SECURITIES AND EXCHANGE RULING ON SLOCK.IT UG

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*Preliminary Note: This article is part of my Biased Journalism series. The views are mine based upon a reading and interpretation of the SEC Ruling Release No. 81207/ 25 July 2017. I omitted citations to law in this piece, but may add them later.*

**Executive Summary**

The Securities and Exchange Commission [SEC] issued a Report, under 21(a) of the Securities and Exchange Act of 1934, finding that the Decentralised Autonomous Organisation [DAO], established by Slock.it UG, a German corporation, violated the Securities laws of the US by failing to register the offer and sale to the public of DAO Tokens, designed to raise capital to fund “projects” expected to generate a return on investment. The SEC found that DAO tokens were an “investment contract” and thus a security within the meaning of the Securities Acts of 1933 and 1934 thereby requiring registration of the security prior to the offer and sale to the public. The SEC found that trading of DAO tokens on the secondary market did not violate the Securities and Exchange Act of 1934, because the platforms that traded DAO Tokens met the requirements of Rule 3b-16(a). The SEC elected not to pursue an enforcement proceeding against the DAO or Slock.it, preferring, alternatively, to clarify the application of SEC legislation to virtual organisations and initial coin offerings.

**Facts**

In 2016, “Slock.it” established a Decentralised Autonomous Organisation [DAO], an unincorporated organisation, on the Ethereum blockchain with the aim of operating a for-profit entity by selling DAO Tokens to the public and using the proceeds of the sale to fund “projects”. No restrictions were placed on potential purchasers of the tokens; any person, despite financial experience or place of residence, could purchase the DAO Tokens. Purchasers of the DAO Tokens had the right to share in the earnings of the “projects” as a return on their investment in DAO Tokens. Alternatively, purchasers of DAO Tokens could monetise their holdings by selling DAO Tokens on the secondary market for cryptocurrency or fiat currency.

During the period 30 April 2016 through 28 May 2016, the DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for approximately 12 million Ether, the virtual currency used on the Ethereum blockchain, and the digital currency required for purchase. At the close of the offer, Slock.it had raised, as measured in US dollars, a total amount of $150 million. The funds were held at an Ethereum Blockchain address; DAO Token holders were to vote on Contractor proposals to fund projects; and the DAO would distribute any earnings to DAO Token holders.

The DAO Token granted certain voting and ownership rights to Token holders in DAO funded projects. However, the method established to vet project proposals rendered voting rights of DAO Token holders virtually meaningless. Contractors submitted project proposals to one or more of DAO’s Curators. The Curators were individuals appointed by Slock.it. In the event a Contractor proposal met pre-defined criteria, Curators could add the proposal to a “whitelist” of projects, and Curators, in their sole discretion, could decide to submit a project proposal for voting by DAO Token holders.

Curators determined whether any particular project proposal should be submitted for vote by DAO Token holders. Curator’s powers included: criteria set forth in the “White Paper”, subjective criteria of an individual Curator, total control over projects posted to the “whitelist”, and authority to reduce the voting quorum requirement by 50% every other week. No project ever was submitted to vote or funded under the DAO/Slock.it scheme. [The theft of approximately one-third of ETH raised is not discussed here as irrelevant to question; the stolen funds also were recovered]

**Question**

Did the DAO offer and sale of DAO Tokens to the public for the purpose of raising capital to fund “projects” constitute the offer and sale of a “security” and violate the 1933 and 1934 Securities Acts?

[Note that the SEC did not consider whether a Decentralised Autonomous Organisation is an investment company as defined by the Investment Company Act of 1940.]

**Short Answer**

Yes, because the offer and sale of DAO Tokens were “investment contracts” under US securities law. Therefore, in the absence of exemption, DAO was required to file a registration statement with the SEC, prior to the offer and sale of DAO Tokens.

**SEC Analysis**

1. *The offer and sale of DAO Tokens were “investment contracts”*

The SEC found that the US “Securities laws apply to virtual organisations or capital raising entities making use of Distributed Ledger Technology”, that is, the Blockchain. This conclusion followed from the definition of security to encompass “an investment contract”. An investment contract “is an investment of money in a common enterprise with a reasonable expectation of profit to be derived from the entrepreneurial or managerial efforts of others”. This test first enunciated in *SEC v W.J. Howey, Co*., 328 U.S. 293, 301 (1946) was intended to implement 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’”. The economic reality of the transaction primes the formal name of the instrument.

1. *Digital currency is money and investors had reasonable expectation of profits*

Purchasers of DAO Tokens invested money, since money need not take the form of cash or fiat currency. Buying DAO Tokens with ETH, the Ethereum digital currency, was a sufficient contribution of value to satisfy the requirements of the *Howey* test. In addition, purchasers of DAO Tokens invested in a common enterprise, the DAO, that pooled all funds, parking them at an Ethereum blockchain address, to be used later for investments in approved projects. “The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment”. The SEC stated that, a reasonable investor would have been motivated, in part, by the prospect of receiving profits on its investment.

1. *Profits were to be derived from efforts of others*

The DAO’s Curators exercised a virtual monopoly of power over receiving proposals submitted by ‘Contractors’, vetting the proposals, and applying criteria [subjective criteria inclusive] to determine whether to place a project on the “whitelist”, the list of projects approved for investment. Investors were totally cut out of the process, despite their purported voting and ownership rights. Investors had to rely on the expertise of the Curators. Investors lacked the authority to remove a Curator, as Curators alone, determined whether a proposal of removal would be put to vote. “The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise”. Consequently, DAO Token holders relied upon the efforts of the DAO, and its Curators to exercise managerial expertise to produce profits and any return on their investment.

The definition of “issuer” includes, “every person who issues or proposes to issue any security, and the term “person” comprises unincorporated associations. Therefore, DAO was an issuer within the meaning of the securities law. Since the offer and sale of DAO Tokens fell within the definition of an investment contract, and the DAO was the issuer of the security, the SEC found that DAO was required to file a registration statement with the SEC, prior to making an offer and sale of DAO Tokens. Consequently, the unregistered offer and sale of DAO Tokens violated the securities laws of the United States.

**Conclusion**

The SEC declined to pursue an enforcement proceeding against the DAO or Slock.it. Rather, the SEC Ruling sends a signal to proprietors of disruptive technology in the financial sector that their actions may be subject, on a case by case basis, to comply with the securities legislation of the United States. SEC requirements extend to digital currency and virtual organisations. It must be stressed that the “*Howey test*” is unique to the United States. Nothing comparable exists in EU securities law, though the EU is in the process of determining how to deal with the rise of FinTech and the Blockchain.