Cassels

Game of Coins: SEC Announces That Certain Crypto Assets Will Be Subject to U.S. Securities Laws

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On July 25, 2017, the Securities and Exchange Commission (the SEC) released its Report of Investigation (the SEC Report) on the 2016 offering of tokens by a group known as "the DAO." The SEC determined that the tokens offered by the DAO (DAO Tokens) qualify as investment contracts, and therefore are securities under the Securities Act of 1933 and the Securities Exchange Act of 1934.

In an article dated July 14, 2017, we discussed some of the basic tenets of blockchain and distributed ledger technology (DLT), as well as the potential legal implications of offering and investing in blockchain tokens in Canada. The concept of a 'security' under Section 1(1) of the *Securities Act* (Ontario) was explored, specifically in relation to whether a token would be considered an 'investment contract', and therefore a security under applicable Canadian securities laws. To date, the Ontario Securities Commission (the OSC) has not explicitly categorized a blockchain token as an investment contract or other type of security, and has gone only so far as to say that such tokens *may* qualify as securities, even if they do not represent shares of a company or similar ownership interests. While further commentary from the OSC is expected, this may come sooner than previously thought given the recent findings in the United States by the SEC.

The following discussion provides a brief background on the DAO and a summary of the findings of the SEC, a synopsis of the relevant Canadian law, as well as the implications and important takeaways for Canadian crypto-currency market participants.

The DAO

As noted in the SEC Report, the DAO was, prior to its demise at the hands of hackers in June 2016, an example of a decentralized autonomous organization; that is, a 'virtual' organization not existing in the physical form, but rather embodied in computer code and executed on a distributed ledger or blockchain.[1] The premise behind the DAO was to remove decision making authority from a board of directors in both commercial and non-profit enterprises, and place it directly in the hands of owners of the DAO in an attempt to reduce the misdirection and misuse (or waste) of resources that generally plague large organizations where control is concentrated in the hands of the few. In its initial coin offering (ICO)[2], The DAO offered and sold approximately 1.15 billion DAO Tokens. Purchasers could exchange their Ethereum tokens (Ether), a type of virtual currency, for DAO Tokens, which would permit the purchaser to vote on proposed actions of the DAO, including which future projects the DAO would invest in, and how to distribute the DAO's anticipated earnings from these projects. Holders of DAO Tokens could also re-sell them on a number of

online exchanges set up to facilitate the transfer of Ether, DAO Tokens, and various other crypto-currencies. As the value of DAO Tokens increased, this allowed holders to monetize their investment by exchanging the DAO Tokens for more Ether or other fiat currencies.

Certain characteristics of the DAO Tokens, including the ability to distribute earnings to holders, and the ability of holders to sell the DAO Tokens on open markets, caught the attention of the SEC, and ultimately led to the publication of the SEC Report.

The SEC Report

The Howey Test

The SEC Report noted that the offering of DAO Tokens and the rights bestowed on holders qualified them as investment contracts.[3] In the United States, there are three factors that must be present in order to make a determination that an offered token is an investment contract: (i) an investment of money in a common enterprise; (ii) with a reasonable expectation of profits; (iii) derived from the managerial efforts of others. This test was established in *SEC v W.J. Howey Co*. (Howey).[4]

Canadian Laws

While the Howey finding formed the basis for the Canadian equivalent of this test, set out in *Pacific Coast Coin Exchange of Canada v. OSC*[5] (Pacific Coin), the Pacific Coin test differs slightly. In Pacific Coin, the Supreme Court of Canada found that an investment contract (and therefore a "security") exists when the following factors are present:

I. a person invests money;

II. the investment of money is made with an intention to profit;

III. in a common enterprise; and

IV. the investor is lead to expect profits solely from the efforts of the promoter or a third party.

Additionally, in *Ontario Securities Commission v Tiffin* (Tiffin)[6], the Ontario Court of Justice adopted a "family resemblance test" as a common sense approach to determining whether an instrument ought to be classified as a security. Essentially, this approach allows a court to examine the context of the offering to determine whether the instrument qualifies as a security. Canadians will have to wait and see whether Canadian regulators will adopt Pacific Coin, Tiffin, a combination of the two, or an entirely new approach with regards to the classification of crypto-currencies as securities.

More information on Pacific Coin and Tiffin can be found here.

SEC's Conclusion

While the SEC determined that the DAO's offering of DAO Tokens qualified as an offering of securities, it chose not to pursue legal action or enforcement in this instance. Rather, the SEC issued the following warning:

> "the federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology."[7]

It is important to note that the SEC did not say what is or is not a security; the SEC only concluded that DAO Tokens are securities, and other virtual tokens may be as well. Issuers whose tokens pass the Howey test may be more likely to attract regulatory scrutiny, and these issuers should avoid offering their tokens, or be prepared to satisfy the SEC's regulatory requirements. Determining whether a token will pass the Howey test is, admittedly, a complex analysis, and one which is beyond the scope of this article.

Takeaways for Businesses and Investors

The SEC has made it clear that while it recognizes the legitimacy of the crypto-currency market, the actions of organizations and investors in the industry are well within its purview. As Stephanie Avakian, Co-Director of the SEC's Enforcement Division noted: "The innovative technology behind these virtual transactions does not exempt securities offerings and trading platforms from the regulatory framework designed to protect investors and the integrity of the markets."[8] It is important to note, however, that while the SEC has concluded that DAO Tokens are a security and therefore subject to regulations, this does not mean that all tokens currently meet this standard, and it certainly does not mean that Canadian regulators will necessarily follow the same analysis and come to the same conclusion.

Some organizations have already begun taking pre-emptive steps to limit the size and scope of their offerings. One example of an organization that is taking a proactive approach is Filecoin.[9] Filecoin is a "decentralized storage network",[10] with the goal of connecting those with significant amounts of online storage space (upwards of 10 terabytes) with users who can use the Filecoin token as currency to rent this digital storage. The creators of Filecoin will launch its ICO through a third party website, with the

qualification that the offering will only be open to “accredited investors”, being a person or entity that can purchase a security in a prospectus exempt offering by satisfying one of the requirements regarding income, net worth, asset size, professional experience or regulatory status.[11] [12]

The SEC’s findings have indicated that a shift in the industry may be imminent. Market participants have been put on notice that their actions and decisions will be closely monitored. Those considering creating and offering tokens, through an ICO or otherwise, must ensure that those tokens will not be considered securities, or alternatively plan to meet all regulatory requirements. Those looking to invest must determine whether such tokens are securities, and whether any resale or other restrictions apply as a result.

In light of the SEC Report, we expect further commentary from Canadian securities regulators on businesses looking to engage in capital raising activities in the crypto-currency market to follow. We would be happy to answer any questions on the SEC Report, the current Canadian position on the regulation of DLT arrangements, capital raising activities, and blockchain technology, and whether your proposed token or DLT arrangement would be considered a security.

Further Information

Businesses with questions about securities law requirements that may potentially apply to their DLT-based activities are encouraged to contact David Gardos or any other member of the Securities Group.

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[1] For further information on blockchain and distributed ledger technology, please refer to our article “The Future of Securities Regulation of Distributed Ledger Technologies”, dated July 14, 2017, a copy of which can be found here.
[2] See SEC bulletin on ICOs: https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings
[3] See SEC press release in connection to the SEC Report: https://www.sec.gov/news/press-release/2017-131
[4] 328 U.S. 293, 301 (1946)
[5] [1978] 2 S.C.R. 112
[6] (2016) 133 O.R.(3d) 341 (O.C.J.)
[7] https://www.sec.gov/news/press-release/2017-131
[8] *Ibid*
[9] https://filecoin.io/
[10] https://filecoin.io/filecoin.pdf (Filecoin Whitepaper)
[11] http://www.cnbc.com/2017/07/19/filecoin-to-run-first-coinlist-based-ico.html
[12] This article does not purport to comment on whether the steps taken by Filecoin or any other party would satisfy a prospectus exempt distribution in the United States or Canada.
