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'I believe every ICO I've seen is a security': Securities regulation in the age of cryptocurrency-based investment contracts

By Jules W. Carter, Esq., ***Moore & Van Allen***

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Unregulated Initial Coin Offerings ("ICOs") are rapidly becoming an industry standard for fintech startups seeking to fund new ventures.

An ICO is a funding mechanism whereby a tech company secures capital for the development of a new cryptocurrency or blockchain-based application or service by selling tokens on the blockchain platform it is developing. ICOs are appealing because they allow virtual asset service providers ("VASPs") to secure buy-in to their platform — thereby increasing its legitimacy and viability — without necessarily having to surrender equity or risk losing control over the venture.

> The foundational principles of securities laws apply to the use of blockchain-enabled capital raising schemes.

Initially, ICOs were an attractive option for tech entrepreneurs who had promising ideas for new blockchain-based technologies but lacked connections to more traditional venture capital funding channels. Today, there are a broad range of blockchain-enabled capital raising schemes, and institutional investors are getting in on the action for fear of being left behind as a new wave of technological innovation renders legacy banking and finance structures obsolete.

However, tech companies and investors often fail to appreciate that the complex regulatory structures that make it cumbersome to invest in other types of securities are necessary to ensure that investors are protected from innocently incomplete disclosures — or worse, deceit, misrepresentations, and fraud. Indeed, the dearth of regulation is a source of enormous risk in the virtual asset services industry and has drawn the concern regulators.

In 2018, former SEC Chairman, Jay Clayton, said, "I believe every ICO I've seen is a security," bluntly stating, "ICOs that are securities offerings, we should regulate them like we regulate securities offerings. End of story."[1]

However, definitive regulatory guidance did not follow. With the transition to a new presidential administration, all signs indicate a swell of new regulatory activity on the horizon that will impact the cryptocurrency space.[2] One key question that VASPs ought to be asking is: When are blockchain-enabled capital raising considered securities offerings?

Transactions that qualify as "investment contracts" under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), to the extent they are not exempt, must be registered with the SEC prior to being offered for sale to investors in the U.S. As a part of the registration process, companies must accurately disclose certain information which may be material to investors, including:

- a description of the company's properties and business;
- a description of the security to be offered for sale;
- information about the management of the company; and
- financial statements certified by independent accountants.

The most basic framework for determining whether a contract qualifies as a security under U.S. law is found in the Supreme Court's 1946 *SEC v. W.J. Howey Co*. decision.[3] The case involved two commonly-managed Florida companies (the "Companies"); with one owning large tracts of citrus acreage, and the other essentially running the citrus business.

The Companies began offering small parcels of the citrus acreage coupled with a service contract for farming the parcel and remitting the net proceeds to the investor. The purchasers received a deed to the parcel, but the service contract gave the Companies a lease on the parcel and total authority over the crops such that purchasers did not even have a right of entry onto the property without the consent of the Companies. The purchasers were typically non-agricultural professionals and the key selling point was the expectation of a substantial return.

When the Companies were sued by the SEC for failure to register the contracts as securities under the Securities Act, the Supreme

Court sided with the SEC, holding that the transactions qualified as "investment contracts" for purposes of the Act because the scheme involved:

(1) an investment of money;

(2) in a common enterprise;

(3) with the expectation of profits; and

(4) with such profits to be generated solely from the efforts of the promoter or a third party.

The Supreme Court intentionally delineated a flexible principle, "one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[4]

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In 2017, with that principle in mind, the SEC produced a report (the "DAO Report") analyzing a Decentralized Autonomous Organization[5] run by a German corporation and its co-founders in which it affirmed that *Howey* applies to VASPs.

The findings published by the SEC in the DAO Report include the following: [6]

- An "investment of money" under *Howey* may refer to a contribution of fiat currency in exchange for cryptocurrency tokens, or it may refer to an investment made using a virtual currency.[7]

- DAOs and other distributed ledger or blockchain-enabled capital raising schemes qualify as a "common enterprise" under *Howey*.

- Although the DAO was digital, and arguably "decentralized," the profitability of the DAO was dependent on the managerial efforts of its co-founders and contract "curators," who were essentially "promoters" responsible for managing the DAO and putting forth project proposals for consideration by the DAO's investors.

In the DAO Report, the SEC maintains, in less colorful language than Mr. Clayton, that the foundational principles of securities laws apply to the use of blockchain-enabled capital raising schemes, of which ICOs are but one form.

If and when U.S. regulators begin more aggressively to apply the *Howey* test, VASPs will find themselves facing the onerous task of achieving compliance with federal securities laws on their cryptocurrency platforms. Some may even find themselves in the position of "investment companies" under the federal Investment Company Act of 1940, with all of the accompanying obligations that status entails.[8]

A number of states' securities regulators have already begun to take more aggressive action than the SEC with at least one state bringing civil and criminal proceedings for the unlicensed sale of an unregistered security arising from a cryptocurrency venture.[9]

Notes

1 SEC Chairman, Jay Clayton, Meeting of Senate Committee on Banking (February 6, 2018).

2 At her confirmation hearing, Dr. Janet Yellen, displayed concerns about the link between cryptocurrencies and illicit finance, noting "I think it important we consider the benefits of cryptocurrencies and other digital assets, and the potential they have to improve the efficiency of the financial system. At the same time, we know they can be used to finance terrorism, facilitate money laundering, and support malign activities that threaten U.S. national security interests and the integrity of the U.S. and international financial systems." *Finance Committee Questions for the Record: Hearing to Consider the Anticipated Nomination of the Honorable Janet L. Yellen to be Secretary of the Treasury Before U.S. Senate Committee on Finance* (2021) (responses by Dr. Yellen).

3 *Securities and Exchange Commission v. W. J. Howey Co. et al.*, 328 U.S. 293 (1946).

4 *Id.* at 299.

5 The DAO was an unincorporated, for-profit, virtual crowdfunding organization that offered its members profits from the funding operation in the form of cryptocurrency tokens that could be purchased through its blockchain-enabled platform.

6 See SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Release No. 81207 at 1 (July 25, 2017). The DAO was an unincorporated, for-profit crowdfunding organization created by a German corporation called Slock.it. Participants in the DAO could use Ethereum (a virtual currency) to purchase DAO Tokens, and DAO Token holders were then permitted to vote on various venture project proposals that could be funded by the DAO using "smart contracts" (a digital transaction protocol that executes the terms of a contract). The DAO Token holders would then earn 'rewards' from the projects that the DAO funded.

7 *Id.* at 11 (quoting *SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of *Howey*)).

8 *Id.* at 2 ("This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.").

9 *See State of North Carolina v. Calabro*, Case No. 18-Cr-090133 (Superior Court Guilford County).

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ABOUT THE AUTHOR

Jules Carter is a Charlotte, North Carolina-based attorney in **Moore & Van Allen**'s Litigation Department who helps clients navigate complex commercial litigation and financial regulatory compliance issues. She has assisted in representing clients in a range of commercial disputes, including matters involving fraud, unfair and deceptive trade practices, and litigation arising out of commercial contracts and transactions. Her financial regulatory experience includes helping financial institution clients respond to regulatory enforcement actions and address the supervisory concerns of state and federal banking authorities. She also assists clients in their recovery and resolution planning efforts, helping prepare board governance playbooks. She can be reached at julescarter@mvalaw.com.

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