SEC signals that Initial Coin Offerings are subject to U.S. securities laws

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In this Update

- SEC report signals that Initial Coin Offerings and other blockchain-enabled means for capital raising are subject to U.S. securities laws.
- Canadian securities administrators can be expected to emphasize the need for ICOs to comply with applicable Canadian securities laws.
- ICO participants should comply with securities laws and address other legal considerations.

An investigation report [PDF] published on July 25, 2017 by the U.S. Securities and Exchange Commission (SEC) strongly signals that the SEC views Initial Coin Offerings (ICOs) and other distributed ledger or blockchain-enabled means for capital raising as subject to U.S. securities law. This view, which is not unexpected, has also been expressed by Canadian securities regulators. While the SEC’s investigation did not lead to enforcement action at this time, we expect that securities regulators in Canada, the U.S. and other jurisdictions will engage in more enforcement activity if participants in ICOs fail to comply with securities law requirements.

THE SEC INVESTIGATION

The report published yesterday arises out of an investigation into whether those involved in an ICO by the so-called Distributed Autonomous Organization, or DAO, violated U.S. securities law. The underlying concept of the DAO was that participants would purchase DAO tokens in exchange for Ethereum virtual currency, which would be held by the DAO. The DAO tokens would entitle the holder to vote on proposals to fund projects using the Ethereum and distribute earnings from those projects. The DAO existed only as a “smart contract” — that is, software code running on the Ethereum blockchain — that would administer the votes, allocate funding based on the results of the votes, and distribute earnings to token holders.
In May 2016, the DAO sold 1.15 billion DAO tokens for Ethereum with a value of US$150 million (today, that same amount of Ethereum would be worth US$2.4 billion). However, the DAO never went into operation and has since become defunct. In June 2016, an unknown attacker exploited a vulnerability in the DAO code to divert 1/3 of the total Ethereum raised to an address controlled by the attacker. This attack resulted in a decision to “hard fork” the Ethereum blockchain — that is, change the Ethereum protocol — to reverse the attacker’s actions, restore the stolen Ethereum and permit DAO token holders to recover their investments.

THE SEC’S CONCLUSIONS

In its report, the SEC concluded that the DAO tokens were securities for the purpose of U.S. securities law. More specifically, the report concluded that DAO tokens were an investment contract, that is, an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

The consequence of this conclusion is that DAO tokens, or any similar distributed ledger or blockchain-enabled tokens that are securities (Securities Tokens), must comply with U.S. securities laws. Among other things, this means that Securities Tokens offered and sold must be registered or must qualify for an exemption from the registration requirements. Notably, the SEC also emphasized that any person operating an exchange for Securities Tokens must register as a national securities exchange or operate pursuant to an exemption from such registration.

A statement accompanying the report noted that market participants should also consider whether an entity offering and selling a Security Token could be an investment company and whether anyone providing advice about an investment in a Security Token could be an investment adviser. The clear implication is that the aspects of U.S. securities law governing investment companies and investment advisers may also apply to those advising on ICOs and Security Tokens generally.

LEGAL IMPLICATIONS

The explosive growth of ICOs has clearly not gone unnoticed by securities regulators. Despite the failure of the DAO, which led to the SEC investigation, other ICOs have continued to occur. There was particularly explosive growth in the second quarter of 2017, when approximately 60 ICOs raised nearly US$900 million, according to Smith + Crown. In this light, the SEC report can be viewed as a warning to companies that have raised, or intend to raise, capital through an ICO.

Canadian securities regulators have not sat idly by while ICOs have proliferated. In March, the Ontario Securities Commission (OSC) issued a news release advising businesses that the use of distributed ledger technologies, such as blockchain, as part of their financial products or service offerings, may be subject to Ontario securities law requirements. We expect that the SEC investigation report may spur the OSC or other Canadian securities administrators to take further steps to emphasize the need for ICOs to comply with applicable Canadian securities laws. An assertive enforcement response from Canadian securities regulators should be anticipated if compliance requirements are ignored.

It should be noted that not every distributed ledger or blockchain-enabled token will be a security. Some tokens have a particular utility for which they are acquired and held. These tokens, often referred to as Utility Tokens, may not be regulated as securities in some circumstances. Both the SEC report and the OSC news release acknowledge that whether a particular transaction involves the offer or sale of a
security will depend on the facts and circumstances, leaving open the possibility that an ICO could be structured such that securities laws do not apply.

Even if securities laws do not apply, however, ICO issuers must also take into account that other laws would likely apply. For example, false or misleading statements made in connection with an ICO or a failure to deliver on projects funded by the proceeds of an ICO may lead to civil liability for negligent or fraudulent misrepresentation, breach of contract or breach of consumer protection laws.

CONCLUSION

We believe that blockchain and distributed ledger technology have great promise, and that the technology is an innovative and viable way to engage in capital raising activity. However, like any other capital raising activity, the need to comply with securities laws and address other legal considerations cannot be ignored.

Please contact the authors should you have any questions concerning the SEC investigation, the position of Canadian securities regulators on ICOs or blockchain technology as a means of capital raising or are interested in pursuing an ICO.
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