



## SEC report on tokens as securities: seven takeaways

### Capital Markets Alert

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One of the more interesting phenomena in early-stage investing is the recent emergence of initial coin offerings (ICOs), token generation events (TGEs), or similar distributed ledger or blockchain-enabled means for raising capital. Much has been written, including by many skilled lawyers in the technology sector, about whether the tokens issued in these structures involve "securities." Hungry for a something that seems like crowdfunding, but that actually works to raise meaningful capital for promising technology initiatives, many in the technology space really want these structures to work.

Unfortunately, most historical questions about whether an instrument is a security are poor analogues for complex, novel, technology-enabled business models. Cases on this topic tend to address payphone routes, variable annuities, viatical or life settlements, tenancy-in-common programs, real estate general partnership interests and other low-tech topics. Sneak peek: most of the time, such investments are securities.

On Tuesday, the SEC issued a report on tokens as securities, using The DAO (a crowdsourced venture capital platform created by Slock.it and based on the Ethereum blockchain) as a lens for analyzing the issue.

Sneak peek: DAO Tokens are securities. Double-sneak peek: many tokens are securities.

## Overview of SEC analysis

The SEC began by emphasizing that the definition of "security" is flexible, must be adapted to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits, and focuses on substance (not form) and the underlying economic realities. It then analyzed DAO Tokens under the "investment contract" test for a security, which generally treats as a security an (i) investment of money (ii) in a common enterprise (iii) with a reasonable expectation of profits (iv) to be derived from the entrepreneurial or managerial efforts of others.

## Top seven takeaways

For businesses considering a token offering or already operating in the token space, below are seven notable takeaways from the SEC's analysis:

1. **"Common enterprise" is a simple inquiry when funds are pooled.** The SEC did not even separately discuss this element. Without explaining "horizontal" versus "vertical" (or "broad" versus "narrow" vertical) commonality, it essentially just asserted that investors "were investing in a common enterprise" and observed in passing that investor funds were pooled to fund projects.
2. **"Use" or "functionality" expectations may be irrelevant.** Some commentators (including law firms) have suggested that a token having utility and functionality on a platform may position the token as more like a license or similar use right, rather than a security. In part, this reflects that securities involve an expectation of investment profits, not an expectation of consuming or using the item purchased. The SEC report did not really discuss this theory at all – and DAO Token holders had access rights to a platform that gave them an opportunity to consider and help shape the future of blockchain technologies. Instead, the SEC reports states that investors were "motivated, at least in part, by the prospect of profits on their investment" (emphasis ours), implying that a token may be a security even if investment is a *secondary* expectation behind other primary, non-investment expectations, such as the token securing platform access, use or functionality. Debatable as this might be, it is certainly an interesting takeaway.
3. **Waiting to sell tokens until a platform is built may actually demonstrate investor reliance on others.** Similarly, while some commentators (including law firms) suggest building a platform before selling the tokens that will fuel the platform (so the tokens have utility and functionality like a license or similar use right), the SEC report prominently profiled these efforts in concluding that investors were relying on the significant efforts of others for investment returns. The SEC referenced the team that built the protocol, designed the smart contracts, built the website, and otherwise worked in support of the foundation and the ICO.
4. **Techniques to avoid money transmitter issues may create securities issues.** Some commentators (including law firms) have suggested that money transmitter issues can be avoided by steps like baking into the protocol an algorithm regarding the amount of tokens in circulation and dispersing control of the platform broadly. But both of these features were highly relevant to the SEC's conclusion that investors rely on the efforts of others for investment returns. Building the protocol in advance was evidence of reliance on the efforts of others, and dispersing control (through pseudonymity and broad dispersion of tokens) prevented token holders from taking action, thereby making them reliant on the efforts of others.
5. **Voting rights are not significant efforts of investors.** The SEC noted that holders of DAO Tokens had rights to vote on projects before funds were deployed for projects, but these limited voting rights did not provide meaningful control or mean that token holders were actively involved in managing the business.
6. **Token offering "participants" may have liability.** The SEC warned that "participants" in unregistered, non-exempt offerings may face liability. The SEC did not explain what constitutes "participation" in a token offering; rather, it simply pointed to those who played a necessary role in the transactions, such as soliciting offers. This test seems likely to reach those with such business roles as drafting white papers or other investor-facing materials, designing the website that markets the ICO or TGE, or otherwise soliciting investors.
7. **Shot across the bow at token exchanges.** After explaining when registration as a "national securities exchange" is required, the SEC observed that the most commonly used exemption from this requirement is for alternative trading systems operated by registered securities broker-dealers. Many token exchange platforms are not run through registered broker-dealers. Token exchange platforms should carefully consider whether any token listed on the platform is a security and should consider adopting policies and procedures

to actively avoid listing such tokens.

### What next?

If you have already conducted or taken part in an ICO or TGE, or if you are pondering this, the SEC report may affect you. The SEC report warns that issuers and those participating in unregistered offerings of tokens that are securities may be exposed to civil or criminal liability. It also warns exchanges that facilitate trading in tokens of their registration obligations. The SEC could have issued several additional warnings to those involved in this space relating to securities compliance when tokens are securities.

Many questions continue to arise around this development. We've read the SEC report five times from start to finish and we are still noticing nuances that we find interesting. We will continue to monitor this area and are happy to answer any questions you might have.

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