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A SHOT ACROSS THE BOW—AND A WELCOME ONE

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In the wild west of token sales, that some refer to as "initial token offerings," on July 25, the SEC finally jumped into the fray and said . . . well, actually, not that much. The SEC investigated Slock.it, a decentralized autonomous organization (DAO) organized under German law, and issued a Report of Investigation in which the SEC concluded that Slock.it violated U.S. federal securities laws in issuing its tokens because, in the view of the SEC, the Slock.it tokens are securities under U.S. securities laws and were sold without being registered with the SEC or pursuant to an effective exemption from registration.

What did the SEC say? "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." This is neither new nor news. This has always been the case. U.S. federal securities laws are, at times, as clear as a pool of bubbling tar.

Most importantly, the SEC DID NOT close the door to token sales in the U.S. or to U.S. persons. The SEC did, however, issue an important reminder—one that many in the nascent token sale market have either forgotten or simply ignored: "U.S. federal securities laws may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale."

If a token looks like and acts like a security, it probably is a security, at least in the eyes of the SEC. Here is the takeaway—the important reminder that potential token issuers should memorize:

> This [SEC] Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, "smart contracts," or computer code, does not remove conduct from the purview of the U.S. federal securities laws.

Potential token issuer, remember this and you will be well served.

The second takeaway is that if a token is a security under U.S. federal securities laws, simply excluding U.S. persons from initial token purchases will not be sufficient. Secondary trading should also preclude U.S. persons from purchasing tokens. Like

most tokens, the Slock.it tokens can be resold on a number of web-based platforms that support secondary token trading. Any exchange that effects transactions in securities must be registered with the SEC as a national securities exchange unless it qualifies for an exemption from registration. So any token exchange that allows for the trading of tokens, if such tokens constitute securities under U.S. federal securities laws, would need to register as a national securities exchange (barring an exemption from registration) if the exchange can be accessed from the U.S. and U.S. persons are allowed to purchase tokens through the exchange.

Generally, securities may be sold outside of the United States without violating U.S. securities laws if the offer and sale of those securities are made as part of an "offshore transaction" and none of the parties issuing or selling the securities make any "directed selling efforts" in the United States. An offshore transaction is, among other things, one where no offer is made to a person in the United States and the buyer is physically outside of the United States or the order is executed on the physical trading floor of an established foreign securities exchange or designated offshore securities market. Directed selling efforts include any activity undertaken for the purpose of, or that could be reasonably expected to result in, conditioning the U.S. market for the securities being sold.

The above restrictions also apply to the resale of securities. Offshore purchasers can resell securities outside of the United States by following SEC regulations for offshore transactions or in the U.S. by either registering the securities or reselling them pursuant to an appropriate registration exemption. In other words, if a token being issued constitutes a security under U.S. securities laws, unless the issuer has complied with applicable U.S. securities laws, it is not sufficient to simply exclude U.S. buyers from the initial purchases of tokens. Steps must also be taken to assure that secondary sales also take place outside of the United States and are limited to non-U.S. persons.

Why Did the SEC Conclude That the Slock.it Tokens are Securities Under U.S. Law?

Determining whether something is or is not a security under U.S. law can be a complex and headache inducing exercise. U.S. law includes "investment contracts" within the laundry list of "things" that may be deemed to be securities. An investment contract includes (i) an investment of money, (ii) in a common enterprise, (iii) with a reasonable expectation of profit, (iv) to be derived from the entrepreneurial or managerial efforts of others. In the case of Slock.it, the SEC determined that the Slock.it tokens satisfied each of these four elements. There are many, many court cases that have dissected how broadly or narrowly each of these four elements should be treated.

After examining legal precedents, the SEC set out its argument as to why the Slock.it tokens satisfied each of the above investment contract elements. First, even though investors used a crypto currency to purchase Slock.it tokens, the SEC concluded that

using a virtual currency nevertheless constituted an exchange of value, the equivalent of an investment of money. Second, proceeds from the initial token sale were pooled by Slock.it in order to fund projects supported by token holders and approved by curators. Third, the SEC noted that token holders stood to share in potential profits resulting from the projects funded by Slock.it. Fourth, the SEC determined that profits are being derived by token holders from the managerial efforts of others—namely, Slock.it, its co-founders and the Slock.it curators.

The SEC also had a "smoking gun" that bolstered its conclusion. At an Ethereum Developer Conference in 2015, the Chief Technology Officer of Slock.it stated that purchasing Slock.it tokens were comparable to buying shares in a company and receiving dividends. Needless to say, that did not help.

Does This Mean That All Tokens are Securities Under U.S. Law or That All Token Sales Must Be Closed to U.S. Markets and U.S. Buyers?

NO and NO. Some tokens are securities. Some tokens are not securities. Some tokens may or may not be securities depending on the facts and circumstances and no definitive answer may be available. If access to U.S. markets and investors are appropriate or necessary, it would be unwise as a business matter to preemptively stay away from U.S. markets and U.S. buyers without first assessing whether a proposed token would be or would likely be considered to be a security under U.S. laws and regulations.

As discussed, a number of complicated factors go into determining whether a token might be a security under U.S. securities laws. To date, there are many different types of tokens that have been issued, or are being contemplated, with many different characteristics. Some tokens, like Bitcoin, are digital currencies and would not likely be considered to be securities. In contrast, tokens that give holders ownership and profit interests are presumably always going to be treated as securities. Other tokens, however, fall into grey areas. For example, tokens that give holders the right to access a platform, provide consulting or programming services to the platform or its participants, or sell products to a system or platform or their participants may not be treated as securities under U.S. laws so long as those tokens do not have other attributes or characteristics such as the right to share profits or the right or option to purchase investment interests.

What Should Future Token Issuers Do?

If a token issuer does not need or want U.S. investors, the issuer can close the offering to U.S. persons and make sure that no solicitation or marketing activities for the tokens occur in the U.S. As noted, however, the issuer should also take steps to assure that U.S. buyers are precluded from acquiring the tokens through secondary markets and trading.

If the token is clearly not a security (for example, it is clear that it is merely a digital currency), it is not unreasonable for a token issuer to allow U.S. buyers or access the U.S. investor market. But issuers of tokens that fall into a grey area should not sell their tokens in the United States or to U.S. persons without first consulting U.S. counsel. In those cases, no U.S. counsel would be able to provide a clear opinion as to the definitive U.S. regulatory treatment of such a token. (Also, as a policy matter, the SEC will not provide advance guidance as to whether something is or is not a security.) However, a U.S. counsel would be able to help the future issuer assess the likelihood as to whether a token could be deemed to be a security under U.S. laws and regulations and could provide the issuer with guidance on minimizing the risk of such an outcome.

Many token issuers require the holding of its tokens as a condition to accessing the issuer's platform or services or in order to be able to sell services or products to, or buy services or products from, other participants of the platform, that is, other token holders. In such cases, if the issuer's token were deemed to constitute a U.S. security, unless the issuer chose to comply with applicable U.S. securities laws, U.S.-based "customers" in addition to U.S. investors would effectively be unavailable to that issuer. U.S. buyers would not even be able to acquire tokens for the purpose of accessing the issuer's business or platform. That is, if a token is otherwise determined to be a security, that treatment is the same regardless of whether a token holder acquires the token as a passive investment or holds the token as a precondition to doing business with the issuer or on or through its platform. In other words, the reason someone buys a token (for investment purposes or otherwise) is not the sole factor in determining whether that token constitutes a security under U.S. laws.

Of course a token issuer could also decide to treat a token as a security for U.S. purposes and, in order to open of the token sale to U.S. buyers, either register the token as a security with the SEC or issue the token pursuant to an available exemption from registration. Issuing a token under the requirements of the JOBS Act might also be appropriate for some issuers.

In any event, the U.S. token market is not dead. We were just given a friendly, and appropriate, reminder, that accessing U.S. buyers and markets are not always easy and appropriate preemptive legal advice is appropriate.