Report, ICO investment increased by a substantial amount, indicating that the SEC's report did not serve as a deterrent to potential ICO capital-raising entities.<sup>62</sup> While August 2017, which is the month following the DAO Report, indicated a slight downturn in the ICO market, the overall trend demonstrates increasing token sales.<sup>63</sup> In fact, September 2017 is the highest recorded month of ICO funding, with more than \$662 million in funding for new ICOs.<sup>64</sup> The trend further solidified after September, because October 2017 yielded more than \$516 million in ICO funding,<sup>65</sup> and the first week of November 2017 accounted for nearly \$487 million in ICO funding.<sup>66</sup> Despite the influx of new ICO investment, many within the ICO market have interpreted the DAO Report to be a warning to capital-raising entities rather than a unique application of SEC authority, even

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claims regarding their investments in ICOs or touted coin/token related news.”).

<sup>60</sup> Andrew Ramonas, *No U.S. Investors Need Apply for Some Digital Coin Offerings*, 49 SEC. REG. & L. REPORT 1397, 1397 (2017) (reporting that certain persons studying and operating businesses using cryptocurrency expressed that “[u]ncertainty about U.S. securities laws in the emerging digital asset world has left Americans excluded from a number of ICOs”).

<sup>61</sup> *Compare* INVESTOR ALERT: PUBLIC COMPANIES MAKING ICO-RELATED CLAIMS, *supra* note 59 (warning investors to be alert for ICO fraud while simultaneously suspending trading of four ICOs), *with Coindesk ICO Tracker*, COINDESK (last visited Nov. 17, 2017), <https://www.coindesk.com/ico-tracker/> [<https://perma.cc/3N53-6HDB>] (reporting as of October 13 that “New ICO Funding” since July 25, 2017 has been approximately \$1 billion).

<sup>62</sup> *Coindesk ICO Tracker*, *supra* note 61 (reporting as of November 17, 2017 that “New ICO Funding” since July 25, 2017 has been approximately \$1.85 billion).

<sup>63</sup> *Id.* (reporting “New ICO Funding” in August 2017 was \$145.9 million).

<sup>64</sup> *Id.* (reporting “New ICO Funding” in September 2017 was \$662.85 million, where the next highest month in recorded ICO history was July 2017 with \$574.48 million).

<sup>65</sup> *Id.* (reporting “New ICO Funding” in October 2017 was \$516.35 million).

<sup>66</sup> *Id.* (reporting “New ICO Funding” in November 2017, through November 7, was \$486.93 million).

though the Report does not explicitly determine that any token other than DAO Token is a security.<sup>67</sup>

Another implication that could arise from securities laws governing ICOs is that any secondary market offering tokens regulated by the SEC would need to register as an exchange with the SEC.<sup>68</sup> There are still greater implications for the way in which courts must engage in the judicial review process due to the inherently complicated nature of the ICO blockchain technology. Based on the DAO Report, it is possible that the complexity of the blockchain technology will force the SEC and reviewing judicial courts to interpret computer code to determine if the “smart contract” creates an investment contract, a concern that could place the capital-raising entity’s ICO under securities laws.<sup>69</sup>

Although capital-raising entities face significant costs in complying with federal securities laws, some suggest that the transparency of adhering to these laws may yield greater returns.<sup>70</sup> Some groups are currently creating “frameworks” for ICO capital-raising entities to use for utility tokens that will avoid SEC securities laws.<sup>71</sup> The Simple Agreement for Future Tokens (SAFT), a partnership between Protocol Labs and Cooley LLP, created a protocol distributing utility tokens to investors when such tokens are

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<sup>67</sup> See Tama Churchouse, *The SEC is Finally Starting to Regulate Bitcoin and Other Cryptocurrencies*, BUS. INSIDER (July 29, 2017, 11:21 AM), <http://www.businessinsider.com/bitcoin-price-security-equity-sec-2017-7> [<http://perma.cc/3DQQ-6L3T>] (“The [DAO] report was a warning.”).

<sup>68</sup> Skadden Memo, *supra* note 10, at 4 (“The Report is also a reminder that, absent an exemption, any exchange on which such tokens are traded may need to register as a national securities exchange or as an ATS.”).

<sup>69</sup> See BATIZ-BENET, CLAYBURGH & SANTORI, *supra* note 12, at 16 (expressing caution to potential capital-raising entities trying to use Protocol Labs’ framework which distributes utility tokens to investors when such tokens are available).

<sup>70</sup> Lindsay Lin, *Why ICOs Should Want to Be Securities*, COINDESK (Oct. 2, 2017, 8:05 PM), <https://www.coindesk.com/icos-want-securities/> [[perma.cc/XMF7-DF62](https://perma.cc/XMF7-DF62)] (“An organization that claims that its tokens are non-security utility tokens, and does not register or use a registration exemption, also must evaluate the ‘Blue Sky’ securities laws of all states in which token buyers reside.”).

<sup>71</sup> BATIZ-BENET, CLAYBURGH & SANTORI, *supra* note 12, at 15 (“The SAFT framework works for tokens which are not themselves independently securities. That is to say, it works for utility tokens, not securities tokens. The SAFT would have little or no beneficial effect for a DAO Token-like arrangement, for example.”).

available.<sup>72</sup> The SAFT essentially functions as the investment contract between investors and the ICO capital-raising entities, but this distribution framework is only necessary until the tokens are fully distributed.<sup>73</sup> If the tokens sold during the ICO have some sort of utility and the tokens retain this utility once distributed, then the SAFT framework could allow the SAFT to be regulated as a security, but the tokens avoid SEC regulation.<sup>74</sup> Even if the tokens from the ICOs are regulated by the SEC, including those built on specialized frameworks such as the SAFT, there are significant risks for investors in recovering investments from fraudulent activity.<sup>75</sup>

## F. Conclusion

Until the SEC releases further guidance on ICOs, the legality of many ICOs remains uncertain. However, the DAO Report makes clear that an ICO is a security if it involves the sale of tokens which *only* serve to make a profit for the investor based on the efforts of others.<sup>76</sup> Nonetheless, it is possible that utility tokens, which have a purpose beyond achieving a profit for the investor, will be regulated under securities laws.<sup>77</sup> Unless the SEC determines that Regulation D exemptions do not apply for ICOs in the United States, capital-raising entities will be able to sell to accredited investors without facing federal securities laws.<sup>78</sup> For ICOs the SEC chooses not to regulate as securities, investors will not enjoy any of the protections offered to

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<sup>72</sup> *Id.* at 15–16 (stating that the tokens would be distributed by the SAFT, which would likely be a security, while the tokens it distributes may not be securities, allowing the ICO to potentially not be implicated by federal securities laws).

<sup>73</sup> *Id.* at 1 (“The SAFT is an investment contract . . . . The SAFT obligates investors to immediately fund the developers. In exchange, the developers use the funds to develop genuinely functional network . . .”).

<sup>74</sup> *Id.* (“The resulting tokens . . . are already functional, and need not be securities under the Howey test. They are consumptive products and, as such, demand compliance with state and federal consumer protection laws.”).

<sup>75</sup> INVESTOR BULLETIN: INITIAL COIN OFFERINGS, *supra* note 2 (“Law enforcement officials may have difficulty freezing or securing investor funds that are held in a virtual currency. Virtual currency wallets are encrypted and unlike money held in a bank or brokerage account, virtual currencies may not be held by a third-party custodian.”).

<sup>76</sup> *See* DAO Report, *supra* note 4, at 12.

<sup>77</sup> *See* Skadden Memo, *supra* note 10, at 6.

<sup>78</sup> 17 C.F.R. § 230.506.

security holders, increasing the likelihood that investors will be unable to recover their investments.<sup>79</sup>

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<sup>79</sup> INVESTOR BULLETIN: INITIAL COIN OFFERINGS, *supra* note 2 (stating the types of fraud that can occur with an ICO).

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