Blockchain Tokens: The SEC's Take

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On July 25, 2017, the SEC issued a number of important pronouncements with respect to initial coin offerings and blockchain tokens.

The SEC issued: (1) a ***press release***; (2) ***an investigative report into The DAO coin offering***; (3) a ***Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO***; and (4) ***an Investor Bulletin on Coin Offerings***.

These materials are important and good reading if you are curious about this area.

The take away for many casual observers has been that the SEC declared that blockchain tokens are securities.

But that is not what the SEC said.

The SEC said that a Blockchain token “may” be a security. But a Blockchain token is not necessarily a security. It depends on what the token does, and what the offeror of the token promises.

The SEC's investigative report said:

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“Accordingly, the Commissioner deems it appropriate and in the public int
erest to issue this Report in order to stress that the U.S. federal secur
ities laws may apply to various activities, including distributed ledger
technology, depending on particular facts and circumstances, without rega
rd to the form of the organization or technology used to effectuate a par
ticular offer or sale.”
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Clearly, if a token grants a right to share in the profits of the business — then the offeror of the token is selling a security under the U.S. securities laws.

In the Investor Bulletin, the SEC said:

> "Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offering or sold may be securities."

The DAO token fell within the definition of a security for a number of reasons. For one, the SEC's investigative report indicated that the intention of the offering was to “distribute the DAO's anticipated earnings from the projects it funded.”

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"the various promotional materials disseminated .... informed investors t
hat the DAO was a for-profit entity whose objective was to fund projects
in exchange for a return on investment."
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The Definition of a Security Under US law

The SEC's analysis of the DAO token or coin as a security is quoted below.

> “Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes “an investment contract.” See 15 U.S.C. §§ 77b-77c. An investment contract is 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. See SEC v. Edwards, 540 U.S. 389, 393 (2004); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); see also United Housing Found., Inc. v. Forman, 421 U.S. 837, 852-53 (1975) (The “touchstone” of an investment contract “is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”). This definition embodies a “flexible rather than a static 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.” Howey, 328 U.S. at 299 (emphasis added). The test “permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of ‘the many types of instruments that in our commercial world fall within the ordinary concept of a security.’” Id. In analyzing whether something is a security, “form should be disregarded for substance,” Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), “and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.” United Housing Found., 421 U.S. at 849."

Using this definition, many types of blockchain projects and their respective tokens likely are not securities. For example, a token which confers a license with language to the effect of “the bearer of this token has my [the author's] permission to copy a specific creative work” most likely is not a security, but rather is more analogous to a content license, similar to one which might be purchased from iTunes. By contrast, a token which promises a share of the profits of a company would clearly be classified as a security, since the purchaser of the token expects a profit from the efforts of the company selling the token.

Blockchains and tokens are capable of an incredibly broad, creative, and flexible range of functionality, far above and beyond solely investment vehicles. Blockchains can be used to store practically any form of data or record, and tokens used to track anything that is transferable, not just securities such as stock or other interests in business enterprises. For example, a venue such as a theater could use a smart contract to automate the sale of tickets, automatically generating a unique token for each seat in the venue for each showing, and sell tokens representing show tickets using an online platform. A ticket is a good example of a function that requires a token that is transferable, but should not be characterized as a security.

In short, although **some** crypto tokens are securities, not necessarily **all** crypto tokens are securities, requiring a careful analysis of the token, its function, and the promotional materials and representations made by its creator(s). And that is what is really the heart and crux of the matter.

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