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Capital Markets

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Cyber-Currency Still Not a Security — DAO Tokens Deemed Investment Contracts

The Securities and Exchange Commission issued a release concerning its investigation of The DAO, a "decentralized autonomous organization … executed on a distributed ledger" that issued DAO Tokens in exchange for Ether (known by the code name ETH), a virtual currency used on the Ethereum Blockchain.

Transferable in several venues, DAO Tokens authorized their holders to vote on matters of company governance, as well as whether The DAO should engage "Contractors" to undertake "projects" to earn profits for The DAO. Any profits might be distributed to DAO Token holders as "rewards," payable in ETH.

The SEC determined, without difficulty, that the DAO Tokens exhibited classic elements of an investment contract and therefore constituted securities because they represented investments "in a common enterprise with a reasonable expectation of profits to be derived from entrepreneurial or managerial efforts of others." Although DAO Token holders were entitled to vote on The DAO's ordinary business matters, *i.e.*, whether to engage Contractors for particular projects, the SEC found the holders' management influence constrained by the company's structure. The holders therefore depended upon (and were subject to individual preferences of) administrators referred to as "Curators," as well as the company's founders, for the success of the enterprise.

Notwithstanding that DAO tokens and cyber-currencies are creatures of the same milieu, it's clear from the "what is a security" standpoint that a DOA Token is less closely related to a cyber-currency than it is to capital stock. The DAO founder likened buying DAO Tokens to "buying shares in a company and getting … dividends," whereas the SEC relies on a Financial Action Task Force definition of "virtual currency" as, "a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; (2) a unit of account; or (3) a store of value … ." Currently, however, few are acquiring Bitcoins or Ether to purchase popcorn at a movie theater and, to many, "store of value" is synonymous with "speculative investment."

So, to distinguish the two, the emphasis may be upon whether a cyber-currency investor is expecting appreciation (or at least absence of depreciation) based upon market action wholly divorced from operational success of the enterprise that issued the digital asset. But the distinction may become harder to maintain, especially as terminology becomes less precise and functionality of the digital coin expands.

In the release, the SEC said that offerings of instruments such as DAO Tokens to raise capital have been referred to as “Initial Coin Offerings” or “Token Sales.” Already, the distinction between digital currency and digital tokens is being lost in their names, while the currencies increasingly include value-added features that could cause the assets to take on equity-like characteristics. For example, if a crypto-currency can be used to buy services or goods from its issuer, demand for the services or goods, reflecting the success of the enterprise, might affect demand for and therefore the value of, the currency.

Meanwhile, the markets for these digital creatures have become as frothy as the quantum vacuum.

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