

## Issuers On Notice After SEC 'Coin Offering' Report

By **Evan Weinberger**

*Law360, New York (July 27, 2017, 5:07 PM EDT)* -- The U.S. Securities and Exchange Commission on Tuesday brought some clarity to the market for “initial coin offerings” when it outlined a test for treating the digital “tokens” that are offered in exchange for money or digital currency as securities, but experts say key questions remain about certain types of tokens that defy easy categorization.

The SEC released an investigative report into a German group known as The DAO, a so-called decentralized autonomous organization that used blockchain technology to raise about \$150 million last year. The report found that the tokens like those used in The DAO’s “ICO” are considered securities under U.S. law despite some attempts to argue otherwise.

“What the SEC has done is it has applied existing and well-established, well-understood principles and applied it to a new technology and applied a simple test,” said James Jalil, a partner with Thompson Hine LLP.

That guidance, which requires a review of the “facts and circumstances” of an offering, answers a major question that was hovering over the market for initial coin offerings.

Similar to initial public offerings for companies, ICOs are used by the creators of blockchain-based structures to raise funds, usually for projects, although in some cases the money is not raised for any specific purpose. Instead of stock, investors receive tokens that can either be traded in the secondary market or used within the blockchain project.

The SEC’s Tuesday statement put to rest the issue of whether such tokens that carry characteristics mimicking those of a traditional security should be treated as securities themselves.

“The 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 distributed ledger technology,” the SEC said.

While that finding was not a surprise to most attorneys advising on initial coin offerings, it did leave a big question about the treatment of so-called appcoins, said Alfredo B.D. Silva, a partner at Morrison & Foerster LLP.

Appcoins — also known as utility coins — are tokens that the backer of a project can purchase and use in exchange for a service like cloud storage or some other tech good provided by the issuer using blockchain, a distributed ledger of transactions that is the backbone of virtual currencies. Those tokens are not necessarily expected to increase in value the way traditional securities are, but do contain some qualities like a voting stake in the operation of a project that a traditional security might.

The SEC may have to come forward with additional guidance to bring more certainty to that part of the market, Silva said.

“The question is, would those be considered securities? The SEC hasn’t really addressed that,” he said.

ICOs like The DAO have become a hot sector in finance, with investors who are looking to get involved in the tech market eager to jump in. However, there have been questions about the level of regulation within the marketplace.

The DAO’s creator, German firm Slock.it UG, had tried to pass itself off as not offering securities during its ICO process, but the SEC said Tuesday that the structure of the offering — including the fact that investors expected to make money on their purchases of tokens used on The DAO — meant that despite the offering being on the blockchain, it was subject to securities law.

The DAO issued its digital tokens, a kind of digital scrip that functioned closely to a security, to investors last year in its ICO. The DAO was hacked soon after, and around a third of the money investors pumped into it was taken.

Despite Slock.it’s contentions that it was not offering securities, the SEC said that the tokens the German group issued bore all the necessary characteristics to be subject to U.S. securities laws.

That reading of the securities law was not unexpected, and was something that attorneys had been telling clients looking to launch ICOs for some time.

Despite that, many groups, including foundations based in countries like Switzerland and Singapore, had been hoping that either their location or their novel technology would prevent them from being touched by SEC disclosure and other rules.

That will have to stop, according to Stephen Wink, a partner at Latham & Watkins LLP.

“There are a lot of folks doing this with impunity, and I think that will stop,” he said.

Virtual currency backers say that, ultimately, the test the SEC applies to tokens will find that many are not securities, nor are they subject to the basic securities laws.

“We believe that applying the same facts and circumstances test to other tokens will mean that some do not fit into the definition of securities, particularly tokens with an underlying utility rather than a mere speculative investment value,” wrote Peter Van Valkenburgh, the director of research at Coin Center, an advocacy group for blockchain and virtual currency businesses, in a blog post.

However, the guidance the SEC provided still leaves the appcoin question murky, and that is something that groups looking to launch ICOs are going to have to consider when they decide on their offering

structures, including whether they want to risk using a utility coin and not register with the SEC, or to go the more traditional route.

“Some appcoins may look like utility coins, but we need to look through the form and take into account all the facts and circumstances, including the economic realities,” said Wenchi Hu, a former top SEC official who is now a partner at Latham.

Even without the SEC registration issue, groups launching ICOs still have to contend with a host of anti-money laundering and other regulations, and they’re considered fiduciaries in some courts.

“Just because you have avoided the securities law, it doesn’t mean that you’ve avoided all of your problems,” Silva said.

With this additional guidance from the SEC, the risk is that while the commission did not bring a penalty to the makers of The DAO, any future violations could come with a big smackdown.

--Additional reporting by Jack Newsham. Editing by Mark Lebetkin and Philip Shea.