

## SEC Issues Report - Declares DAO Tokens to be Securities

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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") were investment contracts, and therefore were securities under the United States *Securities Act of 1933* and the *Securities Exchange Act of 1934*.

The DAO, prior to its demise at the hands of hackers in June 2016, was an example of a decentralized autonomous organization - that is, a 'virtual' organization not existing in a physical form, but rather embodied in computer code and executed on a distributed ledger or blockchain. The purported 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 Tokens in an attempt to reduce the misdirection and misuse (or waste) of resources that its promoters argued plague large organizations where control is concentrated in the hands of the few. In its initial coin offering ("ICO"), the DAO offered and sold approximately 1.15 billion DAO Tokens.

In the United States, there are three factors that must be present in order to make a determination that an 'investment contract' exists: (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"). The SEC Report concluded that the offering of DAO Tokens and the rights bestowed on holders qualified them as 'investment contracts'.

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. The SEC instead 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."

The SEC has made it clear that, while it recognizes the legitimacy of the cryptocurrency market, the actions of organizations and investors in the industry are well within its purview. It is important to note, however, that although the SEC concluded that DAO Tokens are a security and therefore subject to regulation, this does not mean that all tokens currently meet this standard. Rather, market participants have been put on notice that future issuances will be closely monitored.

# Cassels

To date, Canadian regulators have not explicitly categorized a blockchain-based token as an ‘investment contract’ or other type of security. However, 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 cryptocurrency market to follow.

## **We Can Help**

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