

**Testimony on “Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission”**

by

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**Before the**

**Committee on Banking, Housing, and Urban Affairs**

**United States Senate**

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Chairman Crapo, Ranking Member Brown and distinguished senators of the Committee, thank you for the opportunity to testify before you today.<sup>1</sup> I am pleased that the Committee is holding this hearing to bring greater focus to the important issues that cryptocurrencies, initial coin offerings (ICOs) and related products and activities present for American investors and our markets.

I am also pleased to join my counterpart, Commodity Futures Trading Commission (CFTC) Chairman Christopher Giancarlo, for our second time testifying together before Congress. Since I joined the Commission in May, Chairman Giancarlo and I have built a strong relationship. Cryptocurrencies, ICOs and related subjects are the latest in a host of market issues on which we and our staffs have been closely collaborating to strengthen our capital markets for investors and market participants.<sup>2</sup>

The mission of the SEC is to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. We do so through our enforcement of the federal securities laws and our oversight of the securities markets and their participants including (1) approximately \$75 trillion in securities trading annually on U.S. equity markets; (2) the disclosures of approximately 4,100 exchange-listed public companies with an approximate aggregate market capitalization of \$31 trillion; and (3) the activities of over 26,000 registered entities and self-regulatory organizations, including investment advisers, broker-dealers, transfer agents, securities exchanges, clearing agencies, mutual funds, exchange-traded funds (ETFs), the Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB), among others.

For those who seek to raise capital to fund an enterprise, as many in the ICO space have sought to do, a primary entry into the SEC’s jurisdiction is the offer and sale of securities, as set forth in the Securities Act of 1933.<sup>3</sup> As I will explain in greater detail below, determining what

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<sup>1</sup> The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the President, the full Commission, or any Commissioner.

<sup>2</sup> See Jay Clayton and J. Christopher Giancarlo, *Regulators are Looking at Cryptocurrency*, Wall St. J. (Jan. 24, 2018), available at <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363?mod=searchresults&page=1&pos=2>.

<sup>3</sup> Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes, among other items, “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

falls within the ambit of a securities offer and sale is a facts-and-circumstances analysis, utilizing a principles-based framework that has served American companies and American investors well through periods of innovation and change for over 80 years.

The cryptocurrency and ICO markets, while new, have grown rapidly, gained greater prominence in the public conscience and attracted significant capital from retail investors. We have seen historical instances where such a rush into certain investments has benefitted our economy and those investors who backed the right ventures. But when our laws are not followed, the risks to all investors are high and numerous – including risks caused by or related to poor, incorrect or non-existent disclosure, volatility, manipulation, fraud and theft.

To be clear, I am very optimistic that developments in financial technology will help facilitate capital formation, providing promising investment opportunities for institutional and Main Street investors alike. From a financial regulatory perspective, these developments may enable us to better monitor transactions, holdings and obligations (including credit exposures) and other activities and characteristics of our markets, thereby facilitating our regulatory mission, including, importantly, investor protection.

At the same time, regardless of the promise of this technology, those who invest their hard-earned money in opportunities that fall within the scope of the federal securities laws deserve the full protections afforded under those laws. This ever-present need comes into focus when enthusiasm for obtaining a profitable piece of a new technology “before it’s too late” is strong and broad. Fraudsters and other bad actors prey on this enthusiasm.

The SEC and the CFTC, as federal market regulators, are charged with establishing a regulatory environment for investors and market participants that fosters innovation, market integrity and ultimately confidence. To that end, a number of steps the SEC has taken relating to cryptocurrencies, ICOs and related assets are discussed below.

### *Message for Main Street Investors*

Before discussing regulation in more detail, I would like to reiterate my message to Main Street investors from a statement I issued in December.<sup>4</sup> Cryptocurrencies, ICOs and related products and technologies have captured the popular imagination – and billions of hard-earned dollars – of American investors from all walks of life. In dealing with these issues, my key consideration – as it is for all issues that come before the Commission – is to serve the long term interests of our Main Street investors. My efforts – and the tireless efforts of the SEC staff – have been driven by various factors, but most significantly by the concern that too many Main Street investors do not understand all the material facts and risks involved. Unfortunately, it is

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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).

<sup>4</sup> In December, I issued a statement that provided my general views on the cryptocurrency and ICO markets. The statement was directed principally at two groups: 1) Main Street investors and 2) market professionals – including, for example, broker-dealers, investment advisers, exchanges, lawyers and accountants – whose actions impact Main Street investors. *See Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017), *available at* <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

clear that some have taken advantage of this lack of understanding and have sought to prey on investors' excitement about the quick rise in cryptocurrency and ICO prices.<sup>5</sup>

There should be no misunderstanding about the law. When investors are offered and sold securities – which to date ICOs have largely been – they are entitled to the benefits of state and federal securities laws and sellers and other market participants must follow these laws.

Yes, we do ask our investors to use common sense, and we recognize that many investment decisions will prove to be incorrect in hindsight. However, we do not ask investors to use their common sense in a vacuum, but rather, with the benefit of information and other requirements where judgments can reasonably be made.

This is a core principle of our federal securities laws and is embodied in the SEC's registration requirements. Investors should understand that to date no ICOs have been registered with the SEC, and the SEC also has not approved for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies. If any person today says otherwise, investors should be especially wary.

Investors who are considering investing in these products should also recognize that these markets span national borders and that significant trading may occur on systems and platforms outside the U.S. Investors' funds may quickly travel overseas without their knowledge. As a result, risks can be amplified, including the risk that U.S. market regulators, such as the SEC and state securities regulators, may not be able to effectively pursue bad actors or recover funds.

Further, there are significant security risks that can arise by transacting in these markets, including the loss of investment and personal information due to hacks of online trading platforms and individual digital asset "wallets." A recent study estimated that more than 10% of proceeds generated by ICOs – or almost \$400 million – has been lost to such attacks.<sup>6</sup> And less than two weeks ago, a Japanese cryptocurrency market lost over \$500 million in an apparent hack of its systems.<sup>7</sup>

In order to arm investors with additional information, the SEC staff has issued investor alerts, bulletins and statements on ICOs and cryptocurrency-related investments, including with

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<sup>5</sup> In one instance, the SEC brought an enforcement action against a purported bitcoin mining company that claimed to have a product "so easy to use that it is 'Grandma approved.'" In this case, in less than six months, the company allegedly raised more than \$19 million from more than 10,000 investors. The SEC charged that company with operating a Ponzi scheme. See Press Release 2015-271, SEC Charges Bitcoin Mining Companies (Dec. 1, 2015), available at <https://www.sec.gov/news/pressrelease/2015-271.html>; SEC Obtains Final Judgment Against Founder of Bitcoin Mining Companies Used to Defraud Investors (Oct. 4, 2017), available at <https://www.sec.gov/litigation/litreleases/2017/lr23960.htm>.

<sup>6</sup> See EY Research: Initial Coin Offerings (ICOs) (Dec. 2017), available at <http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf>.

<sup>7</sup> See Reuters, *Japan Raps Coincheck, Orders Broader Checks after \$530 Million Cryptocurrency Theft*, Jan. 28, 2018, available at <https://www.reuters.com/article/us-japan-cryptocurrency/japan-raps-coincheck-orders-broader-checks-after-530-million-cryptocurrency-theft-idUSKBN1FI06S>.

respect to the marketing of certain offerings and investments by celebrities and others.<sup>8</sup> If investors choose to invest in these products, they should ask questions and demand clear answers. I would strongly urge investors – especially retail investors – to review the sample questions and investor alerts issued by the SEC’s Office of Investor Education and Advocacy.<sup>9</sup>

These warnings are not an effort to undermine the fostering of innovation through our capital markets – America was built on the ingenuity, vision and spirit of entrepreneurs who tackled old and new problems in new, innovative ways. Rather, they are meant to educate Main Street investors that many promoters of ICOs and cryptocurrencies are not complying with our securities laws and, as a result, the risks are significant.

With my remaining testimony, I would like to provide the Committee an overview of the Commission’s ongoing work on cryptocurrencies and ICOs.

### *Cryptocurrencies and Related Products and Trading*

Speaking broadly, cryptocurrencies purport to be items of inherent value (similar, for instance, to cash or gold) that are designed to enable purchases, sales and other financial transactions. Many are promoted as providing the same functions as long-established currencies such as the U.S. dollar but without the backing of a government or other body. While cryptocurrencies currently being marketed vary in different respects, proponents of cryptocurrencies often tout their novelty and other potential beneficial features, including the ability to make transfers without an intermediary and without geographic limitation and lower transaction costs compared to other forms of payment. Critics of cryptocurrencies note that the purported benefits highlighted by proponents are unproven and other touted benefits, such as the personal anonymity of the purchasers and sellers and the absence of government regulation or oversight, could also facilitate illicit trading and financial transactions, as well as fraud.

The recent proliferation and subsequent popularity of cryptocurrency markets creates a question for market regulators as to whether our historic approach to the regulation of sovereign currency transactions is appropriate for these new markets. These markets may look like our regulated securities markets, with quoted prices and other information. Many trading platforms are even referred to as “exchanges.” I am concerned that this appearance is deceiving. In reality, investors transacting on these trading platforms do not receive many of the market protections that they would when transacting through broker-dealers on registered exchanges or alternative

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<sup>8</sup> Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others (Nov. 1, 2017), available at <https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos>; Investor Alert: Public Companies Making ICO-Related Claims (Aug. 28, 2017), available at [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia\\_ico-related-claims](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_ico-related-claims); Investor Bulletin: Initial Coin Offerings (July 25, 2017), available at [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings); Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014), available at <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency>; Investor Alert: Ponzi Schemes Using Virtual Currencies (July 23, 2013), available at [https://www.sec.gov/investor/alerts/ia\\_virtualcurrencies.pdf](https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf).

<sup>9</sup> See Sample Questions for Investors Considering a Cryptocurrency or ICO Investment Opportunity (Dec. 2017), available at [https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11#\\_ftnref8](https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11#_ftnref8).

trading systems (ATSS), such as best execution, prohibitions on front running, short sale restrictions, and custody and capital requirements. I am concerned that Main Street investors do not appreciate these differences and the resulting substantially heightened risk profile.

It appears that many of the U.S.-based cryptocurrency trading platforms have elected to be regulated as money-transmission services. Traditionally, from an oversight perspective, these predominantly state-regulated payment services have not been subject to direct oversight by the SEC or the CFTC. Traditionally, from a function perspective, these money transfer services have not quoted prices or offered other services akin to securities, commodities and currency exchanges. In short, the currently applicable regulatory framework for cryptocurrency trading was not designed with trading of the type we are witnessing in mind. As Chairman Giancarlo and I stated recently, we are open to exploring with Congress, as well as with our federal and state colleagues, whether increased federal regulation of cryptocurrency trading platforms is necessary or appropriate. We also are supportive of regulatory and policy efforts to bring clarity and fairness to this space.

The SEC regulates securities transactions and certain individuals and firms who participate in our securities markets. The SEC does not have direct oversight of transactions in currencies or commodities, including currency trading platforms.

While there are cryptocurrencies that, at least as currently designed, promoted and used, do not appear to be securities, simply calling something a “currency” or a currency-based product does not mean that it is not a security. To this point I would note that many products labeled as cryptocurrencies or related assets are increasingly being promoted as investment opportunities that rely on the efforts of others, with their utility as an efficient medium for commercial exchange being a distinct secondary characteristic. As discussed in more detail below, if a cryptocurrency, or a product with its value tied to one or more cryptocurrencies, is a security, its promoters cannot make offers or sales unless they comply with the registration and other requirements under our federal securities laws.<sup>10</sup>

In this regard, the SEC is monitoring the cryptocurrency-related activities of the market participants it regulates, including brokers, dealers, investment advisers and trading platforms. Brokers, dealers and other market participants that allow for payments in cryptocurrencies, allow customers to purchase cryptocurrencies (including on margin) or otherwise use cryptocurrencies to facilitate securities transactions should exercise particular caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations.<sup>11</sup> As I have stated previously, these market participants should treat payments and other transactions made in cryptocurrency as if cash were being handed from one party to the other.

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<sup>10</sup> It is possible to conduct an offer and sales of securities, including an ICO, without triggering the SEC’s registration requirements. For example, just as with a Regulation D exempt offering to raise capital for the manufacturing of a physical product, an ICO that is a security can be structured so that it qualifies for an applicable exemption from the registration requirements.

<sup>11</sup> I am particularly concerned about market participants who extend to customers credit in U.S. dollars – a relatively stable asset – to enable the purchase of cryptocurrencies, which, in recent experience, have proven to be a more volatile asset.

Finally, financial products that are linked to underlying digital assets, including cryptocurrencies, may be structured as securities products subject to the federal securities laws even if the underlying cryptocurrencies are not themselves securities. Market participants have requested Commission approval for new products and services of this type that are focused on retail investors, including cryptocurrency-linked ETFs. While we appreciate the importance of continuing innovation in our retail fund space, there are a number of issues that need to be examined and resolved before we permit ETFs and other retail investor-oriented funds to invest in cryptocurrencies in a manner consistent with their obligations under the federal securities laws. These include issues around liquidity, valuation and custody of the funds' holdings, as well as creation, redemption and arbitrage in the ETF space.

Last month, after working with several sponsors who ultimately decided to withdraw their registration statements, the Director of our Division of Investment Management issued a letter to provide an overview of certain substantive issues and related questions associated with registration requirements and to encourage others who may be considering a fund registered pursuant to the Investment Company Act of 1940 to engage in a robust discussion with the staff concerning the above-mentioned issues.<sup>12</sup> Until such time as those questions have been sufficiently addressed, I am concerned about whether it is appropriate for fund sponsors that invest substantially in cryptocurrencies and related products to register. We will continue engaging in a dialogue with all interested parties to seek a path forward consistent with the SEC's tripartite mission.

### *ICOs and Related Trading*

Coinciding with the substantial growth in cryptocurrencies, companies and individuals increasingly have been using so-called ICOs to raise capital for businesses and projects. Typically, these offerings involve the opportunity for individual investors to exchange currency, such as U.S. dollars or cryptocurrencies, in return for a digital asset labeled as a coin or token. The size of the ICO market has grown exponentially in the last year, and it is estimated that almost \$4 billion was raised through ICOs in 2017. Note that this number may understate the size of the ICO market (and the potential for loss) as many ICOs "trade up" after they are issued.

These offerings can take different forms, and the rights and interests a coin is purported to provide the holder can vary widely. A key question all ICO market participants – promoters, sellers, lawyers, officers and directors and accountants, as well as investors – should ask: "Is the coin or token a security?" As securities law practitioners know well, the answer depends on the facts. But by and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws. As noted above, the foundation of our federal securities laws is to provide investors with the procedural protections and information they need to make informed judgments about what they are investing in and the relevant risks

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<sup>12</sup> See Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), *available at* <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>.

involved. In addition, our federal securities laws provide a wide array of remedies, including criminal and civil actions brought by the DOJ and the SEC, as well as private rights of action.

The Commission previously urged market professionals, including securities lawyers, accountants and consultants, to read closely an investigative report it released. On July 25, 2017, the Commission issued a Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934<sup>13</sup> regarding an ICO of DAO Tokens.<sup>14</sup> In the Report, the Commission considered the particular facts and circumstances presented by the offer and sale of DAO Tokens and concluded that DAO Tokens were securities based on longstanding legal principles, and therefore that offers and sales of the DAO Tokens were subject to the federal securities laws. The Report also explained that issuers of distributed ledger or blockchain technology-based securities must register offers and sales of such securities unless a valid exemption from registration applies, and that platforms that provide for trading in such securities must register with the SEC as national securities exchanges or operate pursuant to an exemption from such registration.

The Commission's message to issuers and market professionals in this space was clear: those who would use distributed ledger technology to raise capital or engage in securities transactions must take appropriate steps to ensure compliance with the federal securities laws. The Report and subsequent statements also explain that the use of such technology does not mean that an offering is necessarily problematic under those laws. The registration process itself, or exemptions from registration, are available for offerings employing these novel methods.

The statement I issued in December that was directed to Main Street investors and market professionals provided additional insight into how practitioners should view ICOs in the context of our federal securities laws. Certain market professionals have attempted to highlight the utility or voucher-like characteristics of their proposed ICOs in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions that the federal securities laws do not apply to a particular ICO appear to elevate form over substance. The rise of these form-based arguments is a disturbing trend that deprives investors of mandatory protections that clearly are required as a result of the structure of the transaction. Merely calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security.<sup>15</sup> Tokens and offerings that incorporate features and marketing efforts that emphasize

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<sup>13</sup> Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to "publish information concerning any such violations." The Report does not constitute an adjudication of any fact or issue addressed therein, nor does it make any findings of violations by any individual or entity.

<sup>14</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

<sup>15</sup> See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) ("[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a 'security' ."); see also *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) ("Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.").

the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens, *i.e.*, the ability to sell them on an exchange at a profit. In short, prospective purchasers are being sold on the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.

On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities. I have urged these professionals to be guided by the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.<sup>16</sup>

I also have cautioned market participants against promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions. Engaging in the business of selling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of “scalping,” “pump and dump” and other manipulations and frauds. Similarly, my colleagues and I have cautioned those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act of 1934.

I do want to recognize that recently social media platforms have restricted the ability of users to promote ICOs and cryptocurrencies on their platforms. I appreciate the responsible step.

### *Enforcement*

A number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation. The ability of bad actors to commit age-old frauds with new technologies coupled with the significant amount of capital – particularly from retail investors – that has poured into cryptocurrencies and ICOs in recent months and the offshore footprint of many of these activities have only heightened these concerns.

In September 2017, the Division of Enforcement established a new Cyber Unit focused on misconduct involving distributed ledger technology and ICOs, the spread of false information through electronic and social media, brokerage account takeovers, hacking to obtain nonpublic information and threats to trading platforms.<sup>17</sup> The Cyber Unit works closely with our cross-divisional Distributed Ledger Technology Working Group, which was created in November

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<sup>16</sup> See Opening Remarks at the Securities Regulation Institute (Jan. 22, 2018), *available at* <https://www.sec.gov/news/speech/speech-clayton-012218>.

<sup>17</sup> See Press Release 2017-176, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), *available at* <https://www.sec.gov/news/press-release/2017-176>.



2013. We believe this approach has enabled us to leverage our enforcement resources effectively and coordinate well within the Commission, as well as with other federal and state regulators.

To date, we have brought a number of enforcement actions concerning ICOs for alleged violations of the federal securities laws. In September 2017, we brought charges against an individual for defrauding investors in a pair of ICOs purportedly backed by investments in real estate and diamonds.<sup>18</sup> According to the SEC's complaint, investors provided approximately \$300,000 in funding and were told they could expect sizeable returns despite neither company having real operations. In December 2017, we obtained an emergency asset freeze to halt an alleged ICO fraud that purportedly raised up to \$15 million from thousands of individual investors beginning in August 2017.<sup>19</sup> According to the complaint, the scam was operated by a recidivist securities law violator and promised investors a more than 1,300 percent profit in under 29 days. As another example, after being contacted by the SEC last December, a company halted its ICO to raise capital for a blockchain-based food review service, and then settled proceedings in which we determined that the ICO was an unregistered offering and sale of securities in violation of the federal securities laws.<sup>20</sup> Before tokens were delivered to investors, the company refunded investor proceeds after the SEC intervened.

And most recently, we halted an allegedly fraudulent ICO that targeted retail investors promoting what it portrayed as the world's first decentralized bank.<sup>21</sup> We were able to freeze some of the allegedly ill-gotten cryptocurrency assets and obtained a receiver to try to marshal these assets back to harmed investors.

I also have been increasingly concerned with recent instances of public companies, with no meaningful track record in pursuing distributed ledger or blockchain technology, changing their business models and names to reflect a focus on distributed ledger technology without adequate disclosure to investors about their business model changes and the risks involved. A number of these instances raise serious investor protection concerns about the adequacy of disclosure especially where an offer and sale of securities is involved. The SEC is looking closely at the disclosures of public companies that shift their business models to capitalize on the perceived promise of distributed ledger technology and whether the disclosures comply with the federal securities laws, particularly in the context of a securities offering.

With the support of my fellow Commissioners, I have asked the SEC's Division of Enforcement to continue to police these markets vigorously and recommend enforcement actions against those who conduct ICOs or engage in other actions relating to cryptocurrencies in violation of the federal securities laws. In doing so, the SEC and CFTC are collaborating on our

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<sup>18</sup> Press Release 2017-185, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017), available at <https://www.sec.gov/news/press-release/2017-185-0>.

<sup>19</sup> Press Release 2017-219, SEC Emergency Action Halts ICO Scam (Dec. 4, 2017), available at <https://www.sec.gov/news/press-release/2017-219>.

<sup>20</sup> Press Release 2017-227, Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017), available at <https://www.sec.gov/news/press-release/2017-227>.

<sup>21</sup> Press Release 2018-8, SEC Halts Alleged Initial Coin Offering Scam (Jan. 30, 2018), available at <https://www.sec.gov/news/press-release/2018-8>.

approaches to policing these markets for fraud and abuse.<sup>22</sup> We also will continue to work closely with our federal and state counterparts, including the Department of Treasury, Department of Justice and state attorneys general and securities regulators.

### *Conclusion*

Through the years, technological innovations have improved our markets, including through increased competition, lower barriers to entry and decreased costs for market participants. Distributed ledger and other emerging technologies have the potential to further influence and improve the capital markets and the financial services industry. Businesses, especially smaller businesses without efficient access to traditional capital markets, can be aided by financial technology in raising capital to establish and finance their operations, thereby allowing them to be more competitive both domestically and globally. And these technological innovations can provide investors with new opportunities to offer support and capital to novel concepts and ideas.

History, both in the United States and abroad, has proven time and again that these opportunities flourish best when pursued in harmony with our federal securities laws. These laws reflect our tripartite mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. Being faithful to each part of our mission not in isolation, but collectively, has served us well. Said simply, we should embrace the pursuit of technological advancement, as well as new and innovative techniques for capital raising, but not at the expense of the principles undermining our well-founded and proven approach to protecting investors and markets.

Thank you for the opportunity to testify before you today and for your support of the Commission and its workforce. I stand ready to work with Congress on these issues and look forward to answering your questions.

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<sup>22</sup> See Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions (Jan. 19, 2018), available at <https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors>.

## APPENDIX

[Press Release: SEC Halts Alleged Initial Coin Offering Scam \(Jan. 30, 2018\)](#)

[Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: Regulators Are Looking at Cryptocurrency \(Jan. 25, 2018\)](#)

[Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions \(Jan. 19, 2018\)](#)

[Statement of Chairman Jay Clayton and Commissioners Kara M. Stein and Michael S. Piwowar on “NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution” by NASAA \(Jan. 4, 2018\)](#)

[Statement on Cryptocurrencies and Initial Coin Offerings \(Dec. 11, 2017\)](#)

[Press Release: Company Halts ICO after SEC Raises Registration Concerns \(Dec. 11, 2017\)](#)

[Press Release: SEC Emergency Action Halts ICO Scam \(Dec. 4, 2017\)](#)

[Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others \(Nov. 1, 2017\)](#)

[Investor Alert: Celebrity Endorsements \(Nov. 1, 2017\)](#)

[Press Release: SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds \(Sept. 29, 2017\)](#)

[Investor Alert: Public Companies Making ICO-Related Claims \(Aug. 28, 2017\)](#)

[Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO \(July 25, 2017\)](#)

[Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934: The DAO \(July 25, 2017\)](#)

[Investor Bulletin: Initial Coin Offerings \(July 25, 2017\)](#)

[Investor Alert: Bitcoin and Other Virtual Currency-Related Investments \(May 7, 2014\)](#)

[Investor Alert: Ponzi Schemes Using Virtual Currencies \(July 23, 2013\)](#)

## Press Release

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# SEC Halts Alleged Initial Coin Offering Scam

### FOR IMMEDIATE RELEASE

2018-8

*Washington D.C., Jan. 30, 2018* — The Securities and Exchange Commission obtained a court order halting an allegedly fraudulent initial coin offering (ICO) that targeted retail investors to fund what it claimed to be the world’s first “decentralized bank.”

According to the SEC’s complaint, filed in federal district court in Dallas on Jan. 25 and unsealed late yesterday, Dallas-based AriseBank used social media, a celebrity endorsement, and other wide dissemination tactics to raise what it claims to be \$600 million of its \$1 billion goal in just two months.

AriseBank and its co-founders Jared Rice Sr. and Stanley Ford allegedly offered and sold unregistered investments in their purported “AriseCoin” cryptocurrency by depicting AriseBank as a first-of-its-kind decentralized bank offering a variety of consumer-facing banking products and services using more than 700 different virtual currencies. AriseBank’s sales pitch claimed that it developed an algorithmic trading application that automatically trades in various cryptocurrencies.

The SEC alleges that AriseBank falsely stated that it purchased an FDIC-insured bank which enabled it to offer customers FDIC-insured accounts and that it also offered customers the ability to obtain an AriseBank-branded VISA card to spend any of the 700-plus cryptocurrencies. AriseBank also allegedly omitted to disclose the criminal background of key executives.

“We allege that AriseBank and its principals sought to raise hundreds of millions from investors by misrepresenting the company as a first-of-its-kind decentralized bank offering its own cryptocurrency to be used for a broad range of customer products and services. We sought emergency relief to prevent investors from being victimized by what we allege to be an outright scam,” said Stephanie Avakian, Co-Director of the SEC’s Enforcement Division.

“This is the first time the Commission has sought the appointment of a receiver in connection with an ICO fraud. We will use all of our tools and remedies to protect investors from those who engage in fraudulent conduct in the emerging digital securities marketplace,” said Steven Peikin, Co-Director of the SEC’s Enforcement Division.

Shamoil T. Shipchandler, Director of the SEC’s Fort Worth Regional Office, said, “Attempting to conceal what we allege to be fraudulent securities offerings under the veneer of technological terms like ‘ICO’ or ‘cryptocurrency’ will not escape the Commission’s oversight or its efforts to protect investors.”

The court approved an emergency asset freeze over AriseBank, Rice, and Ford and appointed a receiver over AriseBank, including over its digital assets. The SEC intervened to protect the digital assets before they could be dissipated, enabling the receiver to immediately secure various cryptocurrencies held by AriseBank including Bitcoin, Litecoin, Bitshares, Dogecoin, and BitUSD. AriseCoin's public sale began around Dec. 26, 2017, and was originally scheduled to conclude on Jan. 27, 2018, with distribution to investors on Feb. 10, 2018. The SEC seeks preliminary and permanent injunctions, disgorgement of ill-gotten gains plus interest and penalties, and bars against Rice and Ford to prohibit them from serving as officers or directors of a public company or offering digital securities again in the future.

The SEC's investigation was conducted by David Hirsch and supervised by Jessica Magee and Eric Werner in the Fort Worth Regional Office in coordination with the Enforcement Division's Cyber Unit. The litigation is being conducted by Timothy Evans, Christopher Davis, and Mr. Hirsch, and supervised by B. David Fraser. The SEC appreciates the assistance of the Federal Bureau of Investigation, U.S. Attorney's Office for the Northern District of Texas, Federal Deposit Insurance Corporation, U.S. Patent and Trademark Office, and Texas Department of Banking.

Investors in the AriseBank ICO who believe they may be a victim are asked to [report it to the SEC as a tip or complaint](#).

The SEC's Office of Investor Education and Advocacy issued an [Investor Alert](#) in August 2017 warning investors about scams of companies claiming to be engaging in initial coin offerings.

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## More About This Topic

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- [Investor Alert: Public Companies Making ICO-Related Claims](#)

## Related Materials

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- [SEC Complaint](#)

## Public Statement

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# Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: Regulators are Looking at Cryptocurrency

SEC Chairman Jay Clayton

CFTC Chairman J. Christopher Giancarlo

Jan. 25, 2018

***Excerpts from joint op-ed published in Wall Street Journal, Jan. 25, 2018.***

Distributed ledger technology, or DLT, is the advancement that underpins an array of new financial products, including cryptocurrencies and digital payment services. Many have identified DLT as the next great driver of economic efficiency. Some have even compared it to productivity-driving innovations such as the steam engine and personal computer.

Our task, as market regulators, is to set and enforce rules that foster innovation while promoting market integrity and confidence. In recent months, we have seen a wide range of market participants, including retail investors, seeking to invest in DLT initiatives, including through cryptocurrencies and so-called ICOs—initial coin offerings. Experience tells us that while some market participants may make fortunes, the risks to all investors are high. Caution is merited.

A key issue before market regulators is whether our historic approach to the regulation of currency transactions is appropriate for the cryptocurrency markets. Check-cashing and money-transmission services that operate in the U.S. are primarily state-regulated. Many of the internet-based cryptocurrency trading platforms have registered as payment services and are not subject to direct oversight by the SEC or the CFTC. We would support policy efforts to revisit these frameworks and ensure they are effective and efficient for the digital era.

The CFTC and SEC, along with other federal and state regulators and criminal authorities, will continue to work together to bring transparency and integrity to these markets and, importantly, to deter and prosecute fraud and abuse. These markets are new, evolving and international. As such they require us to be nimble and forward-looking; coordinated with our state, federal and international colleagues; and engaged with important stakeholders, including Congress.

[Click here to read the entire op-ed.](#)



## Public Statement

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# Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions

SEC Co-Enforcement Directors Stephanie Avakian and Steven Peikin and  
CFTC Enforcement Director James McDonald

**Jan. 19, 2018**

"When market participants engage in fraud under the guise of offering digital instruments – whether characterized as virtual currencies, coins, tokens, or the like – the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws. The Divisions of Enforcement for the SEC and CFTC will continue to address violations and bring actions to stop and prevent fraud in the offer and sale of digital instruments."





## Public Statement

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# Statement of Chairman Jay Clayton and Commissioners Kara M. Stein and Michael S. Piwowar on "NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution" by NASAA

Chairman Jay Clayton

Commissioner Kara M. Stein

Commissioner Michael S. Piwowar

**Jan. 4, 2018**

We commend the North American Securities Administrators Association (NASAA) on their [release](#) highlighting important issues and concerns related to cryptocurrencies, initial coin offerings (ICOs) and other cryptocurrency-related investment products.

NASAA's release is a timely and thoughtful reminder to Main Street investors to exercise caution. The release recognizes that cryptocurrencies, while touted as replacements for traditional currencies, lack many important characteristics of traditional currencies, including sovereign backing and responsibility, and now are being promoted more as investment opportunities than efficient mediums for exchange.

The NASAA release also reminds investors that when they are offered and sold securities they are entitled to the benefits of state and federal securities laws, and that sellers and other market participants must follow these laws. Unfortunately, it is clear that many promoters of ICOs and others participating in the cryptocurrency-related investment markets are not following these laws. The SEC and state securities regulators are pursuing violations, but we again caution you that, if you lose money, there is a substantial risk that our efforts will not result in a recovery of your investment.

We encourage investors to read NASAA's release and particularly to keep in mind the common red flags of investment fraud that the release reiterates. We also encourage investors to review the SEC investor bulletins, alerts, reports, and statements linked below.

- [SEC Chairman Jay Clayton Statement on Cryptocurrencies and Initial Coin Offerings \(Dec. 11, 2017\)](#)
- [SEC Division of Enforcement and SEC Office of Compliance Inspections and Examinations Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others \(Nov. 1, 2017\)](#)
- [Investor Alert: Public Companies Making ICO-Related Claims \(Aug. 28, 2017\)](#)

- [Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934: The DAO \(July 25, 2017\)](#)
- [Investor Bulletin: Initial Coin Offerings \(July 25, 2017\)](#)
- [Investor Alert: Bitcoin and Other Virtual Currency-Related Investments \(May 7, 2014\)](#)
- [Investor Alert: Ponzi Schemes Using Virtual Currencies \(July 23, 2013\)](#)

## Related Materials

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- [NASAA Statement](#)

## Public Statement

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# Statement on Cryptocurrencies and Initial Coin Offerings

SEC Chairman Jay Clayton

Dec. 11, 2017

The world's social media platforms and financial markets are abuzz about cryptocurrencies and "initial coin offerings" (ICOs). There are tales of fortunes made and dreamed to be made. We are hearing the familiar refrain, "this time is different."

The cryptocurrency and ICO markets have grown rapidly. These markets are local, national and international and include an ever-broadening range of products and participants. They also present investors and other market participants with many questions, some new and some old (but in a new form), including, to list just a few:

- Is the product legal? Is it subject to regulation, including rules designed to protect investors? Does the product comply with those rules?
- Is the offering legal? Are those offering the product licensed to do so?
- Are the trading markets fair? Can prices on those markets be manipulated? Can I sell when I want to?
- Are there substantial risks of theft or loss, including from hacking?

The answers to these and other important questions often require an in-depth analysis, and the answers will differ depending on many factors. This statement provides my general views on the cryptocurrency and ICO markets<sup>[1]</sup> and is directed principally to two groups:

- "Main Street" investors, and
- Market professionals – including, for example, broker-dealers, investment advisers, exchanges, lawyers and accountants – whose actions impact Main Street investors.

### **Considerations for Main Street Investors**

**A number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.**

Investors should understand that to date no initial coin offerings have been registered with the SEC. The SEC also has not to date approved for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies.<sup>[2]</sup> **If any person today tells you otherwise, be especially wary.**

We have issued investor alerts, bulletins and statements on initial coin offerings and cryptocurrency-related investments, including with respect to the marketing of certain offerings and investments by celebrities and others. <sup>[3]</sup> Please take a moment to read them. **If you choose to invest in these products, please ask questions and demand clear answers.** A list of sample questions that may be helpful is attached.

As with any other type of potential investment, if a promoter guarantees returns, if an opportunity sounds too good to be true, or if you are pressured to act quickly, please exercise extreme caution and be aware of the risk that your investment may be lost.

**Please also recognize that these markets span national borders and that significant trading may occur on systems and platforms outside the United States. Your invested funds may quickly travel overseas without your knowledge. As a result, risks can be amplified, including the risk that market regulators, such as the SEC, may not be able to effectively pursue bad actors or recover funds.**

To learn more about these markets and their regulation, please read the “Additional Discussion of Cryptocurrencies, ICOs and Securities Regulation” section below.

### **Considerations for Market Professionals**

I believe that initial coin offerings – whether they represent offerings of securities or not – can be effective ways for entrepreneurs and others to raise funding, including for innovative projects. However, any such activity that involves an offering of securities must be accompanied by the important disclosures, processes and other investor protections that our securities laws require. A change in the structure of a securities offering does not change the fundamental point that when a security is being offered, our securities laws must be followed.<sup>[4]</sup> Said another way, replacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance.

I urge market professionals, including securities lawyers, accountants and consultants, to read closely the investigative report we released earlier this year (the “21(a) Report”)<sup>[5]</sup> and review our subsequent enforcement actions.<sup>[6]</sup> In the 21(a) Report, the Commission applied longstanding securities law principles to demonstrate that a particular token constituted an investment contract and therefore was a security under our federal securities laws. Specifically, we concluded that the token offering represented 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.

Following the issuance of the 21(a) Report, certain market professionals have attempted to highlight utility characteristics of their proposed initial coin offerings in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions appear to elevate form over substance. Merely calling a token a “utility” token or structuring it to provide some utility does not prevent the token from being a security. Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law. **On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities.** I urge you to be guided by the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.

I also caution market participants against promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions. **Selling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of “scalping,” “pump and dump” and other manipulations and frauds.** Similarly, I also caution those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act of 1934.

On cryptocurrencies, I want to emphasize two points. First, while there are cryptocurrencies that do not appear to be securities, simply calling something a “currency” or a currency-based product does not mean that it is not a security. Before launching a cryptocurrency or a product with its value tied to one or more cryptocurrencies, its promoters must either (1) be able to demonstrate that the currency or product is not a security or (2) comply with applicable registration and other requirements under our securities laws. Second, brokers, dealers and other market participants that allow for payments in cryptocurrencies, allow customers to purchase cryptocurrencies on

margin, or otherwise use cryptocurrencies to facilitate securities transactions should exercise particular caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations.<sup>[7]</sup> **As I have stated previously, these market participants should treat payments and other transactions made in cryptocurrency as if cash were being handed from one party to the other.**

### **Additional Discussion of Cryptocurrencies, ICOs and Securities Regulation**

*Cryptocurrencies.* Speaking broadly, cryptocurrencies purport to be items of inherent value (similar, for instance, to cash or gold) that are designed to enable purchases, sales and other financial transactions. They are intended to provide many of the same functions as long-established currencies such as the U.S. dollar, euro or Japanese yen but do not have the backing of a government or other body. Although the design and maintenance of cryptocurrencies differ, proponents of cryptocurrencies highlight various potential benefits and features of them, including (1) the ability to make transfers without an intermediary and without geographic limitation, (2) finality of settlement, (3) lower transaction costs compared to other forms of payment and (4) the ability to publicly verify transactions. Other often-touted features of cryptocurrencies include personal anonymity and the absence of government regulation or oversight. Critics of cryptocurrencies note that these features may facilitate illicit trading and financial transactions, and that some of the purported beneficial features may not prove to be available in practice.

It has been asserted that cryptocurrencies are not securities and that the offer and sale of cryptocurrencies are beyond the SEC's jurisdiction. Whether that assertion proves correct with respect to any digital asset that is labeled as a cryptocurrency will depend on the characteristics and use of that particular asset. In any event, it is clear that, just as the SEC has a sharp focus on how U.S. dollar, euro and Japanese yen transactions affect our securities markets, we have the same interests and responsibilities with respect to cryptocurrencies. This extends, for example, to securities firms and other market participants that allow payments to be made in cryptocurrencies, set up structures to invest in or hold cryptocurrencies, or extend credit to customers to purchase or hold cryptocurrencies.

*Initial Coin Offerings.* Coinciding with the substantial growth in cryptocurrencies, companies and individuals increasingly have been using initial coin offerings to raise capital for their businesses and projects. Typically these offerings involve the opportunity for individual investors to exchange currency such as U.S. dollars or cryptocurrencies in return for a digital asset labeled as a coin or token.

These offerings can take many different forms, and the rights and interests a coin is purported to provide the holder can vary widely. A key question for all ICO market participants: "Is the coin or token a security?" As securities law practitioners know well, the answer depends on the facts. For example, a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.

By and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws. Generally speaking, these laws provide that investors deserve to know what they are investing in and the relevant risks involved.

I have asked the SEC's Division of Enforcement to continue to police this area vigorously and recommend enforcement actions against those that conduct initial coin offerings in violation of the federal securities laws.

### **Conclusion**

We at the SEC are committed to promoting capital formation. The technology on which cryptocurrencies and ICOs are based may prove to be disruptive, transformative and efficiency enhancing. I am confident that developments in fintech will help facilitate capital formation and provide promising investment opportunities for institutional and Main Street investors alike.

I encourage Main Street investors to be open to these opportunities, but to ask good questions, demand clear answers and apply good common sense when doing so. When advising clients, designing products and engaging in transactions, market participants and their advisers should thoughtfully consider our laws, regulations and guidance, as well as our principles-based securities law framework, which has served us well in the face of new developments for more than 80 years. I also encourage market participants and their advisers to engage with the SEC staff to aid in their analysis under the securities laws. Staff providing assistance on these matters remain available at [FinTech@sec.gov](mailto:FinTech@sec.gov).

**Sample Questions for Investors Considering a Cryptocurrency or ICO  
Investment Opportunity**<sup>[8]</sup>

- Who exactly am I contracting with?
  - Who is issuing and sponsoring the product, what are their backgrounds, and have they provided a full and complete description of the product? Do they have a clear written business plan that I understand?
  - Who is promoting or marketing the product, what are their backgrounds, and are they licensed to sell the product? Have they been paid to promote the product?
  - Where is the enterprise located?
- Where is my money going and what will it be used for? Is my money going to be used to “cash out” others?
- What specific rights come with my investment?
- Are there financial statements? If so, are they audited, and by whom?
- Is there trading data? If so, is there some way to verify it?
- How, when, and at what cost can I sell my investment? For example, do I have a right to give the token or coin back to the company or to receive a refund? Can I resell the coin or token, and if so, are there any limitations on my ability to resell?
- If a digital wallet is involved, what happens if I lose the key? Will I still have access to my investment?
- If a blockchain is used, is the blockchain open and public? Has the code been published, and has there been an independent cybersecurity audit?
- Has the offering been structured to comply with the securities laws and, if not, what implications will that have for the stability of the enterprise and the value of my investment?
- What legal protections may or may not be available in the event of fraud, a hack, malware, or a downturn in business prospects? Who will be responsible for refunding my investment if something goes wrong?
- If I do have legal rights, can I effectively enforce them and will there be adequate funds to compensate me if my rights are violated?

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[1] This statement is my own and does not reflect the views of any other Commissioner or the Commission. This statement is not, and should not be taken as, a definitive discussion of applicable law, all the relevant risks with respect to these products, or a statement of my position on any particular product. Additionally, this statement is not a comment on any particular submission, in the form of a proposed rule change or otherwise, pending before the Commission.

[2] The CFTC has designated bitcoin as a commodity. Fraud and manipulation involving bitcoin traded in interstate commerce are appropriately within the purview of the CFTC, as is the regulation of commodity futures tied directly to bitcoin. That said, products linked to the value of underlying digital assets, including bitcoin and other cryptocurrencies, may be structured as securities products subject to registration under the Securities Act of 1933 or the Investment Company Act of 1940.

[3] Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others (Nov. 1, 2017), *available at* <https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos>; Investor Alert: Public Companies Making ICO-Related Claims (Aug. 28, 2017), *available at* [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia\\_icorelatedclaims](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_icorelatedclaims); Investor Bulletin: Initial Coin Offerings (July 25, 2017), *available at* [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings); Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014), *available at* <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency>; Investor Alert: Ponzi Schemes Using Virtual Currencies (July 23, 2013), *available at* [https://www.sec.gov/investor/alerts/ia\\_virtualcurrencies.pdf](https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf).

[4] It is possible to conduct an ICO without triggering the SEC's registration requirements. For example, just as with a Regulation D exempt offering to raise capital for the manufacturing of a physical product, an initial coin offering that is a security can be structured so that it qualifies for an applicable exemption from the registration requirements.

[5] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), *available at* <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

[6] Press Release, Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017), *available at* <https://www.sec.gov/news/press-release/2017-227>; Press Release, SEC Emergency Action Halts ICO Scam (Dec. 4, 2017), *available at* <https://www.sec.gov/news/press-release/2017-219>; Press Release, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017), *available at* <https://www.sec.gov/news/press-release/2017-185-0>.

[7] I am particularly concerned about market participants who extend to customers credit in U.S. dollars – a relatively stable asset – to enable the purchase of cryptocurrencies, which, in recent experience, have proven to be a more volatile asset.

[8] This is not intended to represent an exhaustive list. Please also see the SEC investor bulletins, alerts and statements referenced in note 3 of this statement.



## Press Release

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# Company Halts ICO After SEC Raises Registration Concerns

### FOR IMMEDIATE RELEASE

2017-227

*Washington D.C., Dec. 11, 2017* — A California-based company selling digital tokens to investors to raise capital for its blockchain-based food review service halted its initial coin offering (ICO) after being contacted by the Securities and Exchange Commission, and agreed to an order in which the Commission found that its conduct constituted unregistered securities offers and sales.

According to the SEC's order, before any tokens were delivered to investors, Munchee Inc. refunded investor proceeds after the SEC intervened. Munchee was seeking \$15 million in capital to improve an existing iPhone app centered on restaurant meal reviews and create an "ecosystem" in which Munchee and others would buy and sell goods and services using the tokens. The company communicated through its website, a white paper, and other means that it would use the proceeds to create the ecosystem, including eventually paying users in tokens for writing food reviews and selling both advertising to restaurants and "in-app" purchases to app users in exchange for tokens.

According to the order, in the course of the offering, the company and other promoters emphasized that investors could expect that efforts by the company and others would lead to an increase in value of the tokens. The company also emphasized it would take steps to create and support a secondary market for the tokens. Because of these and other company activities, investors would have had a reasonable belief that their investment in tokens could generate a return on their investment. As the SEC has said in the [DAO Report of Investigation](#), a token can be a security based on the long-standing facts and circumstances test that includes assessing whether investors' profits are to be derived from the managerial and entrepreneurial efforts of others.

"We will continue to scrutinize the market vigilantly for improper offerings that seek to sell securities to the general public without the required registration or exemption," said Stephanie Avakian, Co-Director of the SEC's Enforcement Division. "In deciding not to impose a penalty, the Commission recognized that the company stopped the ICO quickly, immediately returned the proceeds before issuing tokens, and cooperated with the investigation."

"Our primary focus remains investor protection and making sure that investors are being offered investment opportunities with all the information and disclosures required under the federal securities laws," said Steven Peikin, Co-Director of the SEC's Enforcement Division.

Munchee consented to the SEC's cease-and-desist order without admitting or denying the findings.

The SEC's new Cyber Unit is focused on misconduct involving distributed ledger technology and initial coin offerings, the spread of false information through electronic and social media, brokerage account takeovers, hacking to obtain nonpublic information, and threats to trading platforms. The SEC also has a Distributed Ledger Technology Working Group that focuses on various emerging applications of distributed ledger technology in the financial industry.

The SEC's investigation was conducted by the Enforcement Division's Cyber Unit and Complex Financial Instruments Unit, including Jeff Leasure, Brent Mitchell and James Murtha. The case was supervised by Robert Cohen, Reid Muoio, and Valerie Szczepanik.

The SEC's Office of Investor Education and Advocacy issued [an Investor Bulletin](#) in July 2017 to make investors aware of the potential risks of participating in initial coin offerings.

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## Related Materials

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- [SEC Order](#)

## Press Release

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# SEC Emergency Action Halts ICO Scam

### FOR IMMEDIATE RELEASE

2017-219

*Washington D.C., Dec. 4, 2017* — The Securities and Exchange Commission today announced it obtained an emergency asset freeze to halt a fast-moving Initial Coin Offering (ICO) fraud that raised up to \$15 million from thousands of investors since August by falsely promising a 13-fold profit in less than a month.

The SEC filed charges against a recidivist Quebec securities law violator, Dominic Lacroix, and his company, PlexCorps. The Commission's complaint, filed in federal court in Brooklyn, New York, alleges that Lacroix and PlexCorps marketed and sold securities called PlexCoin on the internet to investors in the U.S. and elsewhere, claiming that investments in PlexCoin would yield a 1,354 percent profit in less than 29 days. The SEC also charged Lacroix's partner, Sabrina Paradis-Royer, in connection with the scheme.

Today's charges are the first filed by the SEC's new Cyber Unit. The unit was created in September to focus the Enforcement Division's cyber-related expertise on misconduct involving distributed ledger technology and initial coin offerings, the spread of false information through electronic and social media, hacking and threats to trading platforms.

"This first Cyber Unit case hits all of the characteristics of a full-fledged cyber scam and is exactly the kind of misconduct the unit will be pursuing," said Robert Cohen, Chief of the Cyber Unit. "We acted quickly to protect retail investors from this initial coin offering's false promises."

Based on its filing, the SEC obtained an emergency court order to freeze the assets of PlexCorps, Lacroix, and Paradis-Royer.

The SEC's complaint charges Lacroix, Paradis-Royer and PlexCorps with violating the anti-fraud provisions, and Lacroix and PlexCorps with violating the registration provision, of the U.S. federal securities laws. The complaint seeks permanent injunctions, disgorgement plus interest and penalties. For Lacroix, the SEC also seeks an officer-and-director bar and a bar from offering digital securities against Lacroix and Paradis-Royer.

The Commission's investigation was conducted by Daphna A. Waxman, David H. Tutor, and Jorge G. Tenreiro of the New York Regional Office and the Cyber Unit, with assistance from the agency's Office of International Affairs. The case is being supervised by Valerie A. Szczepanik and Mr. Cohen. The Commission appreciates the assistance of Quebec's Autorité Des Marchés Financiers.

The SEC's Office of Investor Education and Advocacy issued an Investor Alert in August 2017 warning investors about scams of companies claiming to be engaging in initial coin

offerings: <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making-ico-related>.

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## Related Materials

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- [SEC Complaint](#)

## Public Statement

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# Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others

## SEC Division of Enforcement and SEC Office of Compliance Inspections and Examinations

**Nov. 1, 2017**

Celebrities and others are using social media networks to encourage the public to purchase stocks and other investments. These endorsements may be unlawful if they do not disclose the nature, source, and amount of any compensation paid, directly or indirectly, by the company in exchange for the endorsement. The SEC's Enforcement Division and Office of Compliance Inspections and Examinations encourage investors to be wary of investment opportunities that sound too good to be true. We encourage investors to research potential investments rather than rely on paid endorsements from artists, sports figures, or other icons.

Celebrities and others have recently promoted investments in Initial Coin Offerings (ICOs). In the SEC's Report of Investigation concerning The DAO, the Commission warned that virtual tokens or coins sold in ICOs may be securities, and those who offer and sell securities in the United States must comply with the federal securities laws. Any celebrity or other individual who promotes a virtual token or coin that is a security must disclose the nature, scope, and amount of compensation received in exchange for the promotion. A failure to disclose this information is a violation of the anti-touting provisions of the federal securities laws. Persons making these endorsements may also be liable for potential violations of the anti-fraud provisions of the federal securities laws, for participating in an unregistered offer and sale of securities, and for acting as unregistered brokers. The SEC will continue to focus on these types of promotions to protect investors and to ensure compliance with the securities laws.

Investors should note that celebrity endorsements may appear unbiased, but instead may be part of a paid promotion. Investment decisions should not be based solely on an endorsement by a promoter or other individual. Celebrities who endorse an investment often do not have sufficient expertise to ensure that the investment is appropriate and in compliance with federal securities laws. Conduct research before making investments, including in ICOs. If you are relying on a particular endorsement or recommendation, learn more regarding the relationship between the promoter and the company and consider whether the recommendation is truly independent or a paid promotion. For more information, see an Investor Alert that the SEC's Office of Investor Education and Advocacy issued today regarding celebrity endorsements.

### **Additional Resources**

[Investor Bulletin: Initial Coin Offerings](#)

[Investor Alert: Public Companies Making ICO-Related Claims](#)

[Investor Alert: Social Media and Investing – Avoiding Fraud](#)



**Investor.gov**U.S. SECURITIES AND  
EXCHANGE COMMISSION

Información en Español



# INVESTOR ALERT: CELEBRITY ENDORSEMENTS

**11/01/2017**

*The SEC's Office of Investor Education and Advocacy (OIEA) is warning investors not to make investment decisions based solely on celebrity endorsements.*

Celebrities, from movie stars to professional athletes, can be found on TV, radio, and social media endorsing a wide variety of products and services – sometimes even including investment opportunities. But a celebrity endorsement does not mean that an investment is legitimate or that it is appropriate for all investors. **It is never a good idea to make an investment decision just because someone famous says a product or service is a good investment.**

Celebrities, like anyone else, can be lured into participating (even unknowingly) in a fraudulent scheme. Also, celebrities are sometimes linked to products or services without their consent so the celebrity may not even have endorsed the investment.

Even if the celebrity endorsement and the investment opportunity are genuine, the investment may not be a good one for you. Before investing, always do your research, including these three steps:

- ▶ Check out the background, including registration or license status, of anyone recommending or selling an investment, using the search tool on [Investor.gov](https://www.investor.gov/) (<https://www.investor.gov/>);
- ▶ Learn about the company's finances, organization, and business prospects by carefully reading any prospectus and the company's latest financial reports, which may be available through the SEC's [EDGAR](http://www.sec.gov/edgar/quickedgar.htm) (<http://www.sec.gov/edgar/quickedgar.htm>) database; and
- ▶ Consider the investment's potential costs and fees, risks, and benefits in light of your own investment goals, risk tolerance, investment horizon, net worth, existing investments and assets, debt, and tax considerations.

Never make an investment decision based solely on a celebrity endorsement, or other information you receive through social media, investment newsletters, online advertisements, email, investment research websites, internet chat rooms, direct mail, newspapers, magazines, television, or radio.

## Additional Resources

[Investor Alert: Beware of False or Exaggerated Credentials](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-false-or-exaggerated) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-false-or-exaggerated>)

[Investor Alert: Beware of Stock Recommendations on Investment Research Websites](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations>)

[Investor Alert: Public Companies Making ICO-Related Claims](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making-ico-related) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making-ico-related>)

Report [possible securities fraud](http://www.sec.gov/complaint/tipscomplaint.shtml) (<http://www.sec.gov/complaint/tipscomplaint.shtml>) to the SEC. [Ask a question or report a problem](https://www.sec.gov/complaint/question.shtml) (<https://www.sec.gov/complaint/question.shtml>) concerning your investments, your investment account or a financial professional.

Visit [Investor.gov](http://www.investor.gov/) (<http://www.investor.gov/>), the SEC's website for individual investors.

Receive Investor Alerts and Bulletins from the Office of Investor Education and Advocacy ("OIEA") by [email](http://www.sec.gov/news/press/subscribe_updates.htm) ([http://www.sec.gov/news/press/subscribe\\_updates.htm](http://www.sec.gov/news/press/subscribe_updates.htm)) or [RSS feed](http://www.sec.gov/rss/investor/alertsandbulletins.xml) (<http://www.sec.gov/rss/investor/alertsandbulletins.xml>). Follow OIEA on [Twitter](http://www.twitter.com/SEC_Investor_Ed) ([http://www.twitter.com/SEC\\_Investor\\_Ed](http://www.twitter.com/SEC_Investor_Ed)) @SEC\_Investor\_Ed. Like OIEA on [Facebook](http://www.facebook.com/secinvestoreducation) (<http://www.facebook.com/secinvestoreducation>) at facebook.com/secinvestoreducation.

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The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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## Press Release

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# SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds

### FOR IMMEDIATE RELEASE

2017-185

*Washington D.C., Sept. 29, 2017* — The Securities and Exchange Commission today charged a businessman and two companies with defrauding investors in a pair of so-called initial coin offerings (ICOs) purportedly backed by investments in real estate and diamonds.

The SEC alleges that Maksim Zaslavskiy and his companies have been selling unregistered securities, and the digital tokens or coins being peddled don't really exist. According to the SEC's complaint, investors in REcoin Group Foundation and DRC World (also known as Diamond Reserve Club) have been told they can expect sizeable returns from the companies' operations when neither has any real operations.

Zaslavskiy allegedly touted REcoin as "The First Ever Cryptocurrency Backed by Real Estate." Alleged misstatements to REcoin investors included that the company had a "team of lawyers, professionals, brokers, and accountants" that would invest REcoin's ICO proceeds into real estate when in fact none had been hired or even consulted. Zaslavskiy and REcoin allegedly misrepresented they had raised between \$2 million and \$4 million from investors when the actual amount is approximately \$300,000.

According to the SEC's complaint, Zaslavskiy carried his scheme over to Diamond Reserve Club, which purportedly invests in diamonds and obtains discounts with product retailers for individuals who purchase "memberships" in the company. Despite their representations to investors, the SEC alleges that Zaslavskiy and Diamond have not purchased any diamonds nor engaged in any business operations. Yet they allegedly continue to solicit investors and raise funds as though they have.

The SEC obtained an emergency court order to freeze the assets of Zaslavskiy and his companies.

The SEC's Office of Investor Education and Advocacy recently issued an investor alert warning about the risks of ICOs.

"Investors should be wary of companies touting ICOs as a way to generate outsized returns," said Andrew M. Calamari, Director of the SEC's New York Regional Office. "As alleged in our complaint, Zaslavskiy lured investors with false promises of sizeable returns from novel technology."

The SEC's complaint, filed in federal district court in Brooklyn, N.Y., charges Zaslavskiy, REcoin, and Diamond with violations of the anti-fraud and registration provisions of the federal securities laws. The

complaint seeks permanent injunctions and disgorgement plus interest and penalties. For Zaslavskiy, the SEC also seeks an officer-and-director bar and a bar from participating in any offering of digital securities.

The SEC's investigation, which is continuing, has been conducted by Jorge Tenreiro, Pamela Sawhney and Valerie A. Szczepanik. The case is being supervised by Lara S. Mehraban. The SEC encourages victims of the alleged fraud to contact Ms. Szczepanik at (212) 336-1100.

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## Related Materials

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- [SEC complaint](#)


**Investor.gov**
**U.S. SECURITIES AND  
EXCHANGE COMMISSION**

Información en Español



# INVESTOR ALERT: PUBLIC COMPANIES MAKING ICO-RELATED CLAIMS

**08/28/2017**

*The SEC's Office of Investor Education and Advocacy is warning investors about potential scams involving stock of companies claiming to be related to, or asserting they are engaging in, Initial Coin Offerings (or ICOs). Fraudsters often try to use the lure of new and emerging technologies to convince potential victims to invest their money in scams. These frauds include "pump-and-dump" and market manipulation schemes involving publicly traded companies that claim to provide exposure to these new technologies.*

## Recent Trading Suspensions

Developers, businesses, and individuals increasingly are using ICOs – also called coin or token launches or sales – to raise capital. There has been media attention regarding this form of capital raising. While these activities may provide fair and lawful investment opportunities, there may be situations in which companies are publicly announcing ICO or coin/token related events to affect the price of the company's common stock.

The SEC may suspend trading in a stock when the SEC is of the opinion that a suspension is required to protect investors and the public interest. Circumstances that might lead to a trading suspension include:

- ▶ A lack of current, accurate, or adequate information about the company – for example, when a company has not filed any periodic reports for an extended period;
- ▶ Questions about the accuracy of publicly available information, including in company press releases and reports, about the company's current operational status and financial condition; or
- ▶ Questions about trading in the stock, including trading by insiders, potential market manipulation, and the ability to clear and settle transactions in the stock.

The SEC recently issued several trading suspensions on the common stock of certain issuers who made claims regarding their investments in ICOs or touted coin/token related news. The companies affected by trading suspensions include [First Bitcoin Capital Corp.](https://www.sec.gov/litigation/suspensions/2017/34-81474.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-81474.pdf>), [CIAO Group](https://www.sec.gov/litigation/suspensions/2017/34-81367-o.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-81367-o.pdf>), [Strategic Global](https://www.sec.gov/litigation/suspensions/2017/34-81314-o.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-81314-o.pdf>), and [Sunshine Capital](https://www.sec.gov/litigation/suspensions/2017/34-80435-o.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-80435-o.pdf>).

Investors should be very cautious in considering an investment in a stock following a trading suspension. A trading suspension is one warning sign of possible [microcap fraud](https://investor.gov/investing-basics/avoiding-fraud/types-fraud/microcap-fraud/) (<https://investor.gov/investing-basics/avoiding-fraud/types-fraud/microcap-fraud/>) ([microcap stocks](https://investor.gov/additional-resources/general-resources/glossary/microcap-stock/) (<https://investor.gov/additional-resources/general-resources/glossary/microcap-stock/>), some of which are [penny stocks](http://www.sec.gov/answers/penny.htm) (<http://www.sec.gov/answers/penny.htm>) and/or nanocap stocks, tend to be low priced and trade in low volumes). If current, reliable information about a company and its stock is not available, investors should consider seriously the risk of making an investment in the company's stock. *For*

more on trading suspensions, see our [Investor Bulletin: Trading in Stock after an SEC Trading Suspension – Be Aware of the Risks](https://investor.gov/news-alerts/investor-bulletins/trading-stock-after-sec-trading-suspension-be-aware-risks) (<https://investor.gov/news-alerts/investor-bulletins/trading-stock-after-sec-trading-suspension-be-aware-risks>).

## Pump-and-Dump and Market Manipulations

One way fraudsters seek to profit is by engaging in [market manipulation](https://www.sec.gov/fast-answers/answerstmanipulhtm.html) (<https://www.sec.gov/fast-answers/answerstmanipulhtm.html>), such as by spreading false and misleading information about a company (typically microcap stocks) to affect the stock's share price. They may spread stock rumors in different ways, including on company websites, press releases, email spam, and posts on social media, online bulletin boards, and chat rooms. The false or misleading rumors may be positive or negative.

For example, [“pump-and-dump”](https://investor.gov/additional-resources/general-resources/glossary/pump-dump) (<https://investor.gov/additional-resources/general-resources/glossary/pump-dump>) schemes involve the effort to manipulate a stock's share price or trading volume by touting the company's stock through false and misleading statements to the marketplace. Pump-and-dump schemes often occur on the Internet where it is common to see messages posted that urge readers to buy a stock quickly or to sell before the price goes down, or a promoter will call using the same sort of pitch. In reality, the author of the messages may be a company insider or paid promoter who stands to gain by selling their shares after the stock price is “pumped” up by the buying frenzy they create. Once these fraudsters “dump” their shares for a profit and stop hyping the stock, the price typically falls, and investors lose their money. *Learn more about these schemes in our [Updated Investor Alert: Fraudulent Stock Promotions](https://investor.gov/news-alerts/investor-alerts/investor-alert-fraudulent-stock-promotions)* (<https://investor.gov/news-alerts/investor-alerts/investor-alert-fraudulent-stock-promotions>).

## Tips for Investors

- ▶ Always research a company before buying its stock, especially following a trading suspension. Consider the company's finances, organization, and business prospects. This type of information often is included in filings that a company makes with the SEC, which are available for free and can be found in the Commission's [EDGAR filing system](https://www.sec.gov/edgar.shtml) (<https://www.sec.gov/edgar.shtml>).
- ▶ Some companies are not required to file reports with the SEC. These are known as “non-reporting” companies. Investors should be aware of the risks of trading the stock of such companies, as there may not be current and accurate information that would allow investors to make an informed investment decision.
- ▶ Investors should also do their own research and be aware that information from online blogs, social networking sites, and even a company's own website may be inaccurate and potentially intentionally misleading.
- ▶ Be especially cautious regarding stock promotions, including related to new technologies such as ICOs. Look out for these warning signs of possible ICO-related fraud:
  - Company that has common stock trading claims that its ICO is “SEC-compliant” without explaining how the offering is in compliance with the securities laws; or
  - Company that has common stock trading also purports to raise capital through an ICO or take on ICO-related business described in vague or nonsensical terms or using undefined technical or legal jargon.
- ▶ Look out for these warning signs of possible microcap fraud:
  - SEC suspended public trading of the security or other securities promoted by the same promoter;
  - Increase in stock price or trading volume happening at the same time as the promotional activity;
  - Press releases or promotional activity announcing events that ultimately do not happen (e.g., multiple announcements of preliminary deals or agreements; announcements of deals with unnamed partners; announcements using hyperbolic language);
  - Company has no real business operations (few assets, or minimal gross revenues);

- Company issues a lot of shares without a corresponding increase in the company's assets; and
- Frequent changes in company name, management, or type of business.

## Additional Resources

[Investor Bulletin: Initial Coin Offerings](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings>).

[Updated Investor Alert: Social Media and Investing -- Stock Rumors](https://investor.gov/news-alerts/investor-alerts/updated-investor-alert-social-media-investing-stock-rumors) (<https://investor.gov/news-alerts/investor-alerts/updated-investor-alert-social-media-investing-stock-rumors>).

[Investor Alert: Be Aware of Stock Recommendations On Investment Research Websites](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations>).

[Report possible securities fraud to the SEC](https://www.sec.gov/complaint/tipscomplaint.shtml) (<https://www.sec.gov/complaint/tipscomplaint.shtml>). [Report a problem or ask the SEC a question](http://www.sec.gov/complaint/question.shtml) (<http://www.sec.gov/complaint/question.shtml>). Visit [Investor.gov](https://www.investor.gov/) (<https://www.investor.gov/>), the SEC's website for individual investors.

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The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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## Public Statement

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# Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO

## Divisions of Corporation Finance and Enforcement

July 25, 2017

### Emerging Technologies and the Federal Securities Laws

Distributed ledger and other emerging technologies have the potential to influence and improve the capital markets and the financial services industry. Interest in and funding for these technologies appears to be growing at a rapid pace. We welcome and encourage the appropriate use of technology to facilitate capital formation and provide investors with new investment opportunities. We are particularly hopeful that innovation in this area will facilitate fair and efficient capital raisings for small businesses. We are also mindful of our obligation to protect investors and recognize that new technologies can offer opportunities for misconduct and abuse.

A fundamental tenet of our regulatory framework is that an offer or sale of securities in the United States must comply with the federal securities laws. This approach has been critical to maintaining market integrity and fostering investor protection for over 80 years, including through various changes in technology. In this regard, the issue of whether a particular investment opportunity involves the offer or sale of a security — regardless of the terminology or technology used in the transaction — depends on the facts and circumstances, including the economic realities and structure of the enterprise.

### Report of Investigation — DAO Tokens are Securities

Today, the Commission issued a Report of Investigation (“Report”) relating to an offering by The DAO — a decentralized autonomous organization that used distributed ledger or blockchain technology to operate as a “virtual” entity. The DAO sold tokens representing interests in its enterprise to investors in exchange for payment with virtual currency. Investors could hold these tokens as an investment with certain voting and ownership rights or could sell them on web-based secondary market platforms. Based on the facts and circumstances of this offering, the Commission, as explained in the Report, determined that the DAO tokens are securities.

Sponsors involved in an exchange of something of value for an interest in a digital or other novel form for storing value should carefully consider whether they are creating an investment arrangement that constitutes a security. The definition of a security under the federal securities laws is broad, covering traditional notions of a security, such as a stock or bond, as well as novel products or instruments where value may be represented and transferred in digital form. A hallmark of a security is an investment of money or value in a business or operation where the investor has a reasonable expectation of profits based on the efforts of others.

A market participant engaged in offering an investment opportunity that constitutes a security must either register the offer and sale of the security with the Commission or structure it so that it qualifies for an exemption from registration. Market participants in this area must also consider other aspects of the securities laws, such as

whether a platform facilitating transactions in its securities is operating as an exchange, whether the entity offering and selling the security could be an investment company, and whether anyone providing advice about an investment in the security could be an investment adviser. Structuring an offering so that it involves digital instruments of value or operates using a distributed ledger or blockchain does not remove that activity from the requirements of the federal securities laws.

## Consultation with Securities Counsel and the Staff

Although some of the detailed aspects of the federal securities laws and regulations embody more traditional forms of offerings or corporate organizations, these laws have a principles-based framework that can readily adapt to new types of technologies for creating and distributing securities. We encourage market participants who are employing new technologies to form investment vehicles or distribute investment opportunities to consult with securities counsel to aid in their analysis of these issues and to contact our staff, as needed, for assistance in analyzing the application of the federal securities laws.

In particular, staff providing assistance on these matters can be reached at [FinTech@sec.gov](mailto:FinTech@sec.gov).

## Investors Should Be Mindful of Risks Associated with New Technologies, Including Risks of Fraud

Finally, we recognize that new technologies also present new opportunities for bad actors to engage in fraudulent schemes, including old schemes under new names and using new terminology. We urge the investing public to be mindful of traditional “red flags” when making any investment decision, including: deals that sound too good to be true; promises of high returns with little or no risk; high-pressure sales tactics; and working with unregistered or unlicensed sellers. In that regard, the SEC’s website for individual investors, Investor.gov, has a number of relevant resources — including an Investor Bulletin that the SEC’s Office of Investor Education and Advocacy issued today regarding Initial Coin Offerings.

# SECURITIES AND EXCHANGE COMMISSION

## SECURITIES EXCHANGE ACT OF 1934

Release No. 81207 / July 25, 2017

### Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO

#### I. Introduction and Summary

The United States Securities and Exchange Commission's ("Commission") Division of Enforcement ("Division") has investigated whether The DAO, an unincorporated organization; Slock.it UG ("Slock.it"), a German corporation; Slock.it's co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.

As described more fully below, The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO was created by Slock.it and Slock.it's co-founders, with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ("Platforms") that supported secondary trading in the DAO Tokens.

After DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO's code to steal approximately one-third of The DAO's assets. Slock.it's co-founders and others responded by creating a work-around whereby DAO Token holders could opt to have their investment returned to them, as described in more detail below.

The investigation raised questions regarding the application of the U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").<sup>1</sup> The Commission deems it appropriate and in the public interest to issue this report of investigation ("Report") pursuant to

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<sup>1</sup> This Report does not analyze the question whether The DAO was an "investment company," as defined under Section 3(a) of the Investment Company Act of 1940 ("Investment Company Act"), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.



Section 21(a) of the Exchange Act<sup>2</sup> to advise those who would use a Decentralized Autonomous Organization (“DAO Entity”), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws. All securities offered and sold in the United States must be registered with the Commission or must qualify for an exemption from the registration requirements. In addition, any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.

This 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,”<sup>3</sup> or computer code, does not remove conduct from the purview of the U.S. federal securities laws.<sup>4</sup> This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.

## II. Facts

### A. Background

From April 30, 2016 through May 28, 2016, The DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million Ether (“ETH”), a

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<sup>2</sup> Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to “publish information concerning any such violations.” This Report does not constitute an adjudication of any fact or issue addressed herein, nor does it make any findings of violations by any individual or entity. The facts discussed in Section II, *infra*, are matters of public record or based on documentary records. We are publishing this Report on the Commission’s website to ensure that all market participants have concurrent and equal access to the information contained herein.

<sup>3</sup> Computer scientist Nick Szabo described a “smart contract” as:

a computerized transaction protocol that executes terms of a contract. The general objectives of smart contract design are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs.

See Nick Szabo, *Smart Contracts*, 1994, <http://www.virtualschool.edu/mon/Economics/SmartContracts.html>.

<sup>4</sup> See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (“[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as ‘investment contracts,’ or as ‘any interest or instrument commonly known as a ‘security’.”); see also *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (“Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”).

virtual currency<sup>5</sup> used on the Ethereum Blockchain.<sup>6</sup> As of the time the offering closed, the total ETH raised by The DAO was valued in U.S. Dollars (“USD”) at approximately \$150 million.

The concept of a DAO Entity is memorialized in a document (the “White Paper”), authored by Christoph Jentzsch, the Chief Technology Officer of Slock.it, a “Blockchain and IoT [(internet-of-things)] solution company,” incorporated in Germany and co-founded by Christoph Jentzsch, Simon Jentzsch (Christoph Jentzsch’s brother), and Stephan Tual (“Tual”).<sup>7</sup> The White Paper purports to describe “the first implementation of a [DAO Entity] code to automate organizational governance and decision making.”<sup>8</sup> The White Paper posits that a DAO Entity “can be used by individuals working together collaboratively outside of a traditional corporate form. It can also be used by a registered corporate entity to automate formal governance rules contained in corporate bylaws or imposed by law.” The White Paper proposes an entity—a DAO Entity—that would use smart contracts to attempt to solve governance issues it described as inherent in traditional corporations.<sup>9</sup> As described, a DAO Entity purportedly would supplant traditional mechanisms of corporate governance and management with a blockchain such that contractual terms are “formalized, automated and enforced using software.”<sup>10</sup>

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<sup>5</sup> The Financial Action Task Force defines “virtual currency” as:

a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. “real currency,” “real money,” or “national currency”), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.

*FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks*, FINANCIAL ACTION TASK FORCE (June 2014), <http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>.

<sup>6</sup> Ethereum, developed by the Ethereum Foundation, a Swiss nonprofit organization, is a decentralized platform that runs smart contracts on a blockchain known as the Ethereum Blockchain.

<sup>7</sup> Christoph Jentzsch released the final draft of the White Paper on or around March 23, 2016. He introduced his concept of a DAO Entity as early as November 2015 at an Ethereum Developer Conference in London, as a medium to raise funds for Slock.it, a German start-up he co-founded in September 2015. Slock.it purports to create technology that embeds smart contracts that run on the Ethereum Blockchain into real-world devices and, as a result, for example, permits anyone to rent, sell or share physical objects in a decentralized way. See SLOCK.IT, <https://slock.it/>.

<sup>8</sup> Christoph Jentzsch, *Decentralized Autonomous Organization to Automate Governance Final Draft – Under Review*, <https://download.slock.it/public/DAO/WhitePaper.pdf>.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* The White Paper contained the following statement:

A word of caution, at the outset: the legal status of [DAO Entities] remains the subject of active and vigorous debate and discussion. Not everyone shares the same definition. Some have said that [DAO Entities] are autonomous code and can operate independently of legal systems; others

## B. The DAO

“The DAO” is the “first generation” implementation of the White Paper concept of a DAO Entity, and it began as an effort to create a “crowdfunding contract” to raise “funds to grow [a] company in the crypto space.”<sup>11</sup> In November 2015, at an Ethereum Developer Conference in London, Christoph Jentzsch described his proposal for The DAO as a “for-profit DAO [Entity],” where participants would send ETH (a virtual currency) to The DAO to purchase DAO Tokens, which would permit the participant to vote and entitle the participant to “rewards.”<sup>12</sup> Christoph Jentzsch likened this to “buying shares in a company and getting ... dividends.”<sup>13</sup> The DAO was to be “decentralized” in that it would allow for voting by investors holding DAO Tokens.<sup>14</sup> All funds raised were to be held at an Ethereum Blockchain “address” associated with The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO’s anticipated earnings from the projects it funded.<sup>15</sup> The DAO was intended to be “autonomous” in that project proposals were in the form of smart contracts that exist on the Ethereum Blockchain and the votes were administered by the code of The DAO.<sup>16</sup>

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have said that [DAO Entities] must be owned or operate[d] by humans or human created entities. There will be many use cases, and the DAO [Entity] code will develop over time. Ultimately, how a DAO [Entity] functions and its legal status will depend on many factors, including how DAO [Entity] code is used, where it is used, and who uses it. This paper does not speculate about the legal status of [DAO Entities] worldwide. This paper is not intended to offer legal advice or conclusions. Anyone who uses DAO [Entity] code will do so at their own risk.

*Id.*

<sup>11</sup> Christoph Jentzsch, *The History of the DAO and Lessons Learned*, SLOCK.IT BLOG (Aug. 24, 2016), <https://blog.slock.it/the-history-of-the-dao-and-lessons-learned-d06740f8cfa5#.5o62zo8uv>. Although The DAO has been described as a “crowdfunding contract,” The DAO would not have met the requirements of Regulation Crowdfunding, adopted under Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 (providing an exemption from registration for certain crowdfunding), because, among other things, it was not a broker-dealer or a funding portal registered with the SEC and the Financial Industry Regulatory Authority (“FINRA”). See *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC (Apr. 5, 2017), <https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm>; *Updated Investor Bulletin: Crowdfunding for Investors*, SEC (May 10, 2017), [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_crowdfunding-.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html).

<sup>12</sup> See Slockit, *Slock.it DAO demo at Devcon1: IoT + Blockchain*, YOUTUBE (Nov. 13, 2015), <https://www.youtube.com/watch?v=49wHQoJxYPo>.

<sup>13</sup> *Id.*

<sup>14</sup> See Jentzsch, *supra* note 8.

<sup>15</sup> *Id.* In theory, there was no limitation on the type of project that could be proposed. For example, proposed “projects” could include, among other things, projects that would culminate in the creation of products or services that DAO Token holders could use or charge others for using.

<sup>16</sup> *Id.*

On or about April 29, 2016, Slock.it deployed The DAO code on the Ethereum Blockchain, as a set of pre-programmed instructions.<sup>17</sup> This code was to govern how The DAO was to operate.

To promote The DAO, Slock.it's co-founders launched a website ("The DAO Website"). The DAO Website included a description of The DAO's intended purpose: "To blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code."<sup>18</sup> The DAO Website also described how The DAO operated, and included a link through which DAO Tokens could be purchased. The DAO Website also included a link to the White Paper, which provided detailed information about a DAO Entity's structure and its source code and, together with The DAO Website, served as the primary source of promotional materials for The DAO. On The DAO Website and elsewhere, Slock.it represented that The DAO's source code had been reviewed by "one of the world's leading security audit companies" and "no stone was left unturned during those five whole days of security analysis."<sup>19</sup>

Slock.it's co-founders also promoted The DAO by soliciting media attention and by posting almost daily updates on The DAO's status on The DAO and Slock.it websites and numerous online forums relating to blockchain technology. Slock.it's co-founders used these posts to communicate to the public information about how to participate in The DAO, including: how to create and acquire DAO Tokens; the framework for submitting proposals for projects; and how to vote on proposals. Slock.it also created an online forum on The DAO Website, as well as administered "The DAO Slack" channel, an online messaging platform in which over 5,000 invited "team members" could discuss and exchange ideas about The DAO in real time.

### 1. *DAO Tokens*

In exchange for ETH, The DAO created DAO Tokens (proportional to the amount of ETH paid) that were then assigned to the Ethereum Blockchain address of the person or entity remitting the ETH. A DAO Token granted the DAO Token holder certain voting and ownership rights. According to promotional materials, The DAO would earn profits by funding projects

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<sup>17</sup> According to the White Paper, a DAO Entity is "activated by deployment on the Ethereum [B]lockchain. Once deployed, a [DAO Entity's] code requires 'ether' [ETH] to engage in transactions on Ethereum. Ether is the digital fuel that powers the Ethereum Network." The only way to update or alter The DAO's code is to submit a new proposal for voting and achieve a majority consensus on that proposal. *See* Jentzsch, *supra* note 8. According to Slock.it's website, Slock.it gave The DAO code to the Ethereum community, noting that:

The DAO framework is [a] side project of Slock.it UG and a gift to the Ethereum community. It consisted of a definitive whitepaper, smart contract code audited by one of the best security companies in the world and soon, a complete frontend interface. All free and open source for anyone to re-use, it is our way to say 'thank you' to the community.

SLOCK.IT, <https://slock.it>. The DAO code is publicly-available on GitHub, a host of source code. *See The Standard DAO Framework, Inc., Whitepaper*, GITHUB, <https://github.com/slockit/DAO>.

<sup>18</sup> The DAO Website was available at <https://daohub.org>.

<sup>19</sup> Stephen Tual, *Deja Vu DAO Smart Contracts Audit Results*, SLOCK.IT BLOG (Apr. 5, 2016), <https://blog.slock.it/deja-vu-dai-smart-contracts-audit-results-d26bc088e32e>.

that would provide DAO Token holders a return on investment. The various promotional materials disseminated by Slock.it's co-founders touted that DAO Token holders would receive "rewards," which the White Paper defined as, "any [ETH] received by a DAO [Entity] generated from projects the DAO [Entity] funded." DAO Token holders would then vote to either use the rewards to fund new projects or to distribute the ETH to DAO Token holders.

From April 30, 2016 through May 28, 2016 (the "Offering Period"), The DAO offered and sold DAO Tokens. Investments in The DAO were made "pseudonymously" (i.e., an individual's or entity's pseudonym was their Ethereum Blockchain address). To purchase a DAO Token offered for sale by The DAO, an individual or entity sent ETH from their Ethereum Blockchain address to an Ethereum Blockchain address associated with The DAO. All of the ETH raised in the offering as well as any future profits earned by The DAO were to be pooled and held in The DAO's Ethereum Blockchain address. The token price fluctuated in a range of approximately 1 to 1.5 ETH per 100 DAO Tokens, depending on when the tokens were purchased during the Offering Period. Anyone was eligible to purchase DAO Tokens (as long as they paid ETH). There were no limitations placed on the number of DAO Tokens offered for sale, the number of purchasers of DAO Tokens, or the level of sophistication of such purchasers.

DAO Token holders were not restricted from re-selling DAO Tokens acquired in the offering, and DAO Token holders could sell their DAO Tokens in a variety of ways in the secondary market and thereby monetize their investment as discussed below. Prior to the Offering Period, Slock.it solicited at least one U.S. web-based platform to trade DAO Tokens on its system and, at the time of the offering, The DAO Website and other promotional materials disseminated by Slock.it included representations that DAO Tokens would be available for secondary market trading after the Offering Period via several platforms. During the Offering Period and afterwards, the Platforms posted notices on their own websites and on social media that each planned to support secondary market trading of DAO Tokens.<sup>20</sup>

In addition to secondary market trading on the Platforms, after the Offering Period, DAO Tokens were to be freely transferable on the Ethereum Blockchain. DAO Token holders would also be permitted to redeem their DAO Tokens for ETH through a complicated, multi-week (approximately 46-day) process referred to as a DAO Entity "split."<sup>21</sup>

## 2. *Participants in The DAO*

According to the White Paper, in order for a project to be considered for funding with "a DAO [Entity]'s [ETH]," a "Contractor" first must submit a proposal to the DAO Entity. Specifically, DAO Token holders expected Contractors to submit proposals for projects that could provide DAO Token holders returns on their investments. Submitting a proposal to The DAO involved: (1) writing a smart contract, and then deploying and publishing it on the

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<sup>20</sup> The Platforms are registered with FinCEN as "Money Services Businesses" and provide systems whereby customers may exchange virtual currencies for other virtual currencies or fiat currencies.

<sup>21</sup> According to the White Paper, the primary purpose of a split is to protect minority shareholders and prevent what is commonly referred to as a "51% Attack," whereby an attacker holding 51% of a DAO Entity's Tokens could create a proposal to send all of the DAO Entity's funds to himself or herself.

Ethereum Blockchain; and (2) posting details about the proposal on The DAO Website, including the Ethereum Blockchain address of the deployed contract and a link to its source code. Proposals could be viewed on The DAO Website as well as other publicly-accessible websites. Per the White Paper, there were two prerequisites for submitting a proposal. An individual or entity must: (1) own at least one DAO Token; and (2) pay a deposit in the form of ETH that would be forfeited to the DAO Entity if the proposal was put up for a vote and failed to achieve a quorum of DAO Token holders. It was publicized that Slock.it would be the first to submit a proposal for funding.<sup>22</sup>

ETH raised by The DAO was to be distributed to a Contractor to fund a proposal only on a majority vote of DAO Token holders.<sup>23</sup> DAO Token holders were to cast votes, which would be weighted by the number of tokens they controlled, for or against the funding of a specific proposal. The voting process, however, was publicly criticized in that it could incentivize distorted voting behavior and, as a result, would not accurately reflect the consensus of the majority of DAO Token holders. Specifically, as noted in a May 27, 2016 blog post by a group of computer security researchers, The DAO's structure included a "strong positive bias to vote YES on proposals and to suppress NO votes as a side effect of the way in which it restricts users' range of options following the casting of a vote."<sup>24</sup>

Before any proposal was put to a vote by DAO Token holders, it was required to be reviewed by one or more of The DAO's "Curators." At the time of the formation of The DAO, the Curators were a group of individuals chosen by Slock.it.<sup>25</sup> According to the White Paper, the Curators of a DAO Entity had "considerable power." The Curators performed crucial security functions and maintained ultimate control over which proposals could be submitted to, voted on, and funded by The DAO. As stated on The DAO Website during the Offering Period, The DAO relied on its Curators for "failsafe protection" and for protecting The DAO from "malicious [sic] actors." Specifically, per The DAO Website, a Curator was responsible for: (1) confirming that any proposal for funding originated from an identifiable person or organization; and (2)

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<sup>22</sup> It was stated on The DAO Website and elsewhere that Slock.it anticipated that it would be the first to submit a proposal for funding. In fact, a draft of Slock.it's proposal for funding for an "Ethereum Computer and Universal Sharing Network" was publicly-available online during the Offering Period.

<sup>23</sup> DAO Token holders could vote on proposals, either by direct interaction with the Ethereum Blockchain or by using an application that interfaces with the Ethereum Blockchain. It was generally acknowledged that DAO Token holders needed some technical knowledge in order to submit a vote, and The DAO Website included a link to a step-by-step tutorial describing how to vote on proposals.

<sup>24</sup> By voting on a proposal, DAO Token holders would "tie up" their tokens until the end of the voting cycle. *See* Jentzsch, *supra* note 8 at 8 ("The tokens used to vote will be blocked, meaning they can not [sic] be transferred until the proposal is closed."). If, however, a DAO Token holder abstained from voting, the DAO Token holder could avoid these restrictions; any DAO Tokens not submitted for a vote could be withdrawn or transferred at any time. As a result, DAO Token holders were incentivized either to vote yes or to abstain from voting. *See* Dino Mark et al., *A Call for a Temporary Moratorium on The DAO*, HACKING, DISTRIBUTED (May 27, 2016, 1:35 PM), <http://hackingdistributed.com/2016/05/27/dao-call-for-moratorium/>.

<sup>25</sup> At the time of The DAO's launch, The DAO Website identified eleven "high profile" individuals as holders of The DAO's Curator "Multisig" (or "private key"). These individuals all appear to live outside of the United States. Many of them were associated with the Ethereum Foundation, and The DAO Website touted the qualifications and trustworthiness of these individuals.

confirming that smart contracts associated with any such proposal properly reflected the code the Contractor claims to have deployed on the Ethereum Blockchain. If a Curator determined that the proposal met these criteria, the Curator could add the proposal to the “whitelist,” which was a list of Ethereum Blockchain addresses that could receive ETH from The DAO if the majority of DAO Token holders voted for the proposal.

Curators of The DAO had ultimate discretion as to whether or not to submit a proposal for voting by DAO Token holders. Curators also determined the order and frequency of proposals, and could impose subjective criteria for whether the proposal should be whitelisted. One member of the group chosen by Slock.it to serve collectively as the Curator stated publicly that the Curator had “complete control over the whitelist ... the order in which things get whitelisted, the duration for which [proposals] get whitelisted, when things get unwhitelisted ... [and] clear ability to control the order and frequency of proposals,” noting that “curators have tremendous power.”<sup>26</sup> Another Curator publicly announced his subjective criteria for determining whether to whitelist a proposal, which included his personal ethics.<sup>27</sup> Per the White Paper, a Curator also had the power to reduce the voting quorum requirement by 50% every other week. Absent action by a Curator, the quorum could be reduced by 50% only if no proposal had reached the required quorum for 52 weeks.

### 3. *Secondary Market Trading on the Platforms*

During the period from May 28, 2016 through early September 2016, the Platforms became the preferred vehicle for DAO Token holders to buy and sell DAO Tokens in the secondary market using virtual or fiat currencies. Specifically, the Platforms used electronic systems that allowed their respective customers to post orders for DAO Tokens on an anonymous basis. For example, customers of each Platform could buy or sell DAO Tokens by entering a market order on the Platform’s system, which would then match with orders from other customers residing on the system. Each Platform’s system would automatically execute these orders based on pre-programmed order interaction protocols established by the Platform.

None of the Platforms received orders for DAO Tokens from non-Platform customers or routed its respective customers’ orders to any other trading destinations. The Platforms publicly displayed all their quotes, trades, and daily trading volume in DAO Tokens on their respective websites. During the period from May 28, 2016 through September 6, 2016, one such Platform executed more than 557,378 buy and sell transactions in DAO Tokens by more than 15,000 of its U.S. and foreign customers. During the period from May 28, 2016 through August 1, 2016, another such Platform executed more than 22,207 buy and sell transactions in DAO Tokens by more than 700 of its U.S. customers.

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<sup>26</sup> Epicenter, *EB134 – Emin Gün Siner And Vlad Zamfir: On A Rocky DAO*, YOUTUBE (June 6, 2016), <https://www.youtube.com/watch?v=ON5GhIQdFU8>.

<sup>27</sup> Andrew Quentson, *Are the DAO Curators Masters or Janitors?*, THE COIN TELEGRAPH (June 12, 2016), <https://cointelegraph.com/news/are-the-dao-curators-masters-or-janitors>.

#### 4. Security Concerns, The “Attack” on The DAO, and The Hard Fork

In late May 2016, just prior to the expiration of the Offering Period, concerns about the safety and security of The DAO’s funds began to surface due to vulnerabilities in The DAO’s code. On May 26, 2016, in response to these concerns, Slock.it submitted a “DAO Security Proposal” that called for the development of certain updates to The DAO’s code and the appointment of a security expert.<sup>28</sup> Further, on June 3, 2016, Christoph Jentzsch, on behalf of Slock.it, proposed a moratorium on all proposals until alterations to The DAO’s code to fix vulnerabilities in The DAO’s code had been implemented.<sup>29</sup>

On June 17, 2016, an unknown individual or group (the “Attacker”) began rapidly diverting ETH from The DAO, causing approximately 3.6 million ETH—1/3 of the total ETH raised by The DAO offering—to move from The DAO’s Ethereum Blockchain address to an Ethereum Blockchain address controlled by the Attacker (the “Attack”).<sup>30</sup> Although the diverted ETH was then held in an address controlled by the Attacker, the Attacker was prevented by The DAO’s code from moving the ETH from that address for 27 days.<sup>31</sup>

In order to secure the diverted ETH and return it to DAO Token holders, Slock.it’s co-founders and others endorsed a “Hard Fork” to the Ethereum Blockchain. The “Hard Fork,” called for a change in the Ethereum protocol on a going forward basis that would restore the DAO Token holders’ investments as if the Attack had not occurred. On July 20, 2016, after a majority of the Ethereum network adopted the necessary software updates, the new, forked Ethereum Blockchain became active.<sup>32</sup> The Hard Fork had the effect of transferring all of the funds raised (including those held by the Attacker) from The DAO to a recovery address, where DAO Token holders could exchange their DAO Tokens for ETH.<sup>33</sup> All DAO Token holders

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<sup>28</sup> See Stephan Tual, *Proposal #1-DAO Security, Redux*, SLOCK.IT BLOG (May 26, 2016), <https://blog.slock.it/both-our-proposals-are-now-out-voting-starts-saturday-morning-ba322d6d3aea>. The unnamed security expert would “act as the first point of contact for security disclosures, and continually monitor, pre-empt and avert any potential attack vectors The DAO may face, including social, technical and economic attacks.” *Id.* Slock.it initially proposed a much broader security proposal that included the formation of a “DAO Security” group, the establishment of a “Bug Bounty Program,” and routine external audits of The DAO’s code. However, the cost of the proposal (125,000 ETH), which would be paid from The DAO’s funds, was immediately criticized as too high and Slock.it decided instead to submit the revised proposal described above. See Stephan Tual, *DAO Security, a Proposal to guarantee the integrity of The DAO*, SLOCK.IT BLOG (May 25, 2016), <https://blog.slock.it/dao-security-a-proposal-to-guarantee-the-integrity-of-the-dao-3473899ace9d>.

<sup>29</sup> See *TheDAO Proposal\_ID 5*, ETHERSCAN, <https://etherscan.io/token/thedao-proposal/5>.

<sup>30</sup> See Stephan Tual, *DAO Security Advisory: live updates*, SLOCK.IT BLOG (June 17, 2016), <https://blog.slock.it/dao-security-advisory-live-updates-2a0a42a2d07b>.

<sup>31</sup> *Id.*

<sup>32</sup> A minority group, however, elected not to adopt the new Ethereum Blockchain created by the Hard Fork because to do so would run counter to the concept that a blockchain is immutable. Instead they continued to use the former version of the blockchain, which is now known as “Ethereum Classic.”

<sup>33</sup> See Christoph Jentzsch, *What the ‘Fork’ Really Means*, SLOCK.IT BLOG (July 18, 2016), <https://blog.slock.it/what-the-fork-really-means-6fe573ac31dd>.



who adopted the Hard Fork could exchange their DAO Tokens for ETH, and avoid any loss of the ETH they had invested.<sup>34</sup>

### III. Discussion

The Commission is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital. These offers and sales have been referred to, among other things, as “Initial Coin Offerings” or “Token Sales.” Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the 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 the organization or technology used to effectuate a particular offer or sale. In this Report, the Commission considers the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new paradigm.

#### A. Section 5 of the Securities Act

The registration provisions of the Securities Act contemplate that the offer or sale of securities to the public must be accompanied by the “full and fair disclosure” afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Registration entails disclosure of detailed “information about the issuer’s financial condition, the identity and background of management, and the price and amount of securities to be offered ...” *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), *aff’d*, 155 F.3d 129 (2d Cir. 1998). “The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act’s comprehensive scheme for protecting public investors.” *SEC v. Aaron*, 605 F.2d 612, 618 (2d Cir. 1979) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953)), *vacated on other grounds*, 446 U.S. 680 (1980). Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been filed. Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce. 15 U.S.C. § 77e(a) and (c). Violations of Section 5 do not require scienter. *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976).

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<sup>34</sup> *Id.*

## B. DAO Tokens Are Securities

### 1. *Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology*

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.

### 2. *Investors in The DAO Invested Money*

In determining whether an investment contract exists, the investment of “money” need not take the form of cash. *See, e.g., Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991) (“[I]n spite of *Howey*’s reference to an ‘investment of money,’ it is well established that cash is not the only form of contribution or investment that will create an investment contract.”).

Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under *Howey*. *See SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at \*1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of *Howey*); *Uselton*, 940 F.2d at 574 (“[T]he ‘investment’ may take the form of ‘goods and services,’ or some other ‘exchange of value.’”) (citations omitted).

### 3. *With a Reasonable Expectation of Profits*

Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO’s Ethereum Blockchain address in exchange for DAO Tokens. “[P]rofits” include “dividends, other periodic payments, or the increased value of the investment.” *Edwards*, 540 U.S. at 394. As described above, the various promotional materials disseminated by Slock.it and its co-founders informed investors that The DAO was a for-profit entity whose objective was to fund

projects in exchange for a return on investment.<sup>35</sup> The ETH was pooled and available to The DAO to fund projects. The projects (or “contracts”) would be proposed by Contractors. If the proposed contracts were whitelisted by Curators, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.

4. *Derived from the Managerial Efforts of Others*

a. *The Efforts of Slock.it, Slock.it’s Co-Founders, and The DAO’s Curators Were Essential to the Enterprise*

Investors’ profits were to be derived from the managerial efforts of others—specifically, Slock.it and its co-founders, and The DAO’s Curators. The central issue is “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973). The DAO’s investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO’s Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO’s investors.

Investors’ expectations were primed by the marketing of The DAO and active engagement between Slock.it and its co-founders with The DAO and DAO Token holders. To market The DAO and DAO Tokens, Slock.it created The DAO Website on which it published the White Paper explaining how a DAO Entity would work and describing their vision for a DAO Entity. Slock.it also created and maintained other online forums that it used to provide information to DAO Token holders about how to vote and perform other tasks related to their investment. Slock.it appears to have closely monitored these forums, answering questions from DAO Token holders about a variety of topics, including the future of The DAO, security concerns, ground rules for how The DAO would work, and the anticipated role of DAO Token holders. The creators of The DAO held themselves out to investors as experts in Ethereum, the blockchain protocol on which The DAO operated, and told investors that they had selected persons to serve as Curators based on their expertise and credentials. Additionally, Slock.it told investors that it expected to put forth the first substantive profit-making contract proposal—a blockchain venture in its area of expertise. Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts required to make The DAO a success.

Investors in The DAO reasonably expected Slock.it and its co-founders, and The DAO’s Curators, to provide significant managerial efforts after The DAO’s launch. The expertise of The DAO’s creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a

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<sup>35</sup> That the “projects” could encompass services and the creation of goods for use by DAO Token holders does not change the core analysis that investors purchased DAO Tokens with the expectation of earning profits from the efforts of others.

vote. Investors had little choice but to rely on their expertise. At the time of the offering, The DAO's protocols had already been pre-determined by Slock.it and its co-founders, including the control that could be exercised by the Curators. Slock.it and its co-founders chose the Curators, whose function it was to: (1) vet Contractors; (2) determine whether and when to submit proposals for votes; (3) determine the order and frequency of proposals that were submitted for a vote; and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals. Thus, the Curators exercised significant control over the order and frequency of proposals, and could impose their own subjective criteria for whether the proposal should be whitelisted for a vote by DAO Token holders. DAO Token holders' votes were limited to proposals whitelisted by the Curators, and, although any DAO Token holder could put forth a proposal, each proposal would follow the same protocol, which included vetting and control by the current Curators. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators, including whitelisting and approval of the new address to which the tokens would be directed for such a proposal. In essence, Curators had the power to determine whether a proposal to remove a Curator was put to a vote.<sup>36</sup>

And, Slock.it and its co-founders did, in fact, actively oversee The DAO. They monitored The DAO closely and addressed issues as they arose, proposing a moratorium on all proposals until vulnerabilities in The DAO's code had been addressed and a security expert to monitor potential attacks on The DAO had been appointed. When the Attacker exploited a weakness in the code and removed investor funds, Slock.it and its co-founders stepped in to help resolve the situation.

#### b. DAO Token Holders' Voting Rights Were Limited

Although DAO Token holders were afforded voting rights, these voting rights were limited. DAO Token holders were substantially reliant on the managerial efforts of Slock.it, its co-founders, and the Curators.<sup>37</sup> Even if an investor's efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter's significant managerial efforts or control over the enterprise. See, e.g., *Glenn W. Turner*, 474 F.2d at 482 (finding that a multi-level marketing scheme was an investment contract and that investors relied on the promoter's managerial efforts, despite the fact that investors put forth the majority of the labor that made the enterprise profitable, because the promoter dictated the terms and controlled the scheme itself); *Long v. Shultz*, 881 F.2d 129, 137 (5th Cir. 1989) ("An investor may authorize the assumption of particular risks that would create the possibility of greater profits or losses but still depend on a third party for all of the essential managerial efforts without which the risk could not

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<sup>36</sup> DAO Token holders could put forth a proposal to split from The DAO, which would result in the creation of a new DAO Entity with a new Curator. Other DAO Token holders would be allowed to join the new DAO Entity as long as they voted yes to the original "split" proposal. Unlike all other contract proposals, a proposal to split did not require a deposit or a quorum, and it required a seven-day debating period instead of the minimum two-week debating period required for other proposals.

<sup>37</sup> Because, as described above, DAO Token holders were incentivized either to vote yes or to abstain from voting, the results of DAO Token holder voting would not necessarily reflect the actual view of a majority of DAO Token holders.

pay off.”). *See also generally SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007) (finding an investment contract even where voting rights were provided to purported general partners, noting that the voting process provided limited information for investors to make informed decisions, and the purported general partners lacked control over the information in the ballots).

The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders’ ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.

First, as discussed above, DAO Token holders could only vote on proposals that had been cleared by the Curators.<sup>38</sup> And that clearance process did not include any mechanism to provide DAO Token holders with sufficient information to permit them to make informed voting decisions. Indeed, based on the particular facts concerning The DAO and the few draft proposals discussed in online forums, there are indications that contract proposals would not have necessarily provide enough information for investors to make an informed voting decision, affording them less meaningful control. For example, the sample contract proposal attached to the White Paper included little information concerning the terms of the contract. Also, the Slock.it co-founders put forth a draft of their own contract proposal and, in response to questions and requests to negotiate the terms of the proposal (posted to a DAO forum), a Slock.it founder explained that the proposal was intentionally vague and that it was, in essence, a take it or leave it proposition not subject to negotiation or feedback. *See, e.g., SEC v. Shields*, 744 F.3d 633, 643-45 (10th Cir. 2014) (in assessing whether agreements were investment contracts, court looked to whether “the investors actually had the type of control reserved under the agreements to obtain access to information necessary to protect, manage, and control their investments at the time they purchased their interests.”).

Second, the pseudonymity and dispersion of the DAO Token holders made it difficult for them to join together to effect change or to exercise meaningful control. Investments in The DAO were made pseudonymously (such that the real-world identities of investors are not apparent), and there was great dispersion among those individuals and/or entities who were invested in The DAO and thousands of individuals and/or entities that traded DAO Tokens in the secondary market—an arrangement that bears little resemblance to that of a genuine general partnership. *Cf. Williamson v. Tucker*, 645 F.2d 404, 422-24 (5th Cir. 1981) (“[O]ne would not expect partnership interests sold to large numbers of the general public to provide any real partnership control; at some point there would be so many [limited] partners that a partnership vote would be more like a corporate vote, each partner’s role having been diluted to the level of a single shareholder in a corporation.”).<sup>39</sup> Slock.it did create and maintain online forums on which

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<sup>38</sup> Because, in part, The DAO never commenced its business operations funding projects, this Report does not analyze the question whether anyone associated with The DAO was an “[i]nvestment adviser” under Section 202(a)(11) of the Investment Advisers Act of 1940 (“Advisers Act”). *See* 15 U.S.C. § 80b-2(a)(11). Those who would use virtual organizations should consider their obligations under the Advisers Act.

<sup>39</sup> The Fifth Circuit in *Williamson* stated that:

investors could submit posts regarding contract proposals, which were not limited to use by DAO Token holders (anyone was permitted to post). However, DAO Token holders were pseudonymous, as were their posts to the forums. Those facts, combined with the sheer number of DAO Token holders, potentially made the forums of limited use if investors hoped to consolidate their votes into blocs powerful enough to assert actual control. This was later demonstrated through the fact that DAO Token holders were unable to effectively address the Attack without the assistance of Slock.it and others. The DAO Token holders' pseudonymity and dispersion diluted their control over The DAO. *See Merchant Capital*, 483 F.3d at 758 (finding geographic dispersion of investors weighing against investor control).

These facts diminished the ability of DAO Token holders to exercise meaningful control over the enterprise through the voting process, rendering the voting rights of DAO Token holders akin to those of a corporate shareholder. *Steinhardt Group, Inc. v. Citicorp.*, 126 F.3d 144, 152 (3d Cir. 1997) ("It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negate the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action ... a security may be found to exist ... . [The] emphasis must be placed on economic reality.") (citing *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 n. 14 (5th Cir. 1974)).

By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO's Curators, as described above. Their efforts, not those of DAO Token holders, were the "undeniably significant" ones, essential to the overall success and profitability of any investment into The DAO. *See Glenn W. Turner*, 474 F.2d at 482.

### C. Issuers Must Register Offers and Sales of Securities Unless a Valid Exemption Applies

The definition of "issuer" is broadly defined to include "every person who issues or proposes to issue any security" and "person" includes "any unincorporated organization." 15 U.S.C. § 77b(a)(4). The term "issuer" is flexibly construed in the Section 5 context "as issuers devise new ways to issue their securities and the definition of a security itself expands." *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 909 (5th Cir. 1977); *accord SEC v. Murphy*, 626 F.2d 633, 644 (9th Cir. 1980) ("[W]hen a person [or entity] organizes or sponsors the organization of

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A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venture that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

*Williamson*, 645 F.2d at 424 & n.15 (court also noting that, "this is not to say that other factors could not also give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded.").

limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer ...”).

The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was “crucial” to the DAO Token holders’ investment decision. *See Murphy*, 626 F.2d at 643 (“Here there is no company issuing stock, but instead, a group of individuals investing funds in an enterprise for profit, and receiving in return an entitlement to a percentage of the proceeds of the enterprise.”) (citation omitted). The DAO was “responsible for the success or failure of the enterprise,” and accordingly was the entity about which the investors needed information material to their investment decision. *Id.* at 643-44.

During the Offering Period, The DAO offered and sold DAO Tokens in exchange for ETH through The DAO Website, which was publicly-accessible, including to individuals in the United States. During the Offering Period, The DAO sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million ETH, which was valued in USD, at the time, at approximately \$150 million. Because DAO Tokens were securities, The DAO was required to register the offer and sale of DAO Tokens, unless a valid exemption from such registration applied.

Moreover, those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5. *See, e.g., Murphy*, 626 F.2d at 650-51 (“[T]hose who ha[ve] a necessary role in the transaction are held liable as participants.”) (citing *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63, 81 (2d Cir. 1970); *SEC v. Culpepper*, 270 F.2d 241, 247 (2d Cir. 1959); *SEC v. International Chem. Dev. Corp.*, 469 F.2d 20, 28 (10th Cir. 1972); *Pennaluna & Co. v. SEC*, 410 F.2d 861, 864 n.1, 868 (9th Cir. 1969)); *SEC v. Softpoint, Inc.*, 958 F. Supp 846, 859-60 (S.D.N.Y. 1997) (“The prohibitions of Section 5 ... sweep[] broadly to encompass ‘any person’ who participates in the offer or sale of an unregistered, non-exempt security.”); *SEC v. Chinese Consol. Benevolent Ass’n.*, 120 F.2d 738, 740-41 (2d Cir. 1941) (defendant violated Section 5(a) “because it engaged in selling unregistered securities” issued by a third party “when it solicited offers to buy the securities ‘for value’”).

D. A System that Meets the Definition of an Exchange Must Register as a National Securities Exchange or Operate Pursuant to an Exemption from Such Registration

Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. *See* 15 U.S.C. §78e. Section 3(a)(1) of the Exchange Act defines an “exchange” as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood ...” 15 U.S.C. § 78c(a)(1).

Exchange Act Rule 3b-16(a) provides a functional test to assess whether a trading system meets the definition of exchange under Section 3(a)(1). Under Exchange Act Rule 3b-16(a), an

organization, association, or group of persons shall be considered to constitute, maintain, or provide “a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange,” if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.<sup>40</sup>

A system that meets the criteria of Rule 3b-16(a), and is not excluded under Rule 3b-16(b), must register as a national securities exchange pursuant to Sections 5 and 6 of the Exchange Act<sup>41</sup> or operate pursuant to an appropriate exemption. One frequently used exemption is for alternative trading systems (“ATS”).<sup>42</sup> Rule 3a1-1(a)(2) exempts from the definition of “exchange” under Section 3(a)(1) an ATS that complies with Regulation ATS,<sup>43</sup> which includes, among other things, the requirement to register as a broker-dealer and file a Form ATS with the Commission to provide notice of the ATS’s operations. Therefore, an ATS that operates pursuant to the Rule 3a1-1(a)(2) exemption and complies with Regulation ATS would not be subject to the registration requirement of Section 5 of the Exchange Act.

The Platforms that traded DAO Tokens appear to have satisfied the criteria of Rule 3b-16(a) and do not appear to have been excluded from Rule 3b-16(b). As described above, the Platforms provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.

#### **IV. Conclusion and References for Additional Guidance**

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

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<sup>40</sup> See 17 C.F.R. § 240.3b-16(a). The Commission adopted Rule 3b-16(b) to exclude explicitly certain systems that the Commission believed did not meet the exchange definition. These systems include systems that merely route orders to other execution facilities and systems that allow persons to enter orders for execution against the bids and offers of a single dealer system. See Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) (Regulation of Exchanges and Alternative Trading Systems) (“Regulation ATS”), 70852.

<sup>41</sup> 15 U.S.C. § 78e. A “national securities exchange” is an exchange registered as such under Section 6 of the Exchange Act. 15 U.S.C. § 78f.

<sup>42</sup> Rule 300(a) of Regulation ATS promulgated under the Exchange Act provides that an ATS is:

any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Exchange Act Rule 3b-16]; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of subscribers’ trading on such [ATS]; or (ii) [d]iscipline subscribers other than by exclusion from trading.

Regulation ATS, *supra* note 40, Rule 300(a).

<sup>43</sup> See 17 C.F.R. § 240.3a1-1(a)(2). Rule 3a1-1 also provides two other exemptions from the definition of “exchange” for any ATS operated by a national securities association, and any ATS not required to comply with Regulation ATS pursuant to Rule 301(a) of Regulation ATS. See 17 C.F.R. §§ 240.3a1-1(a)(1) and (3).



economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws. The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology. In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.

To learn more about registration requirements under the Securities Act, please visit the Commission's website [here](#). To learn more about the Commission's registration requirements for investment companies, please visit the Commission's website [here](#). To learn more about the Commission's registration requirements for national securities exchanges, please visit the Commission's website [here](#). To learn more about alternative trading systems, please see the Regulation ATS adopting release [here](#).

For additional guidance, please see the following Commission enforcement actions involving virtual currencies:

- *SEC v. Trendon T. Shavers and Bitcoin Savings and Trust*, Civil Action No. 4:13-CV-416 (E.D. Tex., complaint filed July 23, 2013)
- *In re Erik T. Voorhees*, Rel. No. 33-9592 (June 3, 2014)
- *In re BTC Trading, Corp. and Ethan Burnside*, Rel. No. 33-9685 (Dec. 8, 2014)
- *SEC v. Homero Joshua Garza, Gaw Miners, LLC, and ZenMiner, LLC (d/b/a Zen Cloud)*, Civil Action No. 3:15-CV-01760 (D. Conn., complaint filed Dec. 1, 2015)
- *In re Bitcoin Investment Trust and SecondMarket, Inc.*, Rel. No. 34-78282 (July 11, 2016)
- *In re Sunshine Capital, Inc.*, File No. 500-1 (Apr. 11, 2017)

And please see the following investor alerts:

- *Bitcoin and Other Virtual Currency-Related Investments* (May 7, 2014)
- *Ponzi Schemes Using Virtual Currencies* (July 2013)

By the Commission.

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# INVESTOR BULLETIN: INITIAL COIN OFFERINGS

**07/25/2017**

*Developers, businesses, and individuals increasingly are using initial coin offerings, also called ICOs or token sales, to raise capital. These activities may provide fair and lawful investment opportunities. However, new technologies and financial products, such as those associated with ICOs, can be used improperly to entice investors with the promise of high returns in a new investment space. The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to make investors aware of potential risks of participating in ICOs.*

## **Background - Initial Coin Offerings**

Virtual coins or tokens are created and disseminated using distributed ledger or blockchain technology. Recently promoters have been selling virtual coins or tokens in ICOs. Purchasers may use fiat currency (e.g., U.S. dollars) or virtual currencies to buy these virtual coins or tokens. Promoters may tell purchasers that the capital raised from the sales will be used to fund development of a digital platform, software, or other projects and that the virtual tokens or coins may be used to access the platform, use the software, or otherwise participate in the project. Some promoters and initial sellers may lead buyers of the virtual coins or tokens to expect a return on their investment or to participate in a share of the returns provided by the project. After they are issued, the virtual coins or tokens may be resold to others in a secondary market on virtual currency exchanges or other platforms.

Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities. If they are securities, the offer and sale of these virtual coins or tokens in an ICO are subject to the federal securities laws.

On July 25, 2017, the SEC issued a [Report of Investigation under Section 21\(a\)](https://www.sec.gov/litigation/investreport/34-81207.pdf) (<https://www.sec.gov/litigation/investreport/34-81207.pdf>) of the Securities Exchange Act of 1934 describing an SEC investigation of The DAO, a virtual organization, and its use of distributed ledger or blockchain technology to facilitate the offer and sale of DAO Tokens to raise capital. The Commission applied existing U.S. federal securities laws to this new paradigm, determining that DAO Tokens were securities. The Commission stressed that those who offer and sell securities in the U.S. are required to comply with federal securities laws, regardless of whether those securities are purchased with virtual currencies or distributed with blockchain technology.

To facilitate understanding of this new and complex area, here are some basic concepts that you should understand before investing in virtual coins or tokens:

### **What is a blockchain?**

A blockchain is an electronic distributed ledger or list of entries – much like a stock ledger – that is maintained by various participants in a network of computers. Blockchains use cryptography to process and verify

transactions on the ledger, providing comfort to users and potential users of the blockchain that entries are secure. Some examples of blockchain are the Bitcoin and Ethereum blockchains, which are used to create and track transactions in bitcoin and ether, respectively.

### **What is a virtual currency or virtual token or coin?**

A virtual currency is a digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account, or store of value. Virtual tokens or coins may represent other rights as well. Accordingly, in certain cases, the tokens or coins will be securities and may not be lawfully sold without registration with the SEC or pursuant to an exemption from registration.

### **What is a virtual currency exchange?**

A virtual currency exchange is a person or entity that exchanges virtual currency for fiat currency, funds, or other forms of virtual currency. Virtual currency exchanges typically charge fees for these services. Secondary market trading of virtual tokens or coins may also occur on an exchange. These exchanges may not be registered securities exchanges or alternative trading systems regulated under the federal securities laws. Accordingly, in purchasing and selling virtual coins and tokens, you may not have the same protections that would apply in the case of stocks listed on an exchange.

### **Who issues virtual tokens or coins?**

Virtual tokens or coins may be issued by a virtual organization or other capital raising entity. A virtual organization is an organization embodied in computer code and executed on a distributed ledger or blockchain. The code, often called a “smart contract,” serves to automate certain functions of the organization, which may include the issuance of certain virtual coins or tokens. The DAO, which was a decentralized autonomous organization, is an example of a virtual organization.

### **Some Key Points to Consider When Determining Whether to Participate in an ICO**

If you are thinking about participating in an ICO, here are some things you should consider.

► Depending on the facts and circumstances, the offering may involve the offer and sale of securities. If that is the case, the offer and sale of virtual coins or tokens must itself be registered with the SEC, or be performed pursuant to an exemption from registration. Before investing in an ICO, ask whether the virtual tokens or coins are securities and whether the persons selling them registered the offering with the SEC. A few things to keep in mind about registration:

- If an offering is registered, you can find information (such as a registration statement or “Form S-1”) on [SEC.gov](https://www.sec.gov/) (<https://www.sec.gov/>) through [EDGAR](https://investor.gov/research-before-you-invest/research/researching-investments/using-edgar-researching-public-companies) (<https://investor.gov/research-before-you-invest/research/researching-investments/using-edgar-researching-public-companies>).
- If a promoter states that an offering is exempt from registration, and you are not an [accredited investor](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-accredited-investors) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-accredited-investors>), you should be very careful – most exemptions have net worth or income requirements.
- Although ICOs are sometimes described as [crowdfunding](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-crowdfunding-investors) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-crowdfunding-investors>) contracts, it is possible that they are not being offered and sold in compliance with the requirements of Regulation Crowdfunding or with the federal securities laws generally.

► Ask what your money will be used for and what rights the virtual coin or token provides to you. The promoter should have a clear business plan that you can read and that you understand. The rights the token or coin entitles you to should be clearly laid out, often in a white paper or development roadmap. You should specifically ask about how and when you can get your money back in the event you wish to do so. For example, do you have a right to give the token or coin back to the company or to receive a refund? Or can you resell the coin or token? Are there any limitations on your ability to resell the coin or token?

- ▶ If the virtual token or coin is a security, federal and state securities laws require investment professionals and their firms who offer, transact in, or advise on investments to be licensed or registered. You can visit [Investor.gov](https://www.investor.gov/) (<https://www.investor.gov/>) to check the registration status and background of these investment professionals.
- ▶ Ask whether the blockchain is open and public, whether the code has been published, and whether there has been an independent cybersecurity audit.
- ▶ Fraudsters often use innovations and new technologies to perpetrate fraudulent investment schemes. Fraudsters may entice investors by touting an ICO investment “opportunity” as a way to get into this cutting-edge space, promising or guaranteeing high investment returns. Investors should always be suspicious of jargon-laden pitches, hard sells, and promises of outsized returns. Also, it is relatively easy for anyone to use blockchain technology to create an ICO that looks impressive, even though it might actually be a scam.
- ▶ Virtual currency exchanges and other entities holding virtual currencies, virtual tokens or coins may be susceptible to fraud, technical glitches, hacks, or malware. Virtual tokens or virtual currency may be stolen by hackers.

**Investing in an ICO may limit your recovery in the event of fraud or theft. While you may have rights under the federal securities laws, your ability to recover may be significantly limited.**

If fraud or theft results in you or the organization that issued the virtual tokens or coins losing virtual tokens, virtual currency, or fiat currency, you may have limited recovery options. Third-party wallet services, payment processors, and virtual currency exchanges that play important roles in the use of virtual currencies may be located overseas or be operating unlawfully.

Law enforcement officials may face particular challenges when investigating ICOs and, as a result, investor remedies may be limited. These challenges include:

- ▶ Tracing money. Traditional financial institutions (such as banks) often are not involved with ICOs or virtual currency transactions, making it more difficult to follow the flow of money.
- ▶ International scope. ICOs and virtual currency transactions and users span the globe. Although the SEC regularly obtains information from abroad (such as through cross-border agreements), there may be restrictions on how the SEC can use the information and it may take more time to get the information. In some cases, the SEC may be unable to obtain information from persons or entities located overseas.
- ▶ No central authority. As there is no central authority that collects virtual currency user information, the SEC generally must rely on other sources for this type of information.
- ▶ Freezing or securing virtual currency. Law enforcement officials may have difficulty freezing or securing investor funds that are held in a virtual currency. Virtual currency wallets are encrypted and unlike money held in a bank or brokerage account, virtual currencies may not be held by a third-party custodian.

**Be careful if you spot any of these potential warning signs of investment fraud.**

- ▶ “Guaranteed” high investment returns. There is no such thing as guaranteed high investment returns. Be wary of anyone who promises that you will receive a high rate of return on your investment, with little or no risk.
- ▶ Unsolicited offers. An unsolicited sales pitch may be part of a fraudulent investment scheme. Exercise extreme caution if you receive an unsolicited communication—meaning you didn’t ask for it and don’t know the sender—about an investment opportunity.
- ▶ Sounds too good to be true. If the investment sounds too good to be true, it probably is. Remember that investments providing higher returns typically involve more risk.

- ▶ **Pressure to buy RIGHT NOW.** Fraudsters may try to create a false sense of urgency to get in on the investment. Take your time researching an investment opportunity before handing over your money.
- ▶ **Unlicensed sellers.** Many fraudulent investment schemes involve unlicensed individuals or unregistered firms. Check license and registration status on [Investor.gov](https://investor.gov/) (<https://investor.gov/>).
- ▶ **No net worth or income requirements.** The federal securities laws require securities offerings to be registered with the SEC unless an exemption from registration applies. Many registration exemptions require that investors are [accredited investors](http://www.sec.gov/answers/accred.htm) (<http://www.sec.gov/answers/accred.htm>); some others have investment limits. Be highly suspicious of private (*i.e.*, unregistered) investment opportunities that do not ask about your net worth or income or whether investment limits apply.

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Before making any investment, carefully read any materials you are given and verify the truth of every statement you are told about the investment. For more information about how to research an investment, read our publication [Ask Questions](http://www.sec.gov/investor/pubs/sec-questions-investors-should-ask.pdf) (<http://www.sec.gov/investor/pubs/sec-questions-investors-should-ask.pdf>). Investigate the individuals and firms offering the investment, and check out their backgrounds on [Investor.gov](https://investor.gov/) (<https://investor.gov/>) and by contacting your [state securities regulator](http://www.nasaa.org/about-us/contact-us/contact-your-regulator/) (<http://www.nasaa.org/about-us/contact-us/contact-your-regulator/>). Many fraudulent investment schemes involve unlicensed individuals or unregistered firms.

### **Additional Resources**

[SEC Investor Alert: Bitcoin and Other Virtual Currency-Related Investments](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency>)

[SEC Investor Alert: Ponzi Schemes Using Virtual Currencies](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf) ([http://www.sec.gov/investor/alerts/ia\\_virtualcurrencies.pdf](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf))

[SEC Investor Alert: Social Media and Investing – Avoiding Fraud](http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf) (<http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf>)

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The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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# INVESTOR ALERT: BITCOIN AND OTHER VIRTUAL CURRENCY-RELATED INVESTMENTS

**05/07/2014**

*The SEC's Office of Investor Education and Advocacy is issuing this Investor Alert to make investors aware about the potential risks of investments involving Bitcoin and other forms of virtual currency.*

The rise of Bitcoin and other virtual and digital currencies creates new concerns for investors. *A new product, technology, or innovation – such as Bitcoin – has the potential to give rise both to frauds and high-risk investment opportunities.* Potential investors can be easily enticed with the promise of high returns in a new investment space and also may be less skeptical when assessing something novel, new and cutting-edge.

We previously issued an [Investor Alert](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf) ([http://www.sec.gov/investor/alerts/ia\\_virtualcurrencies.pdf](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf)) about the use of Bitcoin in the context of a Ponzi scheme. The Financial Industry Regulatory Authority (FINRA) also recently issued an [Investor Alert](http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P456458) (<http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P456458>) cautioning investors about the risks of buying and using digital currency such as Bitcoin. In addition, the North American Securities Administrators Association (NASAA) included digital currency on its [list](http://www.nasaa.org/3752/top-investor-threats/) (<http://www.nasaa.org/3752/top-investor-threats/>) of the top 10 threats to investors for 2013.

## **What is Bitcoin?**

Bitcoin has been described as a decentralized, peer-to-peer virtual currency that is used like money – it can be exchanged for traditional currencies such as the U.S. dollar, or used to purchase goods or services, usually online. *Unlike traditional currencies, Bitcoin operates without central authority or banks and is not backed by any government.*

**IRS treats Bitcoin as property.** The IRS recently issued [guidance](http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance) (<http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance>) stating that it will treat virtual currencies, such as Bitcoin, as property for federal tax purposes. As a result, general tax principles that apply to property transactions apply to transactions using virtual currency

If you are thinking about investing in a Bitcoin-related opportunity, here are some things you should consider.

## **Investments involving Bitcoin may have a heightened risk of fraud.**

Innovations and new technologies are often used by fraudsters to perpetrate fraudulent investment schemes. *Fraudsters may entice investors by touting a Bitcoin investment “opportunity” as a way to get into this cutting-edge space, promising or guaranteeing high investment returns.* Investors may find these investment pitches hard to resist.

**Bitcoin Ponzi scheme.** In July 2013, the SEC charged an individual for an alleged Bitcoin-related Ponzi scheme in [SEC v. Shavers](#) (<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583#.Ue6yZODmp-l>). The defendant advertised a Bitcoin “investment opportunity” in an online Bitcoin forum, promising investors up to 7% interest per week and that the invested funds would be used for Bitcoin activities. Instead, the defendant allegedly used bitcoins from new investors to pay existing investors and to pay his personal expenses.

As with any investment, be careful if you spot any of these potential warning signs of investment fraud:

- ▶ **“Guaranteed” high investment returns.** There is no such thing as guaranteed high investment returns. Be wary of anyone who promises that you will receive a high rate of return on your investment, with little or no risk.
- ▶ **Unsolicited offers.** An unsolicited sales pitch may be part of a fraudulent investment scheme. Exercise extreme caution if you receive an unsolicited communication – meaning you didn’t ask for it and don’t know the sender – about an investment opportunity.
- ▶ **Unlicensed sellers.** Federal and state securities laws require investment professionals and their firms who offer and sell investments to be licensed or registered. Many fraudulent investment schemes involve unlicensed individuals or unregistered firms. Check license and registration status by searching the SEC’s [Investment Adviser Public Disclosure \(IAPD\)](#) ([http://www.adviserinfo.sec.gov/IAPD/Content/iapdMain/iapd\\_SiteMap.aspx](http://www.adviserinfo.sec.gov/IAPD/Content/iapdMain/iapd_SiteMap.aspx)) website or FINRA’s [BrokerCheck](http://brokercheck.finra.org/Search/Search.aspx) (<http://brokercheck.finra.org/Search/Search.aspx>) website.
- ▶ **No net worth or income requirements.** The federal securities laws require securities offerings to be registered with the SEC unless an exemption from registration applies. Most registration exemptions require that investors are [accredited investors](#) (<http://www.sec.gov/answers/accred.htm>). Be highly suspicious of private (*i.e.*, unregistered) investment opportunities that do not ask about your net worth or income.
- ▶ **Sounds too good to be true.** If the investment sounds too good to be true, it probably is. Remember that investments providing higher returns typically involve more risk.
- ▶ **Pressure to buy RIGHT NOW.** Fraudsters may try to create a false sense of urgency to get in on the investment. Take your time researching an investment opportunity before handing over your money.

#### **Bitcoin users may be targets for fraudulent or high-risk investment schemes.**

Both fraudsters and promoters of high-risk investment schemes may target Bitcoin users. The exchange rate of U.S. dollars to bitcoins has fluctuated dramatically since the first bitcoins were created. As the exchange rate of Bitcoin is significantly higher today, many early adopters of Bitcoin may have experienced an unexpected increase in wealth, making them attractive targets for fraudsters as well as promoters of high-risk investment opportunities.

Fraudsters target any group they think they can convince to trust them. Scam artists may take advantage of Bitcoin users’ vested interest in the success of Bitcoin to lure these users into Bitcoin-related investment schemes. The fraudsters may be (or pretend to be) Bitcoin users themselves. Similarly, promoters may find Bitcoin users to be a receptive audience for legitimate but high-risk investment opportunities. Fraudsters and promoters may solicit investors through forums and online sites frequented by members of the Bitcoin community.

**Bitcoins for oil and gas.** The Texas Securities Commissioner [recently](#) ([http://www.ssb.state.tx.us/News/Press\\_Release/03-11-14\\_press.php](http://www.ssb.state.tx.us/News/Press_Release/03-11-14_press.php)) entered an emergency cease and desist order against a Texas oil and gas exploration company, which



claims it is the first company in the industry to accept bitcoins from investors, for intentionally failing to disclose material facts to investors including “the nature of the risks associated with the use of Bitcoin to purchase working interests” in wells. The company advertised working interests in wells in West Texas, both at a recent Bitcoin conference and through social media and a web page, according to the emergency order.

**Bitcoin trading suspension.** In February 2014, the SEC [suspended](http://www.sec.gov/litigation/suspensions/2014/34-71568.pdf) trading in the securities of Imogo Mobile Technologies because of questions about the accuracy and adequacy of publicly disseminated information about the company’s business, revenue and assets. Shortly before the suspension, the company announced that it was developing a mobile Bitcoin platform, which resulted in significant movement in the trading price of the company’s securities.

### Using Bitcoin may limit your recovery in the event of fraud or theft.

If fraud or theft results in you or your investment losing bitcoins, you may have limited recovery options. Third-party wallet services, payment processors and Bitcoin exchanges that play important roles in the use of bitcoins may be unregulated or operating unlawfully.

Law enforcement officials may face particular [challenges](http://www.hsgac.senate.gov/download/?id=ac50a1af-cc98-4b04-be13-a7522ea7a70d) when investigating the illicit use of virtual currency. Such challenges may impact SEC investigations involving Bitcoin:

- ▶ **Tracing money.** Traditional financial institutions (such as banks) often are not involved with Bitcoin transactions, making it more difficult to follow the flow of money.
- ▶ **International scope.** Bitcoin transactions and users span the globe. Although the SEC regularly obtains information from abroad (such as through cross-border agreements), there may be restrictions on how the SEC can use the information and it may take more time to get the information. In some cases, the SEC may be unable to obtain information located overseas.
- ▶ **No central authority.** As there is no central authority that collects Bitcoin user information, the SEC generally must rely on other sources, such as Bitcoin exchanges or users, for this type of information.
- ▶ **Seizing or freezing bitcoins.** Law enforcement officials may have difficulty seizing or freezing illicit proceeds held in bitcoins. Bitcoin wallets are encrypted and unlike money held in a bank or brokerage account, bitcoins may not be held by a third-party custodian.

### Investments involving Bitcoin present unique risks.

Consider these risks when evaluating investments involving Bitcoin:

- ▶ **Not insured.** While securities accounts at U.S. brokerage firms are often insured by the [Securities Investor Protection Corporation](http://www.sec.gov/answers/sipc.htm) (SIPC) and bank accounts at U.S. banks are often insured by the Federal Deposit Insurance Corporation (FDIC), bitcoins held in a digital wallet or Bitcoin exchange currently do not have similar protections.

- ▶ **History of volatility.** The exchange rate of Bitcoin historically has been very volatile and the exchange rate of Bitcoin could drastically decline. For example, the exchange rate of Bitcoin has dropped more than 50% in a single day. Bitcoin-related investments may be affected by such volatility.
- ▶ **Government regulation.** Bitcoins are not legal tender. Federal, state or foreign governments may restrict the use and exchange of Bitcoin.
- ▶ **Security concerns.** Bitcoin exchanges may stop operating or permanently shut down due to fraud, technical glitches, hackers or malware. Bitcoins also may be stolen by hackers.
- ▶ **New and developing.** As a recent invention, Bitcoin does not have an established track record of credibility and trust. Bitcoin and other virtual currencies are evolving.

**Recent Bitcoin exchange failure.** A Bitcoin exchange in Japan called Mt. Gox recently failed after hackers apparently stole bitcoins worth hundreds of millions of dollars from the exchange. Mt. Gox subsequently filed for bankruptcy. Many Bitcoin users participating on the exchange are left with little recourse.

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Before making any investment, carefully read any materials you are given and verify the truth of every statement you are told about the investment. For more information about how to research an investment, read our publication [Ask Questions](http://www.sec.gov/investor/pubs/sec-questions-investors-should-ask.pdf) (<http://www.sec.gov/investor/pubs/sec-questions-investors-should-ask.pdf>). Investigate the individuals and firms offering the investment, and check out their backgrounds by searching the SEC's [IAPD](http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx) ([http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd\\_SiteMap.aspx](http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx)) website or FINRA's [BrokerCheck](http://brokercheck.finra.org/Search/Search.aspx) (<http://brokercheck.finra.org/Search/Search.aspx>) website and by contacting your [state securities regulator](http://www.nasaa.org/about-us/contact-us/contact-your-regulator/) (<http://www.nasaa.org/about-us/contact-us/contact-your-regulator/>).

## Additional Resources

[SEC Investor Alert: Ponzi Schemes Using Virtual Currencies](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf) ([http://www.sec.gov/investor/alerts/ia\\_virtualcurrencies.pdf](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf))

[SEC Investor Alert: Social Media and Investing – Avoiding Fraud](http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf) (<http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf>)

[SEC Investor Alert: Private Oil and Gas Offerings](http://www.sec.gov/investor/alerts/ia_oilgas.pdf) ([http://www.sec.gov/investor/alerts/ia\\_oilgas.pdf](http://www.sec.gov/investor/alerts/ia_oilgas.pdf))

[SEC Investor Bulletin: Affinity Fraud](http://www.sec.gov/investor/alerts/affinityfraud.pdf) (<http://www.sec.gov/investor/alerts/affinityfraud.pdf>)

[FINRA Investor Alert: Bitcoin: More Than a Bit Risky](http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P456458) (<http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P456458>)

[NASAA Top Investor Threats](http://www.nasaa.org/3752/top-investor-threats/) (<http://www.nasaa.org/3752/top-investor-threats/>)

[IRS Virtual Currency Guidance](http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance) (<http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance>)

[European Banking Authority Warning to Consumers on Virtual Currencies](http://www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf) (<http://www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf>)

## Contact the SEC

[Submit a question](https://www.sec.gov/oiea/QuestionsAndComments.html) (<https://www.sec.gov/oiea/QuestionsAndComments.html>) to the SEC or call the SEC's toll-free investor assistance line at (800) 732-0330 (dial 1-202-551-6551 if calling from outside of the United States).

[Report a problem](https://www.sec.gov/complaint/question.shtml) (<https://www.sec.gov/complaint/question.shtml>) concerning your investments or [report possible securities fraud](http://www.sec.gov/complaint/tipscomplaint.shtml) (<http://www.sec.gov/complaint/tipscomplaint.shtml>) to the SEC.

## Stay Informed

- ▶ Visit [Investor.gov](http://www.investor.gov) (<http://www.investor.gov>), the SEC's website for individual investors

- ▶ Receive SEC Investor Alerts and Bulletins by [email](http://www.sec.gov/news/press/subscribe_updates.htm) ([http://www.sec.gov/news/press/subscribe\\_updates.htm](http://www.sec.gov/news/press/subscribe_updates.htm)) or [RSS feed](http://www.sec.gov/rss/investor/alertsandbulletins.xml) (<http://www.sec.gov/rss/investor/alertsandbulletins.xml>)
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# INVESTOR ALERT: PONZI SCHEMES USING VIRTUAL CURRENCIES

**07/23/2013**

*The SEC's Office of Investor Education and Advocacy is issuing this investor alert to warn individual investors about fraudulent investment schemes that may involve Bitcoin and other virtual currencies.*

## Ponzi Schemes Generally

A [Ponzi scheme](http://www.sec.gov/answers/ponzi.htm) (<http://www.sec.gov/answers/ponzi.htm>) is an investment scam that involves the payment of purported returns to existing investors from funds contributed by new investors.

Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, rather than engaging in any legitimate investment activity, the fraudulent actors focus on attracting new money to make promised payments to earlier investors as well as to divert some of these "invested" funds for personal use. The SEC investigates and [prosecutes](http://www.sec.gov/spotlight/enf-actions-ponzi.shtml) (<http://www.sec.gov/spotlight/enf-actions-ponzi.shtml>) many Ponzi scheme cases each year to prevent new victims from being harmed and to maximize recovery of assets to investors.

As with many frauds, Ponzi scheme organizers often use the latest innovation, technology, product or growth industry to entice investors and give their scheme the promise of high returns. Potential investors are often less skeptical of an investment opportunity when assessing something novel, new or "cutting-edge."

## Look Out For Potential Scams Using Virtual Currency

Virtual currencies, such as Bitcoin, have recently become popular and are intended to serve as a type of money. They may be traded on online exchanges for conventional currencies, including the U.S. dollar, or used to purchase goods or services, usually online.

We are concerned that the rising use of virtual currencies in the global marketplace may entice fraudsters to lure investors into Ponzi and other schemes in which these currencies are used to facilitate fraudulent, or simply fabricated, investments or transactions. The fraud may also involve an unregistered offering or trading platform. These schemes often promise high returns for getting in on the ground floor of a growing Internet phenomenon.

Fraudsters may also be attracted to using virtual currencies to perpetrate their frauds because transactions in virtual currencies supposedly have greater privacy benefits and less regulatory oversight than transactions in

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of the SEC regardless of whether the investment is made in U.S. dollars or a virtual currency. ***In particular, individuals selling investments are typically subject to federal or state licensing requirements.***

**Bitcoin Ponzi Scheme.** In a recent case, [SEC v. Shavers](https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583) (<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583>), the organizer of an alleged Ponzi scheme advertised a Bitcoin “investment opportunity” in an online Bitcoin forum. Investors were allegedly promised up to 7% interest per week and that the invested funds would be used for Bitcoin arbitrage activities in order to generate the returns. Instead, invested Bitcoins were allegedly used to pay existing investors and exchanged into U.S. dollars to pay the organizer’s personal expenses.

## Common Red Flags Of Fraud

Many Ponzi schemes share common characteristics. Following are some red flags:

- ▶ **High investment returns with little or no risk.** Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. “Guaranteed” investment returns or promises of high returns for little risk should be viewed skeptically.
- ▶ **Overly consistent returns.** Investments tend to go up and down over time, especially those seeking high returns. Be suspect of an investment that generates consistent returns regardless of overall market conditions.
- ▶ **Unregistered investments.** Ponzi schemes typically involve investments that have not been registered with the SEC or with state securities regulators.
- ▶ **Unlicensed sellers.** Federal and state securities laws require certain investment professionals and their firms to be licensed or registered. Many Ponzi schemes involve unlicensed individuals or unregistered firms.
- ▶ **Secretive and/or complex strategies and fee structures.** It is a good rule of thumb to avoid investments you don’t understand or for which you can’t get complete information.
- ▶ **No minimum investor qualifications.** Most legitimate private investment opportunities require you to be an [accredited investor](http://www.sec.gov/answers/accred.htm) (<http://www.sec.gov/answers/accred.htm>). You should be highly skeptical of investment opportunities that do not ask about your salary or net worth
- ▶ **Issues with paperwork.** Be skeptical of excuses regarding why you can’t review information about the investment in writing. Always read and carefully consider an investment’s prospectus or disclosure statement before investing. Be on the lookout for errors in account statements which may be a sign of fraudulent activity.
- ▶ **Difficulty receiving payments.** Be suspicious if you don’t receive a payment or have difficulty cashing out your investment. Ponzi scheme organizers sometimes encourage participants to “roll over” promised payments by offering higher investment returns.
- ▶ **It comes through someone with a shared affinity.** Fraudsters often exploit the trust derived from being members of a group that shares an affinity, such as a national, ethnic or religious affiliation. Sometimes, respected leaders or prominent members may be enlisted, knowingly or unknowingly, to spread the word about the “investment.”

If you have a question or concern about an investment, or you think you have encountered fraud, please contact the SEC, FINRA or your state securities regulator to report the fraud and to get assistance.

[U.S. Securities and Exchange Commission \(http://www.sec.gov/\)](http://www.sec.gov/)

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[SEC.gov \(http://www.sec.gov/\)](http://www.sec.gov/)

[investor.gov \(http://www.investor.gov/\)](http://www.investor.gov/)

[Financial Industry Regulatory Authority \(FINRA\) \(http://www.finra.org\)](http://www.finra.org)

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(301) 590-6500

[www.finra.org/Investors/ \(http://www.finra.org/Investors/\)](http://www.finra.org/Investors/)

[North American Securities Administrators Association \(NASAA\) \(http://www.sec.gov/cgi-bin/goodbye.cgi?www.nasaa.org\)](http://www.sec.gov/cgi-bin/goodbye.cgi?www.nasaa.org)

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[www.nasaa.org \(http://www.sec.gov/cgi-bin/goodbye.cgi?www.nasaa.org\)](http://www.nasaa.org)

## Additional Information

For more information about [Ponzi schemes \(http://www.sec.gov/answers/ponzi.htm\)](http://www.sec.gov/answers/ponzi.htm), visit [sec.gov/answers/ponzi.htm \(http://www.sec.gov/answers/ponzi.htm\)](http://www.sec.gov/answers/ponzi.htm).

For a [list \(http://www.sec.gov/spotlight/enf-actions-ponzi.shtml\)](http://www.sec.gov/spotlight/enf-actions-ponzi.shtml) of SEC enforcement actions against Ponzi schemes, visit [sec.gov/spotlight/enf-actions-ponzi.shtml \(http://www.sec.gov/spotlight/enf-actions-ponzi.shtml\)](http://www.sec.gov/spotlight/enf-actions-ponzi.shtml).

For more information about being an [accredited investor \(http://www.sec.gov/answers/accred.htm\)](http://www.sec.gov/answers/accred.htm), visit [sec.gov/answers/accred.htm \(http://www.sec.gov/answers/accred.htm\)](http://www.sec.gov/answers/accred.htm).

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For additional investor educational information, see the SEC's website for individual investors, [investor.gov \(http://www.investor.gov/\)](http://www.investor.gov/).

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