



SEC DIGITAL ASSET INVESTIGATIVE REPORT

OVERVIEW

For questions on the note below, please contact [Kevin Batteh](#) or [Kwon Park](#) at (202) 547-3035.

On July 26, 2017, the Securities and Exchange Commission (SEC or Commission) [issued an investigative report](#) (Report) cautioning market participants that offers and sales of digital assets by “virtual” organizations are subject to the requirements of the federal securities laws. Along with the report, the SEC’s Office of Investor Education and Advocacy issued an [investor bulletin](#) to educate investors about initial coin offerings (ICOs), and the Divisions of Corporation Finance and Enforcement [issued a statement](#) on the report. See below for a summary prepared by Delta Strategy Group.

Note: The summary below does not in any way constitute legal advice, and instead, simply recaps the analysis and conclusions made by SEC staff.

Key Takeaways

- The Commission found that [DAO Tokens](#) are “securities” under federal securities laws, and [The DAO](#) was an “issuer.” The Commission explained that federal securities laws [may apply](#) to various activities, including distributed ledger technology (DLT). Whether or not a particular coin offering is a security depends on the [particular facts and circumstances](#), including the economic realities of the transaction.
- The Commission decided not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.
- The SEC concluded that platforms trading DAO Tokens should have been registered as a [national securities exchange](#) or operated pursuant to an exemption, such as an [alternative trading system](#) (ATS).
- While the report noted that the digital asset Ether (ETH) was the mechanism to fund investments in the DAO, they did not investigate, conduct any analysis, or make any findings that ETH is a security.
- The Report confirms the long held view of Delta Strategy Group that every digital asset fundraiser must be evaluated based on its unique facts and circumstances and in light of applicable securities laws (e.g. the *Howey Test*.)

SUMMARY

Brief Summary

In the report, the Commission notes that whether a particular investment transaction involves the offer or sale of a security will depend on the [facts and circumstances](#), including the economic realities of the transaction. These offers and sales conducted by organizations using DLT or blockchain technology have been referred to as ICOs or Token Sales.

The report found that tokens offered and sold by “The DAO” were securities, and therefore, subject to federal securities laws. However, the SEC has decided [not to bring charges or make findings of \[securities\] violations in the report](#).

Instead, the Commission cautions the industry and market participants that “federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through DLT.”

SEC Chairman Jay Clayton said, “[t]he SEC is studying the effects of distributed ledger and other innovative technologies and encourages market participants to engage with us. . . [w]e seek to foster innovative and beneficial ways to raise capital, while ensuring – first and foremost – that investors and our markets are protected.”

Report of Investigation: The DAO

Overview

The Commission deemed it appropriate and in the public interest to issue this report¹ to advise those who would use a Decentralized Autonomous Organization (“DAO Entity”) or other DLT or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws.

The report outlines the facts that supplement the SEC’s analysis. The facts provide background on The DAO, DAO Tokens, DAO Participants, Secondary Market Trading on Platforms, and Security Concerns (The “Attack” on The DAO and The Hard Fork).

The Commission considered the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new offering.

Discussion and Breakdown of the SEC Legal Analysis

The Key Issues Addressed

In the report, the SEC analyzes and makes findings on three critical issues:

- 1) Whether DAO Tokens are Securities; and if so:
- 2) Whether the DAO was an Issuer; and
- 3) Whether platforms offering DAO Token trading satisfy the Exchange definition, and therefore, should be registered.

Issue 1) Whether DAO Tokens are Securities

In order to determine the first issue, the SEC addresses the fundamental question, “What is a “Security?””

The term security includes an “investment contract.”² While no statutory definition for an investment contract exists, courts apply the *Howey Test*³ to determine whether something is an investment contract, and therefore, meets the SEC’s statutory definition of a security.

Per the *Howey Test*, an investment contract is an: 1) investment of money; 2) in a common enterprise; 3) with a reasonable expectation of profits; 4) to be derived from the entrepreneurial or managerial efforts of others. All four elements must be satisfied to have an investment contract.

The SEC analyzed each prong of the *Howey Test* as follows:

- 1) Investment of Money
 - Courts
 - An “investment of money” does not need to be in the form of cash.
 - Courts have held that virtual currencies (i.e. Bitcoin), goods and services, or some other exchange of value will meet the “investment of money” element.

¹ The Commission’s authority to issue this report is pursuant to Section 21(a) of the Securities Exchange Act of 1934 (“34 Act”).

² Section 2(a) of the 33 Act and Section 3(a)(10) of the 34 Act.

³ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

- DAO
 - DAO investors used ETH to make their investments. DAO Tokens were received in exchange for ETH.
 - The SEC determined that such investment is the type of contribution of value satisfying the “investment of money” element.
- 2) Common Enterprise
- Courts
 - Although the U.S. Supreme Court in *Howey* did not expressly articulate what constitutes a common enterprise, the opinion read that “[a] common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.”
 - However, Circuit Courts apply three different methods to determine whether the “common enterprise” element is satisfied: 1) the horizontal approach; 2) the narrow vertical approach; or 3) the broad vertical approach.
 - DAO
 - In the report, the SEC did not expressly address the common enterprise element on its own.
 - The Commission states that “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.”
 - Promotional materials disseminated by Slock.it and its co-founders informed investors that The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment.
- 3) Reasonable Expectation of Profits
- Courts
 - Profits include dividends, other periodic payments, or the increased value of the investment.
 - DAO
 - ETH investments were pooled and available to The DAO to fund projects proposed by contractors. If the Curators whitelisted a proposed contract, DAO Token holders could vote on whether to fund the project.
 - Depending on contract terms, DAO Token holders share in potential profits from the projects.
 - The SEC determined that a reasonable investor would have been motivated by the prospect of profits on their investment of ETH in The DAO.
- 4) Solely from the Efforts of Others
- Courts
 - The central issue is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.
 - DAO
 - The SEC found that investors’ profits were to be derived from the managerial and entrepreneurial efforts of Slock.it, its co-founders, and The DAO’s Curators (the “Parties”). The Parties’ efforts, not those of DAO Token holders, were undeniably significant and essential to the overall success and profitability of any investment into The DAO.
 - Factors which contributed to this finding include:
 - Marketing
 - Slock.it created The DAO Website and published a White Paper on how The DAO

Entity would work. Slock.it and its co-founders actively engaged with The DAO and DAO Token holders.

- Slock.it created, maintained, and closely monitored multiple online forums to provide information on voting and other tasks related to DAO Token holders' investments.
- The DAO creators held themselves out as experts in Ethereum and self-selected people to serve as Curators.
- Slock.it told investors that it expected to put forth the first substantive profit-making contract proposal.
- Expertise
 - The DAO's creators and Curators expertise was critical in monitoring The DAO's operations, safeguarding investor funds, and determining whether proposed contracts should be put for a vote (by DAO Token holders).
 - Curator functions included: 1) vetting Contractors; 2) determining whether and when to submit proposals for votes; 3) determining the order and frequency of proposals that were submitted for a vote; and 4) determining whether to halve the default quorum necessary for a successful vote on certain proposals.
 - Curators were selected by Slock.it and its co-founders and exercised significant control over the order and frequency of proposals, and could impose their own subjective criteria on whether a proposal should be whitelisted for a vote by DAO Token holders.
 - While DAO tokens could put forth proposals to replace a Curator, the proposals were subject to control by the current Curators – Curators had the power to determine whether a proposal to remove a Curator was put to a vote.
- Active Monitoring
 - Slock.it and its co-founders actively monitored The DAO and addressed issues as they arose, proposing a moratorium on all proposals until vulnerabilities in The DAO's code had been addressed and a security expert was appointed to monitor potential attacks.
 - When an attacker exploited a weakness in the code and removed investor funds, Slock.it and its co-founders stepped in to help resolve the situation.
- Limited Voting Rights
 - DAO Token holders could only vote on proposals cleared by Curators, and were incentivized either to vote yes or to abstain from voting. The voting record, therefore, would not necessarily reflect the actual view of a majority of DAO Token holders.
 - Voting rights afforded to DAO Token holders did not provide meaningful control over the enterprise because: 1) DAO Token holders' ability to vote for contracts was largely a perfunctory one;⁴ and 2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.⁵
 - The SEC determined that the diminished ability of DAO Token holders to exercise meaningful control over the enterprise through the voting process renders their voting rights akin to those of a corporate shareholder.

⁴ For example, Slock.it founders put forth their own contract proposal and, in response to questions and requests to negotiate the proposal terms, explained that the proposal was intentionally vague and was, in essence, a take it or leave it proposition not subject to negotiation or feedback.

⁵ DAO Tokens were traded by thousands of individuals and entities in the secondary market – an arrangement that bears little resemblance to that of a genuine partnership. Although DAO Token holders could submit forum posts on proposals, their posts were pseudonymous and anyone was permitted to post (even non-DAO Token holders).

Conclusion: The SEC found that DAO Tokens are “Securities.”

Issue 2) Whether the DAO was an Issuer

In order to address this issue, the SEC considered the question, “Who is an “Issuer?” and found that an “Issuer” is broadly defined to include “every person who issues or proposes to issue any security” and “person” includes “any unincorporated organization.” The term “issuer” is flexibly construed “as issuers devise new ways to issue their securities and the definition of a security itself expands.”

Applying this to the DAO, the SEC found that The DAO was an “unincorporated organization” and information about The DAO was “crucial” to the DAO Token holders’ investment decision. The DAO was “responsible for the success or failure of the enterprise,” and accordingly was the entity about which the investors needed information material to their investment decision.

- The DAO offered and sold DAO Tokens in exchange for ETH through The DAO Website, which was publicly-accessible, including to individuals in the U.S.
- Because DAO Tokens were securities, The DAO was required to register the offer and sale of DAO Tokens, unless a valid exemption applied.

Conclusion: The DAO was an issuer.

Issue 3) Whether platforms offering DAO Token trading satisfy the Exchange definition, and therefore, should be registered.

Per the Report, SEC rules⁶ make it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange⁷ or is exempted from registration.⁸

The SEC provides a functional test⁹ to assess whether a trading system meets the exchange definition. An exchange is an organization, association, or group of persons that:

- 1) Brings together the orders for securities of multiple buyers and sellers; and
- 2) Uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

Analysis and Conclusion. The SEC found that platforms trading DAO Tokens satisfied the definition of an exchange, and did not qualify for any exemption.

- 1) The platforms provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens; and
- 2) For execution based on non-discretionary methods.

Therefore, platforms trading DAO Tokens should have been registered as a national securities exchange¹⁰ or operate pursuant to an exemption – i.e. as an ATS.¹¹

⁶ Section 5 of the 34 Act.

⁷ Section 6 of the 34 Act.

⁸ Section 3(a)(1) of the 34 Act. An Exchange is “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange. . .”

⁹ Rule 3b-16(a) of the 34 Act.

¹⁰ Section 5 and 6 of the 34 Act.

¹¹ Rule 3a1-1(a)(2) of the 34 Act.

Along with the Report the SEC issued “Investor Bulletin: Initial Coin Offerings (ICOs)”

ICOs: The SEC states that depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities. If they are securities, the offer and sale of these virtual coins or tokens in an ICO are subject to the federal securities laws.

The Investor Bulletin provides additional background on blockchain; virtual currency, token, or coin; virtual currency exchanges; and virtual token or coin issuers.

Some Key Points to Consider When Determining Whether to Participate in an ICO

- If an offering is registered, the information can be found on EDGAR.
- If a promoter states that an offering is exempt from registration, and you are not an accredited investor, be careful – most exemptions have net worth or income requirements.
- Although ICOs are sometimes described as crowdfunding, it may not be in compliance with Regulation Crowdfunding or with federal securities laws.
- Ask what your money will be used for and what rights the virtual coin or token provides to you.
- If the virtual token or coin is a security, those who offer, transact in, or advise on investments are required to be licensed or registered.
- Ask whether the blockchain is open and public, whether the code has been published, and whether there has been an independent cybersecurity audit.
- Investors should be suspicious of jargon-laden pitches, hard sells, and promises of outsized returns – fraudsters often use innovations and new technologies to perpetrate fraudulent investment schemes.
- Virtual currency exchanges and other entities holding virtual currencies, tokens, or coins may be susceptible to fraud, technical glitches, hacks, or malware.

Other Information

The Investor Bulletin states that investing in an ICO may limit your recovery in the event of fraud or theft. While you may have rights under the federal securities laws, your ability to recover may be significantly limited. Law enforcement challenges include:

- Tracing money
- International scope
- No central authority
- Freezing or securing virtual currency

Be careful if you spot any of these potential warning signs of investment fraud:

- Guaranteed high investment returns
- Unsolicited offers
- Sounds too good to be true
- Pressure to buy right now
- Unlicensed sellers
- No net worth or income requirements