On July 25, 2017, the Securities and Exchange Commission (“SEC”) Division of Enforcement issued a report of investigation under Section 21(a) (the “Report”) concluding that blockchain tokens sold by The DAO (“DAO Tokens”) were securities as defined under relevant law. These blockchain tokens are analyzed under the so-called Howey test, and the SEC found that DAO Tokens allowed the holders to profit from the efforts of others, a key element of that test. We labeled a blockchain token that meets the definition of security a “security token” in our memorandum that accompanied “A Securities Law Framework for Blockchain Tokens,” published by Coinbase, Coin Center, Union Square Ventures and ConsenSys.

As a result of the Report’s finding that DAO Tokens are security tokens, the Division of Enforcement concluded that the full weight of both the Securities Act of 1933 and the Securities Exchange Act of 1934 (together, the “U.S. Federal Securities Laws”) apply to their issuance and trading. As detailed in the Report, this finding has several key implications for DAO Tokens and any other security token:

- An issuance of security tokens must comply with the registration requirements of the U.S. Federal Securities Laws, or rely on an exemption therefrom. There is extensive law and interpretation on this subject that is well-known to securities market participants and their counsel.

- Anyone engaging in the business of trading security tokens must consider whether they need to register as a broker, dealer, exchange and/or alternative trading system. Individuals trading for their own account generally need not worry about this issue, unless they are affiliates of the issuer or the underwriters.

- The anti-fraud provisions of the U.S. Federal Securities Laws apply with respect to the issuance, sale and trading of security tokens.

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Security tokens also may raise issues for certain market participants under the Investment Advisers Act of 1940 and the Investment Company Act of 1940.

The Division of Enforcement exercised discretion in not pursuing civil penalties and disciplinary action against the relevant parties, despite concluding that there were violations of several aspects of the U.S. Federal Securities Laws. It did not, however, foreclose the possibility of civil actions by purchasers of DAO Tokens.

The Report contains a thorough analysis of DAO Tokens to support the SEC’s conclusion that they are securities. As one would expect, the Howey test provides the cornerstone of the analysis, and the Report walks through the facts and circumstances of DAO Tokens that led the Division of Enforcement to its conclusion. As readers of the Report continue to look for nuggets of insight, we note three takeaways:

- The Report seems to distinguish between Ether, labeled a virtual currency, and DAO Tokens, labeled a security. Market participants may take comfort in this distinction, as it supports the view that not all blockchain tokens are securities under the U.S. Federal Securities Laws.

- In several places, the Report emphasizes the facts and circumstances nature of the Howey test, further buttressing the view that not all blockchain tokens are securities. Each token needs separate analysis to see if it meets the Howey factors.

- With the Report, the SEC has affirmatively asserted its jurisdiction over security tokens. Regardless of the seller’s identity and location, any sale of a security token by a U.S. entity or to any U.S. person(s) will be subject to the U.S. Federal Securities Laws. For these purposes, U.S. persons include individuals and legal entities resident or located in the United States.

The Report was accompanied by an investor alert and a press release quoting Chairman Jay Clayton, who makes clear that the SEC is not seeking to stifle innovation and creativity, but will be diligent in enforcing its mandate.

CONCLUSION

The SEC has taken a nuanced approach in keeping with the U.S. Federal Securities Laws and applicable case law. As a result, projects, token issuers and other community participants need to carefully analyze their projects and tokens to determine whether the U.S. Federal Securities Laws apply.

We also strongly encourage the blockchain community, projects, token issuers and other participants to think about these five areas that we discuss with all the projects that contact us:

- First and foremost, figure out your blockchain solution and your token mechanic. The business case and, perhaps more importantly, the legal analysis, will flow from these foundational elements.
• Don’t commit fraud. This means a lot of things, but we emphasize particularly that you should have good disclosures about your project, the associated token and the use of proceeds. It also means good communication with the community. As discussed above, if tokens are security tokens, the anti-fraud provisions of the U.S. Federal Securities Laws will apply.

• Think globally. Most likely the project will sell tokens to people in various countries. The Report clarifies the SEC’s view about what this means under the U.S. Federal Securities Laws, but there are plenty of other laws and regulations, both in the U.S. and other countries, that may apply. Be prepared to comply.

• Remember the taxman. Make sure you fully understand the taxation of your token launch, which could have implications beyond the location where you are based.

• Communication does not end with the public token launch. You have sold something to the public and people will want to understand what is happening.

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Please do not hesitate to contact us with any questions.

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