Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Legal Considerations After SEC's Warning Shot At ICOs

By **Robert Crea, Sonia Gioseffi, Vincente Martinez and Anthony Nolan**

Robert Crea

Sonia Gioseffi

Vincente Martinez

Anthony Nolan

Law360, New York (August 21, 2017, 11:36 AM EDT) --
A few weeks ago, in the midst of market excitement surrounding initial coin offerings, the U.S. Securities and Exchange Commission issued an investigative report warning that digital tokens may be securities subject to the U.S. Securities Act of 1933, as amended (the "Securities Act"), and other U.S. securities laws. See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC Release No. 81207 (July 25, 2017). As discussed below, this guidance presents significant legal ramifications for issuers and the intermediaries of such offerings.

The report, which analyzes distributed ledger tokens issued by a "virtual" organization known as The DAO, makes clear that the SEC will scrutinize the facts and circumstances of a token offering under the traditional Howey analysis. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946). In applying Howey, the SEC specifically focused on (1) whether The DAO tokens created a commonality of interests between the purchaser and the enterprise, thus creating an investment contract and (2) the vesting of voting or other ownership rights in such tokens similar to those rights associated with traditional equity investments. Given the structural similarity of other token offerings to that of the DAO, such offerings may be susceptible to similar scrutiny.

The report also serves as a warning to the secondary marketplace. Subsequent resales of digital tokens that are an unregistered, nonexempt security could themselves violate U.S. securities laws.

Considerations

When a token is a security, a variety of legal considerations come into play:

Securities Considerations

If tokens are deemed securities, their offer and sale would need to be registered under the Securities Act or qualify for an exemption from registration. If the token offering is exempt from registration, the

offering likely would need to be made to accredited investors, the tokens would be subject to limitations on resales or transfers, and general solicitation may be prohibited. Regardless of whether the offering is registered or exempt, careful consideration should be given to ensuring that prospective investors receive sufficient disclosure about the offering, including the associated risks.

Issuers in initial coin offerings (ICOs) have emphasized the purported ease of transferability. Assuming a token is a security, any purchaser of such token, including individuals, should expect to be bound by the customary transfer restrictions associated with holding a restricted security.

Offering Considerations

If a token offering is subject to securities registration in the U.S., then the tokens sold pursuant to such offering may need to be listed on an exchange registered under the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"), or be exempt therefrom.

Issuers will need to do an analysis under the Exchange Act, as token offerings are frequently conducted on crowdfunding platforms that are not registered as national exchanges. Exchange operators hosting tokens that are securities need to be cognizant of their responsibilities under the Exchange Act to register as an exchange or find an exemption therefrom. Potentially, an offering could fall within the Regulation Crowdfunding exemption, although the report expressly noted that The DAO would not have qualified for this exemption.

Investment Advisers Act Considerations

Depending on the structure of a token offering and the token structure's investment objective, a sponsor of a token offering may be deemed an investment adviser under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), and subject to registration with the SEC or with one or more states as such. Even if the sponsor is an investment adviser but is exempt from registration, the sponsor nonetheless would be subject to certain aspects of the Advisers Act, including the anti-fraud rule. Registration under the Advisers Act entails various disclosure and ongoing compliance requirements, which increases operational costs.

Investment Company Act Considerations

If a digital token is a security, the sponsor should also consider whether the issuing platform may be required to register as an investment company under the U.S. Investment Company Act of 1940, as amended (the "1940 Act") or structure the platform to meet an applicable exclusion. Investment company registration and ongoing structural requirements are highly complex and issuing platforms may find complying with them without compromising the business model difficult or impracticable. The platform would therefore likely need to be structured to meet an applicable exclusion from the definition of an investment company under the 1940 Act, which would limit the number of U.S. investors due to eligibility requirements and other limitations under the 1940 Act.

Broker-Dealer Considerations

If tokens are deemed securities, intermediaries such as token exchanges and promoters would likely need to comply with broker-dealer registration requirements, especially if a platform used to make such offering relies on Regulation Crowdfunding. Even in the absence of a token platform's needing to register as a national exchange, persons or platforms facilitating the purchase or sale of tokens in a

token offering may be subject to broker or dealer registration requirements. Failing to register when required can have severe consequences, including rescission rights among other civil and regulatory penalties.

Anti-Money Laundering

A sponsor of a token offering or a token exchange could have obligations under the U.S. Bank Secrecy Act (the "BSA"), which requires all entities meeting its definition of "financial institution" to assist the U.S. government to detect and prevent money laundering. The BSA also could affect the sponsor of a token offering or token exchange indirectly to the extent it relies on banks, exchanges or other financial institutions for clearing, settlement, custody, or other functions. The much vaunted "pseudonymity" associated with some token offerings may create tension with a financial institution's anti-money laundering obligations.

Commodity Issues

The U.S. Commodity Futures Trading Commission has taken the view that bitcoin and other digital currencies are "exempt commodities" (as defined in the U.S. Commodity Exchange Act (the "CEA")) that are subject to its jurisdiction. See In the Matter of Coinflip Inc. (CFTC, Sept. 17, 2015) (stating that bitcoin and other virtual currencies are encompassed in the definition of and properly defined as commodities under the CEA). This may have implications for whether sponsors or other participants in token offerings may be required to register as commodity pool operators or commodity trading advisers with the National Futures Association and whether investors in such tokens must be "eligible contract participants" as defined in the CEA.

Cybersecurity

A sponsor of a token offering or a token exchange may have obligations under cybersecurity regulations pursuant to the U.S. Gramm-Leach-Bliley Act and various state laws. The SEC and the Financial Industry Regulatory Authority also expect investment advisers and broker-dealers to maintain cybersecurity policies and procedures under existing privacy-related regulations.

Taxation Considerations

Although unclear under current law, tokens structured similar to those of The DAO could be treated as interests in an unincorporated association (or partnership) for tax purposes, giving rise to various reporting and tax return filing obligations. In addition, the transferability or resale of the tokens may cause any such tax entity to be treated as a "publicly traded partnership," which may be tax-inefficient.

Extraterritorial Considerations

Securities laws of non-U.S. jurisdictions may be applicable and could limit or otherwise affect token offerings. Other jurisdictions are focused on token offerings as well. One week after the SEC issued the report, the Monetary Authority of Singapore issued clarification that it also views certain tokens as securities. See MAS Clarifies Regulatory Position on the Offer of Digital Tokens in Singapore, Monetary Authority of Singapore (Aug. 1, 2017). This clarification should disabuse many token sponsors of the perception that Singapore might be more flexible than U.S. law on whether digital tokens are securities.

Concluding Thoughts

The SEC report, along with the accompanying press release and investor bulletin, is clearly designed to send a message that the SEC will scrutinize the ICO marketplace as it pertains to securities regulation. Although the SEC did not bring an enforcement action or make formal findings of violations against The DAO, we do not believe this suggests the SEC intends to apply a light touch in this emerging field. The report was issued pursuant to Section 21(a) of the Exchange Act. Such reports are used as a means of conveying important information to the markets, even where the SEC has elected initially not to bring an enforcement action.

Given the SEC's warning and the number and scale of ongoing token offerings, we anticipate that there will be enforcement actions and private litigation in connection to the securities law issues raised in the report. Participants in any aspect of the issuance, sale or distribution of virtual currencies and digital tokens should carefully consider the application of the U.S. securities laws. Failure to comply with such laws may result in civil penalties, which may include investor rescission rights and monetary penalties, as well as criminal penalties.

Robert M. Crea is an of counsel and Sonia R. Gioseffi is a partner in the San Francisco office of K&L Gates LLP. Vincente L. Martinez is a partner in the firm's Washington, D.C., office. Anthony R.G. Nolan is a partner in the firm's New York office.

K&L Gates attorneys Eden L. Rohrer and Kevin White also contributed to this article.