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## ICOs, The DAO, and the Investment Company Act of 1940

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### Initial Coin Offerings

The blockchain and its endless potentials are common motifs in 2017.<sup>1</sup> The blockchain has spawned a multitude of new businesses and applications all intending to take advantage of blockchain technology. Many of these new businesses are funded through the issuance of crypto coins or digital tokens in an initial sale or distribution (collectively, these are often described under the nomenclature initial coin offering or ICO). These coin or token<sup>2</sup> offerings typically follow some sort of crowdfunding type model. Because some believe that these token offerings are the blockchain world's equivalent to an initial public offering (IPO) of securities, the use of the term ICO has quickly gained popularity.<sup>3</sup> Tokens are typically generated by smart contracts<sup>4</sup> on a blockchain platform and sold to purchasers in exchange for fiat currency or, more typically, a virtual currency such as Bitcoin or Ether.<sup>5</sup> Proceeds from ICOs are typically used by issuers to continue to develop their business platforms, for software applications and development, and future business strategies. In the case of The DAO (as defined below), the proceeds were also intended to be used to fund future third-party projects that would be launched on The DAO's platform. It is estimated that in excess of \$1.5 billion has been raised through ICOs in the first seven months of 2017.<sup>6</sup>

As eagerly as businesses and developers have looked to ICOs as the potential future of fundraising,

the legal underpinnings of many ICOs have been murky.<sup>7</sup> A number of the tokens sold in ICOs have characteristics that resemble equity securities. Notwithstanding this, many have chosen to believe that by raising funds through the issuance of a digital coin, somehow, magically, traditional securities laws no longer apply. This view was and remains no more than a hopeful fantasy. The US Securities and Exchange Commission (SEC) recently said as much when it issued an enforcement report on a decentralized autonomous organization (The DAO).<sup>8</sup> In its report, the SEC answered the much discussed question<sup>9</sup> of whether an ICO's tokens are securities, finding in the affirmative, at least in the case of the tokens that were issued by the DAO.<sup>10</sup> The SEC reaffirmed what at least some legal experts have said from the beginning of the ICO boom: "Whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction."<sup>11</sup> In other words, depending on their characteristics and attributes, some tokens may be securities and others may not.

Even while providing some clarity in The DAO Report (or at least a reaffirmation of the status quo), the SEC also opened the door to the question of whether organizations like The DAO might be investment companies as defined under the

Investment Company Act of 1940 (the 1940 Act or the Act).<sup>12</sup>

This article examines how the 1940 Act may apply to ICOs structured similar to The DAO offering as well as to other token sales. It first reviews the underpinnings of ICOs such as the blockchain, virtual currencies, and smart contracts as well as ICOs themselves. It then discusses the SEC's DAO Report and its reasoning for finding that The DAO's tokens are securities. Finally, the article summarizes the definition of "investment company" under the 1940 Act, and provides considerations for decentralized autonomous organizations and other organizations that may aid in evaluating how the 1940 Act could apply.

## What Is an ICO?

ICO is a generalized term for using digital tokens to raise capital for a venture. ICOs rely on several key pieces of rapidly developing technology: blockchains, digital or crypto currencies, and smart contracts. Therefore, before tackling ICOs themselves, it will be helpful to examine each key component of an ICO first. Ending with ICOs, the following sections define and describe blockchain, virtual currencies, and smart contracts, and discuss how all three ICO components are interrelated.

## Blockchain

A blockchain is a distributed ledger of data compiled into a structure that is shared and maintained by a peer-to-peer network.<sup>13</sup> The network stores the ledger data across a series of computers<sup>14</sup> and each device on the network locally maintains a copy of the digital ledger.<sup>15</sup> The data itself is comprised of blocks that are linked together in a chain so that the information stored on the blockchain cannot be altered without having to change all of the preceding data blocks.<sup>16</sup>

Not all blockchains operate the same way but in a typical blockchain structure, additions to a blockchain require the cooperation of the entire network. To add new information to a blockchain, the

nodes (that is, computers)<sup>17</sup> on the network must work independently to verify the proposed addition.<sup>18</sup> If a majority of the nodes, using a cryptographic algorithm, agree on the validity of the new information, the new information will be added to the blockchain.<sup>19</sup> Once added to the blockchain, that information is considered to be immutable and unalterable.

The networks themselves can be public or private.<sup>20</sup> Public networks, such as the Bitcoin network,<sup>21</sup> have no restrictions on membership and can be accessed by anyone.<sup>22</sup> Public networks have no, or only limited, central authority and rely on a documented protocol for how the network will verify new information.<sup>23</sup> Private networks are restricted to members that have been granted access and have a network operator to manage the network.<sup>24</sup>

With these technical underpinnings, blockchains have a wealth of potential applications. One such application is ICOs, where developers issue tokens on a blockchain and investors purchase the tokens in exchange for a digital currency such as Ether.<sup>25</sup> Blockchains also have potential applications in the financial services space,<sup>26</sup> real estate,<sup>27</sup> insurance,<sup>28</sup> healthcare,<sup>29</sup> and beyond.<sup>30</sup>

## Virtual Currency

Virtual or digital currencies are one application of blockchain technology<sup>31</sup> and have moved from obscure white papers<sup>32</sup> toward the center of the world's financial system.<sup>33</sup> They are also the primary currency used to purchase ICO tokens. The SEC has consistently used the following definition of virtual currency:

A "virtual currency" is a digital representation of value that can be digitally traded and functions as a medium of exchange; a unit of account; and/or a store of value, but does not have legal tender status (*i.e.*, when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any

jurisdiction, and fulfills the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinct from fiat currency, which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It also is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency, *i.e.*, e-money electronically transfers value that has legal tender status.<sup>34</sup>

The most popular examples of virtual currency are Bitcoin<sup>35</sup> and Ether.<sup>36</sup> Exemplifying the SEC's definition of virtual currency, Bitcoin has been described as "a decentralized currency that may be used to purchase goods and services online, or traded on online exchanges for conventional currencies, including the US dollar."<sup>37</sup> While Bitcoin was first to market in 2009,<sup>38</sup> Ether, the currency of the Ethereum platform, has emerged as the primary currency for ICOs due to the popularity of the Ethereum platform among developers.<sup>39</sup> For instance, The DAO at the center of the SEC's DAO Report exchanged its tokens for Ether.<sup>40</sup>

## Smart Contracts

At some point in the ICO process, a digital token must be exchanged for virtual currency. Enter the smart contract. In general, a smart contract is a digital agreement that self-executes if specified conditions are fulfilled.<sup>41</sup> The agreement's automatic execution is "effected through a computer running code that has translated legal prose into an executable program."<sup>42</sup> Smart contracts require several key elements in order to work. First and foremost, the smart contract must be coded into a programming language.<sup>43</sup> Second, smart contracts require a system on which contracting parties can connect, such as a blockchain.<sup>44</sup> And finally, many smart contracts rely on outside information for performance.<sup>45</sup> This

outside information is best provided by at least one third-party source that is referred to as an "oracle."<sup>46</sup>

Smart contracts and blockchains are well suited to each other. A distributed ledger can provide the shared platform for the contracting parties as well as the means of performance.<sup>47</sup> The permanence of blockchains ensures that malicious or negligent parties cannot alter the terms of a smart contract once it is on a blockchain.<sup>48</sup> Ethereum is one example of a blockchain that enables smart contracts using its common programming language, Solidity,<sup>49</sup> its blockchain, and its virtual currency, Ether.<sup>50</sup> For instance, smart contracts on the Ethereum blockchain allow for the transfer of Ether between parties if certain conditions of a smart contract are met.<sup>51</sup> The DAO operated on this premise of smart contracts on the Ethereum blockchain. Anyone wanting to build an application for The DAO would be able to launch their project on the Ethereum blockchain upon approval by The DAO and receive funding from The DAO through an exchange of The DAO's tokens for Ether.<sup>52</sup> All of this would occur through the use of smart contracts.

## Initial Coin Offerings

ICOs are an emerging alternative to other types of crowdfunding and, in some cases, even IPOs, that harness new trends in technology.<sup>53</sup> ICOs are a confluence of blockchain and smart contract technology in the form of raising funds for ventures. Generally in an ICO, an organization (which may be a "virtual" organization that lacks traditional corporate form) or enterprise creates and issues virtual tokens using blockchain technology.<sup>54</sup> Depending on the construction of the ICO, purchasers of the tokens may be able to use fiat currency (for example, US dollars) or virtual currencies such as Bitcoin.<sup>55</sup> The organization, labeled as a promoter by the SEC, provides information to the token purchasers on how the proceeds of the token sales will be used, such as for developing projects.<sup>56</sup> In most cases, once issued, tokens may be able to be resold in secondary markets and can fluctuate in value.<sup>57</sup>

ICOs and their issuers take a variety of forms. Some ICOs raise funds through decentralized autonomous organizations (each a DAO, collectively, DAOs, and differentiated from the subject of the SEC's DAO Report, which is referred to herein as The DAO).<sup>58</sup> The DAO is an example of a DAO deployed on the Ethereum blockchain.<sup>59</sup> DAOs are comprised of an online community of individuals.<sup>60</sup> When a DAO issues tokens the purchasers become its members. The members can choose whether to purchase tokens and in what quantity.<sup>61</sup> In the case of The DAO, once the tokens had been purchased, The DAO intended to use the proceeds from the token sale to fund projects selected by the token holders.<sup>62</sup> Other token issuers use the proceeds from their token sales to fund ongoing development of their platforms and software, to market their platform and incentivize third-party developers to develop applications for their platform. The attributes and characteristics of tokens can vary significantly. Some tokens provide voting rights or earnings based on the success of the projects.<sup>63</sup> Some tokens give holders the right to access a platform, gain access to software, or use the tokens to purchase goods or services. Many of the tokens themselves can be traded on secondary cryptocurrency exchanges (which more often than not, are unregulated).<sup>64</sup>

Investors can purchase the tokens and either retain them or trade them subject to whatever trading restrictions may be imposed by the token issuer. ICO tokens generally are more liquid than IPO shares, allowing investors to convert ICO tokens into other digital currencies (and, ultimately, fiat currency) after the launch of the ICO and following the expiration of any lockup period to which the tokens may be subject.<sup>65</sup>

ICOs have been incredibly popular in 2017. Prior to the SEC's DAO Report in July 2017, *Financial Times* reported that almost \$1.3 billion had been raised by start-up technology companies through 56 ICOs.<sup>66</sup> Even after the SEC issued its report on July 25, 2017, another 46 new ICOs were announced by August 7, 2017, with an additional 204 approaching fund-raising.<sup>67</sup>

In July 2017, the social messaging company Kik made headlines when it decided to raise money by means of an ICO, thereby becoming one of the more high profile companies to spurn the more traditional IPO fundraising process.<sup>68</sup> Under Kik's ICO, which launched on September 12, 2017 and raised 168,732 Ether,<sup>69</sup> it created its own cryptocurrency, Kin, and sold a portion to investors while retaining a portion for itself.<sup>70</sup> In the ICO, Kik raised almost \$50 million from the private sale of Kin to institutional investors and had a goal of raising an additional \$75 million through the public offering of Kin.<sup>71</sup> The company plans to use the proceeds from the sale similar to the way proceeds from an IPO are used, such as developing an ecosystem surrounding the Kik messaging app.<sup>72</sup> However, Kik hopes that Kin will become used as a currency beyond the Kik app.<sup>73</sup> If this were to happen, Kik's goal would be to create a self-sustaining economy, and with Kik owning a large portion of the Kin currency, "the value of [its] stake in Kin could end up being more valuable than the potential exit valuation for Kik as an ad-based business in an IPO or through an acquisition."<sup>74</sup>

## The SEC's DAO Report

On July 25, 2017, the SEC's Division of Enforcement issued a report pursuant to Section 21(a) of the Securities Exchange Act of 1934 (the Exchange Act) on whether The DAO was issuing "securities" under the laws of the United States when it issued crypto-tokens as part of an ICO in 2016.<sup>75</sup> The report was the SEC's first evaluation of the legal classification of crypto-tokens. Ultimately, the SEC chose not to pursue any enforcement action as a result of the report; however, the agency did find that ICO crypto-tokens, at least those constructed as part of The DAO's ICO in 2016, were securities.<sup>76</sup>

The DAO Report centered on The DAO and its corporate creator, Slock.it UG (Slock.it), and Slock.it's co-founders, Christoph Jentzsch, Simon Jentzsch, and Stephan Tual.<sup>77</sup> The DAO was an

unincorporated organization. The SEC described The DAO as “a ‘virtual’ organization embodied in computer code and executed on a distributed ledger or blockchain.”<sup>78</sup> The DAO aimed to operate as an entity that would create and hold assets by selling tokens (DAO Tokens) to investors through ICOs.<sup>79</sup> Investors could purchase DAO Tokens with Ether on the Ethereum Blockchain.<sup>80</sup> The DAO Tokens would, in turn, be used to fund projects and DAO Token investors would receive earnings from these projects as a return for their investment.<sup>81</sup> Individuals labeled as curators would shepherd potential projects through the evaluation and selection process.<sup>82</sup> Once they owned the DAO Tokens, investors could re-sell their tokens on a platform that supported secondary trading of DAO Tokens.<sup>83</sup>

The DAO held an ICO from April 30, 2016 through May 28, 2016.<sup>84</sup> In the offering, The DAO offered and sold approximately 1.15 billion DAO Tokens, and it raised an amount of Ether that was valued at approximately \$150 million at closing.<sup>85</sup> On June 17, 2016, a cyber attacker diverted roughly one-third of the total Ether raised by The DAO offering to an Ethereum blockchain address controlled by the cyber attacker.<sup>86</sup> To reclaim the stolen DAO Tokens and make the investors whole, Slock.it created a solution called a Hard Fork, whereby the Ethereum blockchain’s protocol was changed with the effect of restoring to the DAO Token holders their lost investment.<sup>87</sup> As a result of the cyber attack, The DAO never commenced its proposed business of funding projects.

In the DAO Report, the SEC examined the DAO Tokens issued during the 2016 offering and determined that the DAO Tokens were securities under the securities laws of the United States.<sup>88</sup> The SEC compared the DAO Tokens to the definition of an investment contract,<sup>89</sup> which is listed as a form of security under Section 2(a)(1) of the Securities Act of 1933 (the Securities Act)<sup>90</sup> and Section 3(a)(10) of the Exchange Act.<sup>91</sup> The US Supreme Court has described an investment contract as 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 *Howey* Test).<sup>92</sup> It is like a conventional security in that it “is a passive means of gaining a financial interest in an asset.”<sup>93</sup> The SEC found that the DAO Tokens fulfilled the test for an investment contract because the investors invested money in The DAO in the form of Ether, with a reasonable expectation of profits in the form of dividends from projects paid for with pooled money, and because the investors relied on the efforts of The DAO’s Curators to select projects for investment.<sup>94</sup>

In concluding that the DAO Tokens were securities, the SEC explained that The DAO was an issuer of securities, and was required to register the DAO Tokens as securities with the SEC, or utilize an applicable exemption.<sup>95</sup> Likewise, any system that was operating to exchange DAO Tokens would be required to be registered as an exchange under Section 6 of the Exchange Act, unless exempted from registration.<sup>96</sup> Thus, while the DAO Report did not result in any enforcement actions, the SEC did use the report to eliminate some of the ambiguities surrounding the legal framework of ICOs, at least for those structured similar to that of The DAO.

## The DAO, ICOs, and the 1940 Act

In its DAO Report, the SEC explicitly stated that it was not evaluating whether The DAO was an investment company under Section 3(a) of the 1940 Act.<sup>97</sup> Despite not addressing the topic, the issue remains as to whether or how the 1940 Act might apply to DAOs and other types of token issuers. This section explains the definition of an “investment company” under the 1940 Act as well as several exceptions. It then provides a step-by-step look at considerations for token issuers similar to The DAO and for other types of token issuers under the 1940 Act, proposing questions such organizations might consider in their own review.



### Section 3(a)(1)—Definition of “Investment Company” Under the 1940 Act

“[A]n investment company is any arrangement by which a number of persons invest funds in a ‘company’ that is itself engaged in investing in securities.”<sup>98</sup> The archetypical example of investment company is a mutual fund; however, other types of investment companies exist.<sup>99</sup> Section 3(a)(1) of the 1940 Act defines an investment company as an issuer of securities, that:

(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis.<sup>100</sup>

It is important to note that intention is not an element of the definition of “investment company” under the 1940 Act.<sup>101</sup> An enterprise can find itself to be an investment company and, thus, subject to all of the 1940 Act’s obligations, simply by triggering any of the three definitions in Section 3(a)(1).<sup>102</sup> This uncertainty typically entraps companies whose investments rise above 40 percent of the value of their total assets;<sup>103</sup> however, the lack of intention applies to the entire definition of investment company under the 1940 Act.

In addition, an investment company is not required to be a company in the sense of a legal entity. Rather, an investment company under the 1940 Act does not have to be organized as any form of recognized business entity.<sup>104</sup> It can take any number of forms, including a fund or an organized group of persons.<sup>105</sup> For instance, the legislative history for the 1940 Act explained that “one type of investment company involves an agency relationship between the individual contributors to the fund and the management upon whom they confer substantially a power of attorney to act as agent in the investment of the moneys contributed. The group of individual investors is not a legal entity but rather constitutes in essence a combination of distinct individual interests.”<sup>106</sup> When fleshing out the meaning of fund in the context of the definition of an investment company, the Third Circuit Court of Appeals listed three key factors for finding one: (1) the fund is a completely segregated account, devoted to investing in securities; (2) the assets for these investments is derived from payments made by the purchaser of the fund’s securities; and (3) the purchaser of the fund’s securities only has an interest in the fund.<sup>107</sup>

The definitions for the three types of issuer each have a progeny of factors and prongs; however, the threshold crux of all investment companies is that they both issue<sup>108</sup> and invest in securities.<sup>109</sup> This overly simplistic view of investment companies is valuable for establishing two key threshold questions when determining if something is an investment company under the 1940 Act: (1) whether the assets of the enterprise are invested in securities; and (2) whether the enterprise issues securities to its own investors.<sup>110</sup> If either condition is not met, the enterprise may not be an investment company under the 1940 Act.

Because the definition of an investment company places a multi-dimensional emphasis on securities, the definition of a security is a critical issue for whether a pool of assets is an investment company. As explained above, the interpretation of security is similar across the securities acts.<sup>111</sup> The 1940 Act

defines a security to include many different types of instruments including an investment contract.<sup>112</sup> Also as described above, under the *Howey* Test, an investment contract is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”<sup>113</sup> In other words, an investment contract is a security when an investor provides money to an enterprise in which the investor has no control, with the reasonable expectation of earning profits from the enterprise.<sup>114</sup>

One last issue in the simplified two-step question of whether an enterprise is an investment company is whether the enterprise is investing in securities.<sup>115</sup> The 1940 Act does not define “invest” or “investing” itself,<sup>116</sup> but courts have defined the term in the context of the 1940 Act to mean “put[ting] out money at risk in the hope of gain.”<sup>117</sup> In its DAO Report, the SEC equated making a payment with Ether as the equivalent of an investment of money.<sup>118</sup>

The three types of investment companies defined in Section 3(a)(1) of the 1940 Act each have a variety of additional components, such as “business” of investing, “primarily engaged in,” etc.<sup>119</sup> While these components are critical for conducting an analysis as to whether an enterprise is an investment company under the 1940 Act, the threshold issues are whether the enterprise primarily invests in securities and issues securities. If both questions are answered in the affirmative, then companies should particularly look to the first and third types of investment companies defined in Section 3(a)(1) and evaluate their business model, investments, and distribution of assets to evaluate whether they qualify as investment companies.<sup>120</sup>

For companies meeting the statutory definition of an investment company under Section 3(a)(1), the 1940 Act does include exceptions for certain types of enterprises.<sup>121</sup> Two of the more popular exceptions are for private investment companies. Under Section 3(c)(1), a company is excepted from the definition of an investment company if its outstanding

securities are beneficially owned by 100 or fewer investors and the company is not proposing to make a public offering of its securities.<sup>122</sup> Under Section 3(c)(7), a company is excepted from the definition of an investment company if its outstanding securities are owned exclusively by qualified purchasers and the company is not proposing to make a public offering of its securities.<sup>123</sup>

## 1940 Act Considerations for DAOs and Other Token Issuers

In the DAO Report, the SEC explicitly stated that it was not addressing whether The DAO, in the construction contemplated in the DAO Report, qualified as an investment company under Section 3(a)(1) of the 1940 Act.<sup>124</sup> However, because there is no intention requirement to be considered an investment company under the 1940 Act, it is worthwhile to evaluate several 1940 Act considerations in the context of DAOs and other business structures that may issue tokens and use the proceeds to invest in other tokens (collectively, Token Issuers).<sup>125</sup> The primary considerations include the existence or lack thereof of a company, the issuing of securities, and the investing in securities.

As noted above, the 1940 Act does not require that an enterprise be a company in order to be considered an investment company under Section 3(a)(1) of the Act.<sup>126</sup> There merely needs to be at least a fund or an organized group of people who are pooling their assets to issue and invest in securities.<sup>127</sup> When considering whether Token Issuers could be investment companies under the 1940 Act, it is irrelevant that a Token Issuer is structured as an unincorporated organization (like The DAO), or as a non-profit foundation, which is a structure that has been used by a number of token issuers.<sup>128</sup> Rather, it is important to consider the organization and operation of the Token Issuer to evaluate whether it qualifies as a fund, an organized group of people, or any other type of enterprise considered to be a company under the 1940 Act.<sup>129</sup> For instance, a Token Issuer could consider several factors delineated

in *Prudential* for determining what constitutes a fund under Section 2(a)(8) of the 1940 Act: (1) whether the Token Issuer is a completely isolated pool of assets, devoted to investing in securities; and (2) whether the Token Issuer's assets for these investments are derived from payments made by the purchasers of the Token Issuer's tokens.<sup>130</sup>

The SEC likely settled the issue of whether The DAO, and other similarly constructed ICO issuers, are issuing securities in the DAO Report. After evaluating The DAO's structure and its tokens, the SEC found that DAO Tokens were securities under the Securities Act and the Exchange Act.<sup>131</sup> Because the definition of "security" is similarly interpreted across the securities acts, this finding likely means that The DAO's Tokens are also securities under the 1940 Act.<sup>132</sup> Thus, in the wake of the SEC's DAO Report, because Token Issuers issue tokens to raise funds in the course of an ICO, they may very well be issuers of securities, where their tokens have the attributes typically attributable to a security.<sup>133</sup>

The third key issue for Token Issuers and the 1940 Act is whether Token Issuers invest in securities. Both of the key definitions for an investment company under Section 3(a)(1) of the 1940 Act require that the enterprise is "investing... in securities."<sup>134</sup> As the SEC concluded, The DAO's tokens were securities. Accordingly, the purchasers of The DAO tokens were considered by the SEC to be investors in The DAO. The question left unanswered by the SEC was whether, under the structure of The DAO's proposed business plan, by funding projects that were approved by The DAO investors, The DAO would have been deemed to itself be investing in securities. The DAO's stated purpose for issuing tokens was to raise capital in order to provide funding to projects.<sup>135</sup> These projects would have been represented by smart contracts or tokens issued by a project developer and required funding approval in some manner by The DAO. In other words, the Ether received by The DAO would be used to fund a project and would be transferred to the developer of the funded contract.<sup>136</sup> Thus, the key issue for The

DAO as well as other Token Issuers following a similar strategy is whether the projects, smart contracts, or tokens that they invest in are securities.

One way to make such a determination is to apply the *Howey* Test for investment contracts. Investment contracts are considered securities under the securities acts.<sup>137</sup> In *Howey*, the US Supreme Court laid out its seminal test for whether an investment contract is a security.<sup>138</sup> The test includes four factors:<sup>139</sup> (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) derived from the managerial efforts of others.<sup>140</sup>

Each factor of the *Howey* Test will bring with it certain considerations for Token Issuers as they evaluate whether the projects, smart contracts, or tokens that they invest in are securities:

- (1) *An investment of money*: The requirement of an investment of money is designed to capture only those investors who have undertaken some degree of economic risk.<sup>141</sup> Courts have held that the investment of money under the *Howey* Test does not need to take the form of cash.<sup>142</sup> In 2014, a federal district court found that an investment of Bitcoin satisfies the requirement of an investment of money.<sup>143</sup> The SEC concurred with this conclusion in The DAO Report. Therefore, an investment by a Token Issuer that is funded with digital currency such as Ether or its own token would likely satisfy the first prong of the *Howey* Test.
- (2) *In a common enterprise*: The common enterprise element of the *Howey* Test lives in a state of "confusion and uncertainty."<sup>144</sup> Some courts apply a horizontal commonality test, which examines whether there is a pooling of investor contributions,<sup>145</sup> and, accordingly, a sharing of profits that depends on the success of the overall venture.<sup>146</sup> Other courts apply a vertical commonality test, which has two versions. Broad vertical commonality requires that the fortunes of investors depend on the efforts or expertise



of a promoter.<sup>147</sup> Narrow vertical commonality requires that the investor's profits be tied to a manager's profits; that is, they must rise and fall together.<sup>148</sup> Some legal scholars have argued that based on more recent Supreme Court decisions, the existence of multiple investors is all that is required to demonstrate the existence of a common enterprise. This may explain why the SEC chose not to elaborate as to the reasoning behind its conclusion that the common enterprise element of the *Howey* test was satisfied in the DAO Report.

The test applied can have a significant impact on whether a common enterprise is found to exist. For example, the SEC determined, using a vertical commonality test, that an investment contract existed when a condominium developer sold condominium units that included a management agreement that provided for the manager to rent vacant units to vacationers when not being used by the respective owners. The manager had agreed to pay owners a percentage of the rental income obtained. The SEC said that the arrangement should be treated as an investment contract because by combining the condominiums with the rental arrangements, the arrangements were being "offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from the rental of the units."<sup>149</sup>

The arrangements satisfied the broad vertical commonality test because the investor's fortunes were dependent on the manager's managerial and entrepreneurial effort and skill in attracting renters and obtaining high rental income for the investors. The arrangements equally satisfied the narrow vertical commonality test. Under the rental arrangement, the manager agreed to pay investors a percentage of the rental proceeds. As a result, the manager's income would rise and fall in harmony with investor income.

If the SEC had instead applied a horizontal commonality analysis, it is much less likely that the SEC would have been able to conclude that a common enterprise existed because each owner owned a separate asset—its own condominium—and the investment funds were not pooled.<sup>150</sup> Further, profits weren't pooled. The amount of profit available to a particular condominium owner was solely dependent on how often the unit owner made the unit available for rent and how much rental income could be obtained.

For a horizontal commonality jurisdiction, a Token Issuer should consider whether the developer of a project, smart contract, or token that the Token Issuer invests in pools the assets from the Token Issuer and whether any returns from the project are equitably distributed to token holders.

In applying a strict vertical commonality approach, a Token Issuer should consider whether the fortune of the investors in a developer's project is intertwined and dependent on the efforts of the developer. Could an investor benefit from the developer's efforts in the development of its project? For a broad vertical commonality jurisdiction, a Token Issuer should consider whether the fortune of the investors in a developer's project is reliant on the expertise of the developer. Generally speaking, in circumstances where at least a portion of the proceeds from a token sale are being used by the token sponsor to develop, support, maintain, or enhance the product, platform or system, the more likely it is that a common enterprise would be deemed to exist.

- (3) *With a reasonable expectation of profits:* The US Supreme Court has defined "profit" as either "capital appreciation resulting from the development of the initial investment... or a participation in earnings resulting from the use of investors' funds."<sup>151</sup> However, "when a purchaser is motivated by a desire to use or consume the item purchased—to occupy the land or to develop it themselves," as the *Howey* Court put

it, ... the securities laws do not apply.”<sup>152</sup> Token Issuers should consider whether the project developers for projects invested in have a reasonable expectation of profits. What are an investor’s intentions when it provides virtual currency to the project creator? Do the projects (or their tokens) provide dividends or some form of period payments? If so, do investors expect to receive periodic payments from funded projects (or their tokens)? Do the funded projects (or their tokens) fluctuate in value? If so, do investors expect to reap a benefit from the project or token increasing in value? Would a reasonable investor be motivated to provide funding to the projects because of these benefits? Would investors in a developer’s project be motivated by a desire to use or consume the item produced by the project?

- (4) *Derived from the managerial efforts of others:* The Ninth Circuit Court of Appeals described the central issue for the fourth prong of the *Howey* Test as “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.”<sup>153</sup> Does the project invested in by the Token Issuer have a developer or developing entity that is managing its code? Does this developer maintain its participation in the project once the project has been uploaded onto a blockchain? Does the project have developers (in some form) that perform roles such as security? How much control do investors have in the success of the projects? Will the long-term value of the projects be derived independently of their developers, such as through the available applications of the tokens (which could potentially be developed by non-affiliated developers)?

If, after conducting a full review, a Token Issuer finds that it is a company that both issues and invests in securities, then it would need to turn to the two major definitions of “investment company” to see

if it meets either definition. Under the first definition, it would mean that a Token Issuer would be an investment company if it is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing in securities.<sup>154</sup> Under the other prominent definition, a Token Issuer could be an investment company if it is engaged or proposes to engage in the business of investing in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer’s total assets on an unconsolidated basis.<sup>155</sup>

Even if a Token Issuer is not “primarily” in the business of investing in securities, with the always present possibility of becoming an inadvertent investment company, a Token Issuer that thinks it may qualify as an investment company should pay close attention to the second definition of investment company. A key question for Token Issuers that believe they may qualify as investment companies is, what percentage of the Token Issuer’s assets is being used to fund projects? Alternatively, Token Issuers may wish to evaluate their business model to determine if, rather than investing in securities as a holding corporation (that is, as passive investments), they are an operating company that provides an indirect managerial role (for example, by providing early stage funding to software and application development companies).<sup>156</sup> Token Issuers should determine what they consider to be the Token Issuer’s assets. Token Issuers should frequently monitor the value of their overall assets, particularly because of the fluctuations in the value of virtual currencies. Token Issuers should also frequently audit the value of the funded projects.

Finally, for any Token Issuers that do believe that they invest in securities and believe that they meet any definition of investment company under Section 3(a)(1), they should consider whether they may qualify for an exception under the 1940 Act. In particular, such Token Issuers should examine the two private investment company exceptions in Sections 3(c)(1) and 3(c)(7). For the exception in Section 3(c)(1), a Token Issuer may qualify if it limits its number of token

holders to 100 persons and it is not proposing to make a public offering of its tokens. For the exception in Section 3(c)(7), a Token Issuer may qualify if it limits the sale of its tokens to only qualified purchasers and it is not proposing to make a public offering of its tokens.<sup>157</sup> For a Token Issuer that believes it meets some definition of investment company, it should consider several questions. Does the Token Issuer restrict the type or number of persons who can purchase tokens? How many token holders are there? Are the token holders exclusively qualified purchasers? Is the Token Issuer considering a public offering of its tokens under the Securities Act?

## Conclusion

The SEC propelled ICOs into a new area of clarity under the securities laws when it found that The DAO's tokens were securities under the Exchange Act in its DAO Report. However, like a game of whack-a-mole, this new clarity creates newer areas of uncertainty. One such area of uncertainty is whether Token Issuers and other enterprises that are issuing ICO tokens may qualify as investment companies under the 1940 Act. Without further clarity from the SEC, the key question in this regard is a preliminary threshold question: are the smart contracts or tokens for the projects being funded by Token Issuers securities? Because of the constant looming of the inadvertent investment company, Token Issuers, ICO enterprises, and others should carefully evaluate their models and projects under the 1940 Act to ensure compliance with all securities and investment laws.

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## NOTES

<sup>1</sup> See, e.g., Peter Huminski, "The technology behind bitcoin could revolutionize these 8 industries in

the next few years," BUSINESS INSIDER (July 16, 2017, 9:00 A.M.), <http://www.businessinsider.com/8-applications-of-blockchain-2017-7> (listing eight potential applications of blockchain, including smart contracts, clearing and settlement, voting, health care, among others).

<sup>2</sup> For purposes of this article, we use the terms "coin" and "token" interchangeably with no intended difference in meaning.

<sup>3</sup> See Moe Adham, "Backing a new digital currency: Initial Coin Offerings," FORBES (May 23, 2017, 9:00 A.M.), <https://www.forbes.com/sites/forbesfinancecouncil/2017/05/23/backing-a-new-digital-currency-initial-coin-offerings/#51b5b0aa1d90>.

<sup>4</sup> Smart contracts are a way of referring to computer program code that can be used to facilitate entering into agreements or arrangements between parties (such as contracts) and enforcing (automatically) the performance of that agreement through the use of blockchain technology.

<sup>5</sup> See Shawn Langlois, "What is an ICO," MARKETWATCH.COM (Aug. 14, 2017, 5:12 P.M.), <http://www.marketwatch.com/story/what-are-icos-and-why-is-the-sec-taking-steps-to-protect-investors-from-them-2017-07-27>.

<sup>6</sup> See Martin Arnold, "Tech start-ups raise \$1.5b this year from initial coin offerings," FIN. TIMES (July 18, 2017), <https://www.ft.com/content/1a164d6c-6b12-11e7-bfeb-33fe0c5b7eaa>.

<sup>7</sup> See Jeff John Roberts, "Why Tech Investors Love ICOs - and Lawyers Don't," FORTUNE (June 26, 2017), <http://fortune.com/2017/06/26/ico-initial-coin-offering-investing/> (discussing the potential regulatory and legal issues of ICOs).

<sup>8</sup> *The DAO*, Exchange Act Release No. 81,207 (July 25, 2017) (hereinafter DAO Report), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

<sup>9</sup> See, e.g., Amy Wan, "Why Your Initial Coin Offering Is Probably Regulated By Securities Law," CROWDFUND INSIDER (Mar. 6, 2017, 10:20 A.M.), <https://www.crowdfundinsider.com/2017/03/96598-initial-coin-offering-probably-regulated-securities-law/> (displaying

the confusion surrounding whether ICO tokens are securities, explaining that they likely are, but it may also depend).

<sup>10</sup> See DAO Report, *supra* n.8, at 1.

<sup>11</sup> See *id.* at 17-18; see also Joel Telpner, “A Shot Across the Bow—And a Welcome One” (July 2017), available at <http://www.sandw.com/assets/htmldocuments/telpnerarticle.pdf>.

<sup>12</sup> DAO Report, *supra* n.8, at 1 n.1.

<sup>13</sup> “Fin. Indus. Regulatory Auth., Distributed Ledger Technology: Implications of Blockchain for the Securities Industry” at 2 (2017), [https://www.finra.org/sites/default/files/FINRA\\_Blockchain\\_Report.pdf](https://www.finra.org/sites/default/files/FINRA_Blockchain_Report.pdf) (hereinafter FINRA Report); see also “U.K. Fin. Conduct Auth., Discussion Paper on Distributed Ledger Technology” at 10 (2017), <https://www.fca.org.uk/publication/discussion/dp17-03.pdf> (defining DLT as “a set of technological solutions that enables a single, sequenced, standardised and cryptographically-secured record of activity to be safely distributed to, and acted upon, by a network of varied participants.”) (hereinafter FCA Report). See generally Jesse P. Kanach, Andrew P. Cross, & Mary C. Moynihan, “As Fintech Platforms Grow Up, Investment Management Firms Face the ‘Problems of Tomorrow,’” *THE INV. LAW.*, Mar. 2017, at 1 (discussing blockchain developments in the investment management space), available at <https://dptax5jbd3l.cloudfront.net/images/content/1/6/v2/168892/IL-0317-Kanach.pdf>.

<sup>14</sup> *United States v. Ross William Ulbricht*, No. 15-1815, slip op. at 4 n.3 (2d Cir. May 31, 2017).

<sup>15</sup> Steven Norton, “CIO Explainer: What is Blockchain?,” *WALL ST. J.* (Feb. 2, 2016, 12:49 A.M.), <https://blogs.wsj.com/cio/2016/02/02/cio-explainer-what-is-blockchain/>.

<sup>16</sup> Mary Jo White, Chair, “SEC, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative” (Mar. 31, 2016) (“Blockchain ... is a database comprised of unchangeable transaction data in packages called blocks; each block in the chain is a record of transactions and contains information about previous transactions.”); see also Satoshi Nakamoto, “Bitcoin: A Peer-to-Peer Electronic Cash

System” at 3 (2008), <https://bitcoin.org/bitcoin.pdf> (presenting the concept and construction of Bitcoin on the Bitcoin blockchain).

<sup>17</sup> FCA Report, *supra* n.13, at 10 (defining “nodes” as “participants on a distributed ledger. Different nodes may have different rights to read, write and/or delete data”).

<sup>18</sup> Norton, *supra* n.15; see also Complaint at 1, SEC v. Homero Joshua Garza, No. 3:15-cv-01760 (D. Conn. filed Dec. 1, 2015) (defining “mining” as the process that computers “try to solve complex equations that verify a group of transactions in [a] virtual currency”); FCA Report, *supra* n.13, at 10 (explaining that “miners” are the actors on the network that solve cryptographic puzzles in order to verify the information in new transactions).

<sup>19</sup> Norton, *supra* n.15 (explaining that the nodes are seeking to verify that the identifying information for the new transaction matches the blockchain’s history when seeking to validate a new transaction); see also FINRA Report, *supra* n.13, at 3 (providing the term “cryptographically hashed” for when a new transaction is verified and permanently added to a blockchain).

<sup>20</sup> FINRA Report, *supra* n.13, at 3.

<sup>21</sup> *How Does Bitcoin Work?*, BITCOIN (last visited Oct. 13, 2017), <https://bitcoin.org/en/how-it-works>.

<sup>22</sup> FINRA Report, *supra* n.13, at 3.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Jason Rowley, “How Ethereum Became the Platform of Choice for ICO’d Digital Assets,” *TECH CRUNCH* (June 8, 2017), <https://techcrunch.com/2017/06/08/how-ethereum-became-the-platform-of-choice-for-icod-digital-assets/>.

<sup>26</sup> See FINRA Report, *supra* n.13, at 4-5; see also Transfer Agent Regulations, 80 Fed. Reg. 81,948, 81,986 (proposed Dec. 31, 2015) (to be codified at 17 C.F.R. pt. 240) (seeking comment on what utility blockchain would have for transfer agents).

<sup>27</sup> See Kim S. Nash, “Blockchain: Real Estate Industry Could See Benefits in 2016,” *WALL ST. J.* (Dec. 22, 2015, 4:44 P.M.), <https://blogs.wsj.com/cio/2015/12/22/blockchain-real-estate-industry-could-see-benefits-in-2016/>.

- <sup>28</sup> See Dante Disparte, “Blockchain Could Make the Insurance Industry Much More Transparent,” *HARVARD BUS. REV.* (July 12, 2017), <https://hbr.org/2017/07/blockchain-could-make-the-insurance-industry-much-more-transparent>.
- <sup>29</sup> See Reenita Das, “Does Blockchain Have a Place in Healthcare,” *FORBES* (May 8, 2017, 12:08 P.M.), <https://www.forbes.com/sites/reenitadas/2017/05/08/does-blockchain-have-a-place-in-healthcare/#782321ab1c31>.
- <sup>30</sup> See Amelia Tomasicchio, “Italian Wines Will Soon Be Recorded on Blockchain, Authenticity Guaranteed,” *COINTELEGRAPH.COM* (Apr. 16, 2017), <https://cointelegraph.com/news/italian-wines-will-be-recorded-on-blockchain-authenticity-guaranteed>.
- <sup>31</sup> Erik T. Voorhees, Securities Act Release No. 9592, slip op. at 2 (June 3, 2014), <https://www.sec.gov/litigation/admin/2014/33-9592.pdf>.
- <sup>32</sup> See NAKAMOTO, *supra* n.16, at 1 (presenting the concept of Bitcoin).
- <sup>33</sup> See Arjun Kharpal, “Bitcoin Market Cap is Within Touching Distance of Major Stocks Like Netflix,” *CNBC.COM* (Aug. 15, 2017, 6:08 P.M.) (last updated Aug. 15, 2017, 8:48 A.M.), <https://www.cnbc.com/2017/08/15/bitcoin-price-market-cap.html> (reporting that Bitcoin’s market capitalization had reached a high of \$73.5 billion).
- <sup>34</sup> *Bitcoin Inv. Trust*, Exchange Act Release No. 78,282, slip op. at 2 n.1 (July 11, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-78282.pdf>; *BTC Trading, Corp.*, Securities Act Release No. 9685, Exchange Act Release No. 73,783, Investment Company Act Release No. 31,366 slip op. at 2 n.1 (Dec. 8, 2014), <https://www.sec.gov/litigation/admin/2014/33-9685.pdf>; Erik T. Voorhees, Securities Act Release No. 9592, slip op. at 2 n.1. Other federal agencies have similarly defined “virtual currency.” See, e.g., I.R.S. Notice 2014-21, at 1 (Mar. 25, 2014), available at <https://www.irs.gov/pub/irs-drop/n-14-21.pdf> (defining “virtual currency” while finding that virtual currencies are property for federal tax purposes); Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FinCEN Guidance, FIN-2013-G001, at 1 (Mar. 18, 2013), <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf> (defining “virtual currency” against “real” currency).
- <sup>35</sup> BITCOIN (last visited Oct. 13, 2017), <https://bitcoin.org/en/>.
- <sup>36</sup> ETHER, ETHEREUM (last visited Oct. 13, 2017), <https://www.ethereum.org/ether>.
- <sup>37</sup> SEC v. Trendon T. Shavers, No. 4:13-CV-416, slip op. at 2 (E.D. Tex. Sept. 18, 2014); see also Investor Alert: Bitcoin and Other Virtual Currency-Related Investments, SEC (May 7, 2014), [https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia\\_bitcoin.html](https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html) (defining Bitcoin as a “decentralized, peer-to-peer virtual currency that is used like money—it can be exchanged for traditional currencies such as the US dollar”); NAKAMOTO, *supra* n.16.
- <sup>38</sup> Nick Wingfield, “Bitcoin Pursues the Mainstream,” *N.Y. TIMES* (Oct. 30, 2013), <http://www.nytimes.com/2013/10/31/technology/bitcoin-pursues-the-mainstream.html>.
- <sup>39</sup> Nathaniel Popper, “Move Over, Bitcoin. Ether is the Digital Currency of the Moment,” *N.Y. TIMES* (June 19, 2017), <https://www.nytimes.com/2017/06/19/business/dealbook/ethereum-bitcoin-digital-currency.html>. The registration statement of Etherindex Ether Trust provides a detailed description of Ether, and the Ether industry and market. Etherindex Ether Trust, Registration Statement (Form S-1) (July 15, 2016).
- <sup>40</sup> DAO Report, *supra* n.8, at 2.
- <sup>41</sup> *Id.* at 2 n.3 (citing Nick Szabo, Smart Contracts (1994), <http://www.virtualschool.edu/mon/Economics/SmartContracts.html>; Jenny Cieplak & Simon Leefatt, Smart Contracts: A Smart Way to Automate Performance, 1 *GEO. L. TECH. REV.* 417, 417-18 (2017)).
- <sup>42</sup> Max Raskin, “The Law and Legality of Smart Contracts,” 1 *GEO. L. TECH. REV.* 305, 309 (2017); see also Cieplak & Leefatt, *supra* n.41, at 418 (citing Nick Szabo, The Idea of Smart Contracts, NICK SZABO’S ESSAYS, PAPERS, & CONCISE TUTORIALS (1997), <http://www.fon.hum.uva.nl/rob/Courses/InformationInSpeech/CDROM/Literature/LOTwinterschool2006/szabo.best>).



- vwb.net/smart\_contracts\_idea.html*) (summarizing the concept as “incorporating contract terms into computer hardware”).
- <sup>43</sup> Raskin, *supra* n.42, at 312.
- <sup>44</sup> Cieplak & Leefatt, *supra* n.41, at 420.
- <sup>45</sup> *Id.* at 423.
- <sup>46</sup> *Id.*
- <sup>47</sup> See generally *Id.* at 422 (presenting a section titled, “Smart Contracts on Distributed Ledger - Automating Performance”).
- <sup>48</sup> Raskin, *supra* n.42, at 319.
- <sup>49</sup> SOLIDITY (last visited Oct. 13, 2017), <https://solidity.readthedocs.io/en/develop/>.
- <sup>50</sup> Cieplak & Leefatt, *supra* n.41, at 422.
- <sup>51</sup> *Id.* (“On the Ethereum blockchain, a smart contract consists of program code, a storage file, and an account balance. The smart contract can receive money into its account balance and send money from its account balance. In order to invoke the smart contract process, the parties to the contract “contribute” a certain amount of Ether to the contract. This contributed Ether becomes subject to the smart contract and is used to fulfill the parties’ payment obligations. The program code runs automatically once the parties contribute their Ether, and pays Ether to the party that is supposed to receive it in accordance with the terms of the contract.”)
- <sup>52</sup> Christoph Jentzsch, “Decentralized Autonomous Organization to Automate Governance Final Draft - Under Review” at 3, <https://download.slock.it/public/DAO/WhitePaper.pdf>.
- <sup>53</sup> See Erin Griffith, “Why Startups are Trading IPOs for ICOs,” FORTUNE (May 5, 2017), <http://fortune.com/2017/05/05/ico-initial-coin-offering/>.
- <sup>54</sup> Investor Bulletin: Initial Coin Offerings, SEC (July 25, 2017), [https://www.sec.gov/oiea/investor-alerts-and-bulletins/lib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/lib_coinofferings) (hereinafter ICO Bulletin).
- <sup>55</sup> *Id.*
- <sup>56</sup> *Id.*
- <sup>57</sup> *Id.*
- <sup>58</sup> Three examples of decentralized autonomous organizations are dash.org, steemit.com, and ethereum.org/dao. See generally *Decentralized Autonomous Organization*, ETHEREUM (last visited Oct. 13, 2017), <https://ethereum.org/dao>.
- <sup>59</sup> DAO Report, *supra* n.8, at 1.
- <sup>60</sup> Leah Stella Stephens, “How to Get Funded by a Decentralized Autonomous Organization,” MEDIUM (Mar. 31, 2017), <https://medium.com/dash-for-newbies/how-to-get-funded-by-a-decentralized-autonomous-organization-4d2430572bcb>.
- <sup>61</sup> See, e.g., JENTZSCH, *supra* n.52, at 1-31 (describing the construction of The DAO, the decentralized autonomous organization at the center of the SEC’s DAO Report).
- <sup>62</sup> See, e.g., *id.* at 2.
- <sup>63</sup> See, e.g., *id.* at 2.
- <sup>64</sup> See, e.g., *Id.*
- <sup>65</sup> Richard Kastelein, “What Initial Coin Offerings Are, and Why VC Firms Care,” HARVARD BUS. REV. (Mar. 24, 2017); Oscar Williams-Grut, “People are raising hundreds of millions selling digital coins online—it’s either the future of funding or a ‘bubble,’” BUSINESS INSIDER (July 8, 2017, 3:35 A.M.), <http://www.businessinsider.com/initial-coin-offerings-explained-icos-token-crowdsale-2017-7>.
- <sup>66</sup> Arnold, *supra* n.6.
- <sup>67</sup> Nathaniel Popper, “Despite S.E.C. Warning, Wave of Initial Coin Offerings Grows,” N.Y. TIMES (Aug. 7, 2017), [https://www.nytimes.com/2017/08/07/business/dealbook/initial-coin-offerings-sec-virtual-currency.html?ref=dealbook&\\_r=0](https://www.nytimes.com/2017/08/07/business/dealbook/initial-coin-offerings-sec-virtual-currency.html?ref=dealbook&_r=0).
- <sup>68</sup> Eric Jackson, “Why a Messaging Start-Up is Making its Own Digital Currency Instead of Going Public,” CNBC.COM (July 11, 2017, 2:08 P.M.), <https://www.cnbc.com/2017/07/11/kik-looks-to-cryptocurrency-instead-of-an-ipo-commentary.html>.
- <sup>69</sup> Rachel Rose O’Leary, “\$75 Million Goal: Kik ICO Kicks Off to Small Scams and Big Demand,” COINDESK.COM (Sept. 12, 2017), <https://www.coindesk.com/70-million-far-kik-ico-kicks-off-small-scams-big-demand/>; KIN, <https://kin.kik.com/> (last visited Oct. 13, 2017).
- <sup>70</sup> Jackson, *supra* n.68.
- <sup>71</sup> O’Leary, *supra* n.69; In the wake of the DAO Report, Kik filed a notice with the SEC under

Rule 506(c) of Regulation D to raise \$50 million. *Kik Interactive Inc., Notice of Exempt Offering of Securities (Form D)* (Sept. 12, 2017), available at [https://www.sec.gov/Archives/edgar/data/1574601/000157460117000001/xslFormDX01/primary\\_doc.xml](https://www.sec.gov/Archives/edgar/data/1574601/000157460117000001/xslFormDX01/primary_doc.xml).

<sup>72</sup> Kik, “Kin: a decentralized ecosystem of digital services for daily life” (2017) available at [https://kin.kik.com/papers/Kin\\_Whitepaper\\_V1\\_English.pdf?ver=3](https://kin.kik.com/papers/Kin_Whitepaper_V1_English.pdf?ver=3).

<sup>73</sup> Jackson, *supra* n.68.

<sup>74</sup> *Id.*

<sup>75</sup> DAO Report, *supra* n.8, at 1. Section 21(a) authorizes the SEC to issue reports of investigation even when the SEC determines not to issue an enforcement action. The SEC typically issues reports in situations where the application of the federal securities laws is unclear. *See* 15 USC § 78u(a) (2016).

<sup>76</sup> DAO Report, *supra* n.8, at 1.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 2-3. *See generally id.* at 3 n.5 (quoting the Financial Action Task Force definition of “virtual currency” as a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (*i.e.*, when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. “real currency,” “real money,” or “national currency”), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.” FIN. ACTION TASK FORCE, VIRTUAL CURRENCIES, KEY DEFINITIONS AND POTENTIAL AML/CFT RISKS 4 (June 2014), <http://www.fatf-gafi.org/medialfatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>); DAO Report, *supra* n.8, at 3 n.6 (describing “Ethereum” as developed by the Ethereum Foundation, a Swiss nonprofit organization, it is a “decentralized platform that runs smart contracts on a blockchain known as the Ethereum Blockchain.”)

<sup>81</sup> DAO Report, *supra* n.8, at 1.

<sup>82</sup> *Id.* at 13.

<sup>83</sup> *Id.* at 1.

<sup>84</sup> *Id.* at 2-3.

<sup>85</sup> *Id.* at 3.

<sup>86</sup> *Id.* at 9.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* at 11.

<sup>89</sup> *Id.*

<sup>90</sup> 15 USC § 77b(a)(1).

<sup>91</sup> 15 USC § 78c(a)(10). The 1940 Act also lists “investment contract” under its definition of “security.” *Id.* at § 80a-2(a)(36).

<sup>92</sup> SEC v. Edwards, 540 US 389, 393 (2004); SEC v. W.J. Howey Co., 328 US 293, 301 (1946).

<sup>93</sup> Christopher L. Borsani, “A Common Problem: Examining the Need for Common Ground in the Common Enterprise Element of the *Howey* Test,” 10 DuQ. Bus. L. J. 1, 3 (2008) (citing SEC v. Lauer, 52 F.3d 667, 670 (7th Cir. 1995)).

<sup>94</sup> DAO Report, *supra* n.8, at 11-15.

<sup>95</sup> *Id.* at 15; 15 USC § 77b(a)(4) (defining “issuer” to include “every person who issues or proposes to issue any security”). Since issuing the DAO Report, the SEC has started to bring enforcement actions against alleged issuers who did not register their ICO tokens as securities. *See, e.g.*, Complaint at 1, SEC v. ReCoin Group Foundation, LLC, No. 1:17-cv-05725 (E.D.N.Y. filed Sept. 29, 2017), available at <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf>.

<sup>96</sup> DAO Report, *supra* n.8, at 16 (citing 15 USC § 78e).

<sup>97</sup> DAO Report, *supra* n.8, at 1 n.1.

<sup>98</sup> Tamar Frankel, Arthur Laby, & Ann Taylor Schwing, “The Regulation of Money Managers: Mutual Funds and Advisers” § 5.01 (3d. ed. 2017) (quoting SEC,

- Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337, at 33 (1966)).
- <sup>99</sup> *Investment Companies*, SEC. & EXCH. COMM'N (last visited Oct. 13, 2017), <https://www.sec.gov/fast-answers/answersmfinvcohtm.html>.
- <sup>100</sup> 15 USC § 80a-3(a)(1)(A)-(C).
- <sup>101</sup> See Edmund H. Kerr, "The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act," 12 STAN. L. REV. 29, 29 (1959).
- <sup>102</sup> Brian Vito, "Revisiting the Inadvertent Investment Company," 16 FORDHAM J. CORP. & FIN. L. 125, 127 (2011); see also SEC v. Nat'l Presto Indus., Inc., 486 F.3d 305, 312 (7th Cir. 2007) (discussing the SEC's tests for "inadvertent investment companies").
- <sup>103</sup> 15 USC § 80a-3(a)(1)(C); see also Vito, *supra* n.102, at 127-28 (explaining how the 40 percent threshold is a risk for inadvertent investment companies).
- <sup>104</sup> Prudential Ins. Co. v. SEC, 326 F.2d 383, 387 (3d Cir. 1964), *cert. denied*, 377 US 953 (1964).
- <sup>105</sup> 15 USC § 80a-2(a)(8) (defining "company" under the 1940 Act as "a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not").
- <sup>106</sup> Status of Investment Advisory Programs Under the Investment Company Act of 1940, 60 Fed. Reg. 39,574, 39,575 n.14 (proposed Aug. 2, 1995) (to be codified 17 C.F.R. Pts. 270 & 274) (citing H.R. Doc. No. 75-707, at 24 (1939)).
- <sup>107</sup> *Prudential Ins. Co.*, 326 F.2d at 387; see also, Gilmore v. MONY Life Insurance Company of America, 165 F. Supp. 2d 1276, 1287 (M.D. Ala. 2001) (citing *Prudential Ins. Co.*, 326 F.2d at 387).
- <sup>108</sup> 15 USC § 80a-3(a)(1).
- <sup>109</sup> *Id.* § 80a-3(a)(1)(A), (C); see also, SEC "Investment Company Registration and Regulation Package," (last visited Oct. 13, 2017), [https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvccoreg121504htm.html#P75\\_10439](https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvccoreg121504htm.html#P75_10439) ("Investment pools that do not meet the definition of "investment company" in Section 3(a) of the Investment Company Act because, for example, they do not invest in securities . . .").
- <sup>110</sup> FRANKEL, *supra* n.98, at § 5.01.
- <sup>111</sup> See *Moultrie Nat'l Bank*, SEC No-Action Letter, [1974-1975 CCH Dec.] Fed. Sec. L. Rep. (CCH) ¶80,081 (Nov. 27, 1974) (hereinafter *Moultrie Nat'l Bank*) (equating the interpretation of "security" in the Securities Act of 1933 with that of the 1940 Act); see also Securities Act of 1933, 15 USC § 77b(a)(1) (defining "security"); 1940 Act, *id.* § 80a-2(a)(36) (defining "security").
- <sup>112</sup> 15 USC § 80a-2(a)(36).
- <sup>113</sup> 328 US at 298-99; accord *Edwards*, 540 US at 393 (quoting *W.J. Howey Co.*, 328 US at 298-99); see also DAO Report, *supra* n.8, at 11. In a later decision, the US Supreme Court did away with the condition of "solely" from its definition of "investment contract." *United Hous. Found., Inc. v. Forman*, 421 US 837, 852 n.16 (1975).
- <sup>114</sup> See SEC v. Int'l Loan Network, Inc., 968 F.2d 1304, 1308 (D.C. Cir. 1992) (quoting *Forman*, 421 US at 852).
- <sup>115</sup> 15 USC § 80a-3(a)(1)(A), (C).
- <sup>116</sup> *Cf. Id.* § 80a-2(a) (lacking a definition for "invest" or "investing").
- <sup>117</sup> SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 30 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970).
- <sup>118</sup> DAO Report, *supra* n.8, at 11.
- <sup>119</sup> See 15 USC § 80a-3(a)(1).
- <sup>120</sup> *Id.* § 80a-3(a)(1)(A), (C).
- <sup>121</sup> *Id.* §§ 80a-3(b)-(c).
- <sup>122</sup> *Id.* § 80a-3(c)(1); see also Investment Company Registration and Regulation Package, *supra* n.109 (explaining that the term "public offering" has the same meaning as in Section 4(2) of the Securities Act); 15 USC § 77d(a)(2).
- <sup>123</sup> 15 USC § 80a-3(c)(7); see also, *id.* § 80a-2(a)(51) (defining "qualified purchaser").
- <sup>124</sup> DAO Report, *supra* n.8, at 1 n.1.
- <sup>125</sup> See Kerr, *supra* n.101, at 29 (explaining the possibility of becoming an "inadvertent investment company"); see, e.g., Decentralized Autonomous Organizations, *supra* n.58 (providing a platform for anyone to create a decentralized autonomous organization).

- <sup>126</sup> 15 USC § 80a-2(a)(8) (defining “company”); *Prudential Ins. Co.*, 326 F.2d at 387.
- <sup>127</sup> *Prudential Ins. Co.*, 326 F.2d at 387; see also FRANKEL, *supra* n.98, at § 5.01 (summarizing the threshold question for an “investment company” as whether the enterprise issues and invests in securities).
- <sup>128</sup> DAO Report, *supra* n.8, at 1; see, e.g., KIK, *supra* n.72, at 6.
- <sup>129</sup> 15 USC § 80a-2(a)(8).
- <sup>130</sup> See *Prudential Ins. Co.*, 326 F.2d at 387.
- <sup>131</sup> DAO Report, *supra* n.8, 1.
- <sup>132</sup> See Moultrie Nat’l Bank, *supra* n.111 (equating the interpretation of “security” in the Securities Act of 1933 with that of the 1940 Act); see also Securities Act of 1933, 15 USC § 77b(a)(1) (defining “security”); Exchange Act, 15 USC § 78c(a)(10) (defining “security”); 1940 Act, 15 USC § 80a-2(a)(36) (defining “security”).
- <sup>133</sup> See 15 USC § 80a-3(a)(1) (requiring “investment companies” to be “issuers” of securities).
- <sup>134</sup> *Id.* § 80a-3(a)(1)(A), (C).
- <sup>135</sup> See, e.g., DAO Report, *supra* n.8, at 1 (providing a summary of the DAO’s ICO structure).
- <sup>136</sup> See DAO Report, *supra* n.8, at 7, 12.
- <sup>137</sup> See Securities Act, 15 USC § 77b(a)(1); Exchange Act, *Id.* § 78c(a)(10); 1940 Act, *id.* § 80a-2(a)(36).
- <sup>138</sup> *W.J. Howey Co.*, 328 US at 298-99.
- <sup>139</sup> *Borsani*, *supra* n.93, at 15 (writing that the SEC has a “newly acquired distaste” for the “common enterprise” element of the *Howey* Test, pointing out that the SEC did not address the element in *Edwards*); see, e.g., DAO Report, *supra* n.8, at 11 (omitting “in a common enterprise” when evaluating DAO tokens under the *Howey* Test).
- <sup>140</sup> *W.J. Howey Co.*, 328 US at 298-99.
- <sup>141</sup> *Reves v. Ernst & Young*, 494 US 56, 67 (1990).
- <sup>142</sup> See, e.g., *Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991) (“[I]t is well established that cash is not the only form of contribution or investment that will create an investment contract.”).
- <sup>143</sup> *Shavers*, slip op. at 2.
- <sup>144</sup> *Borsani*, *supra* n.93, at 3; see also *Mordaunt v. Incomco*, 469 US 1115 (1985), *cert. denied* (White, J. dissenting) (“In light of the clear and significant split in the circuits, I would grant certiorari”).
- <sup>145</sup> See, e.g., *SEC v. Infinity Group Co.*, 212 F.3d 180, 187-88 (3d Cir. 2000); *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1019 (7th Cir. 1994); *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994); *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278, 281-82 (6th Cir. 1989); *Hart v. Pulte Homes of Michigan Corp.*, 735 F.2d 1001, 1004 (6th Cir. 1984); *Salcer v. Merrill Lynch, Pierce, Fenner and Smith Inc.*, 682 F.2d 459, 460 (3d Cir. 1982); *Union Planters Nat’l Bank v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174, 1183 (6th Cir. 1981); *Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980), *aff’d on other grounds*, 456 US 353 (1982).
- <sup>146</sup> See, e.g., *Revak*, 18 F.3d at 87; *Deckebach*, 867 F.2d at 282; *Hart*, 735 F.2d at 1004; *SEC v. Prof. Assocs.*, 731 F.2d 349, 354 (6th Cir. 1984); *Union Planters Nat’l Bank*, 651 F.2d at 1183; *Curran*, 622 F.2d at 223-24.
- <sup>147</sup> See, e.g., *SEC v. ETS Payphones, Inc.*, 408 F.3d 727, 732 (11th Cir. 2005); *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1283-84 (11th Cir. 2002) (*per curiam*), *rev’d and remanded on other grounds sub nom.*, *SEC v. Edwards*, 540 US 389 (2004); *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1999 (11th Cir. 1999); *Eberhardt v. Waters*, 901 F.2d 1578, 1580-81 (11th Cir. 1990); *Long v. Shultz Cattle Co.*, 881 F.2d 129, 140-41 (5th Cir. 1989); *United States v. Morse*, 785 F.2d 771, 776 (9th Cir. 1986); *Villeneuve v. Advanced Bus. Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983) (en banc); *SEC v. Cont’l Commodities Corp.*, 497 F.2d 516, 521-22 (5th Cir. 1974).
- <sup>148</sup> See, e.g., *Revak*, 18 F.3d at 88; *SEC v. Eurobond Exch., Ltd.*, 13 F.3d 1334, 1340-41 (9th Cir. 1994); *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978); *SEC v. Pinckney*, 923 F. Supp. 76, 82 (E.D.N.C. 1996); *Schofield v. First Commodity Corp.*, 638 F. Supp. 4, 7 (D. Mass. 1985), *aff’d on other grounds*, 793 F.2d 28 (1st Cir. 1986); *Shotto v. Laub*, 635 F. Supp. 835, 839 (D. Md. 1986); *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1238 (S.D.N.Y. 1981).

<sup>149</sup> *Interpretative Releases Relating to the Securities Act of 1933 and General Rules and Regulations Thereunder*, SEC Release No. 33-5347, 17 C.F.R. § 231.5347, 38 Fed. Reg. 1735 (Jan. 18, 1973) (“The offer of real estate as such, without any collateral with the seller or others, does not involve the offer of a security. When the real estate is offered in conjunction with certain services, a security, in the form of an investment contract, may be present.”).

<sup>150</sup> *See, e.g., Wals v. Fox Hills Dev. Corp.*, 24 F.3d at 1018-19 (7th Cir. 1994) (holding that because the time share promoter did not pool profits, no common enterprise existed).

<sup>151</sup> *Edwards*, 540 US at 395.

<sup>152</sup> *United Hous. Found., Inc.*, 421 US at 852-53.

<sup>153</sup> *Glenn W. Turner Enters., Inc.*, 474 F.2d at 482.

<sup>154</sup> 15 USC § 80a-3(a)(1)(A).

<sup>155</sup> *Id.* § 80a-3(a)(1)(C). For an enterprise to potentially meet the definition of “investment company”

under Section 3(a)(1)(C), the enterprise must invest at least 40 percent of its total assets in “investment securities.” Section 3(a)(2) excludes securities issued by majority-owned subsidiaries (that are themselves not investment companies and that are not investment companies relying on one of the exemptions in Section 3(c)) from the definition of “investment securities.” *Id.* § 80a-3(a)(2). Therefore, if a DAO invests at least 60 percent of its total assets in enterprises that it itself is the majority owner of, then it may potentially fall outside the definition of “investment company” under Section 3(a)(1)(C).

<sup>156</sup> If a Token Issuer is an operating company providing indirect managerial services, its holdings may not qualify as “investment securities” and therefore may leave the Token Issuer below the 40 percent threshold for being an “investment company” under Section 3(a)(1)(C).

<sup>157</sup> *Id.* § 80a-3(c)(7); *see also id.* § 80a-2(a)(51) (defining qualified purchaser).

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