SEC Leaves ICO Questions Unanswered

Jul 26, 2017

Categories:
Publications

Yesterday's flurry of releases from the U.S. Securities and Exchange Commission leaves open the question of whether any individual initial coin offering (ICO) represents the sale of securities under applicable U.S. law.

"Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens may be securities," the SEC noted in an Investor Bulletin released yesterday.[1]

SEC Applies Howey Test to the DAO

Applying the Howey test[2], the SEC's Division of Enforcement concluded that the DAO's 2016 token sale constituted an offering of securities.[3] However, whether any specific distributed ledger token is a security remains a fact-specific inquiry – the exact same analysis which was required prior to the issuance of the SEC's guidance yesterday.

Skirting securities laws with creative monikers or structures will not suffice as the SEC "stress[ed] that U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of organization or technology used to effectuate a particular offering or sale."[4]

Similarly, simply requiring purchasers to pay in tokens instead of fiat currency does not provide any safe harbor from the application of securities laws. Likewise, a presale of tokens where any future value is closely correlated with the promoter's efforts to develop and eventually launch the token probably would fall within the ambit of U.S. securities laws.

Analysis of Future Profits and Managerial Efforts

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The fundamental question in this fact-specific analysis remains how any future value will be determined. If the token's ultimate value is tied to its promoter's efforts, it likely will be considered a security. Such linkage, for example, could be established through a promised dividend stream (as was the case with DAO tokens) or the fact that the token is worthless until future development occurs (as is the case with most presales).

However, if the issuer's actions have materially limited impact on the future value of any token, the odds of it being considered a security are drastically reduced. To avoid classification as a security, the token's value should not be linked to the economic health or business activities of an issuer.

SEC Intends to Regulate ICOs by Regulating the Exchanges

While yesterday's guidance does not provide a definitive answer to whether an individual token is a security, it does make clear that the exchanges that have sprung up to trade these tokens may fall within the definition of a securities "exchange" under the Securities Exchange Act of 1934. The operators of token exchanges may be forced to abandon making the market for any token which could be considered a security or otherwise register as a national securities exchange. However, it should be noted that the SEC did specifically mention that exchanges could exempt themselves from registration by complying with "alternative trading systems" (ATS) exemption.

Conclusion

Viewing yesterday's guidance as a blanket statement that any ICO constitutes the sale of securities would be a mistake. The analysis remains intensely fact-specific. That said, while the SEC may not have imposed any fines on the DAO's promoters, subsequent developers need to walk through the SEC's analysis closely before launching any ICO.

If you have additional questions regarding the SEC's guidance on ICOs, please contact Gray Sasser (gsasser@fbtlaw.com), Josh Rosenblatt (jrosenblatt@fbtlaw.com), or any member of Frost

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[1] Investor Alerts and Bulletins, U.S. Securities and Exchange Commission, *Investor Bulletin: Initial Coin Offerings* (July 25, 2017), *available at* https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

[2] "An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed by the enterprise." SEC v. W.J. Howey, 328 U.S. 293, 299 (1946).

[3] Report of Investigation Pursuant to Section 21(a) of the Sec. Exch. Act of 1934: The DAO, Release No. 81207 (Jul. 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.

[4] *Id*, p. 10.

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