

**ICO Series Discussion 1**  
***The DAO & The Dutch Auction***

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INITIAL COIN OFFERINGS, or ICOs, are the new fad of the digital asset space. However much securities regulators might caution the token's potentially securitised status, if applied correctly, a clear chasm of difference lies between a security and a token which is traded on the Blockchain. I have pointed out before now a number of differences with respect to a security and a token. To recap:

- A security represents a fixed form of value only: asset value, income value, or some sort of derivative thereof whereas a token can represent any sort of value-utility construct
- Whereas a security is a capital markets instrument, its utility being only ever the value inherent in it, a token may have other forms of utility
- The token presents an infinity paradox that a security does not; whereas a security is value-utility, a token, being in effect utility-value, distinguishes itself apart from a security by binding the securitised nature of financial product offerings on the Blockchain in an apparently never-ending circle wherein the final product is neither value nor utility. Clearly, if a token was a security this paradox would not exist; it would simply be value-utility

There has been some evidence lately in the form of official legal challenges to the notion that tokens are securities, both in case studies of publicised legal opinion by law firms representing ICO participants and also in the form of legal professionals writing on this subject in the main stream press.

Still, it is clear that the Securities & Exchange Commission is on the hunt for unregistered issuers of what might be deemed potential securities: Prostar, a celebrity/social media entertainment token issued by two tech developers in the United States, was voluntarily folded by

the founders after the SEC warned that they may qualify as potential violators of financial services law. The case of Prostar was surprising for a couple of reasons; first, far from being an instrument of value-utility, the token in question appeared to have quite strong utility-oriented characteristics, being as it was a type of celebrity voting device and not in and of itself having much inherent value inbuilt in the model; second, the entrepreneurs, barely past adolescence, had only raised \$50,000 in their ICO. What stuck about Prostar was centrally, it's employment of a mechanism known as the Decentralised Autonomous Organisation (DAO).

The employment of DAO structures has been a hot topic for regulatory authorities who regard them as a potentially criminal violation of securities issuance law. A DAO is essentially a form of special purpose vehicle (SPV) that is established in a non-legally-structured format to avoid the process of management having any responsibility associated with cashflows raised for a specific project. That is not the same thing as saying that management wants no *control* over the cashflows however, and herein is the problem with DAO structures – management wants *full* ownership rights over cashflows passed through DAO structures, but none of the hassle associated with the legal

responsibility of managing it. Needless to say, this is a highly unsatisfactory position for both investors and government authorities alike: millions of dollars of people's cash sat under the direct control of a few individuals who, if anything goes wrong, simply wash their hands of the problem and claim that the structure which they are employing is decentralised, and therefore, no one in particular's responsibility at all.

When considered thus, it is clear by looking at the Prostar case that the SEC's attempt was less concerned about the amount of money raised and more bound up instead with the process of ensuring some form of precedent was set whereby the founders of a structure employing DAO-structures took some form of ownership over its set-up. The point was not to go after a case where big money was at stake, in other words, but something of precisely the opposite: to create ownership precedent of some form in a case where the money raised was so inconsiderable that fighting the Commission would seem like nothing other than sheer folly.

DAO structures are most certainly at the heart of legal disputes over the regulated/non-regulated status of ICOs, at least for now. But it is my contention that this need not be the case at all, nor that it is

in anyway an essential or even beneficial structure for ICOs to adopt.

To be certain, the days of Crypto being an unregulated section of the financial services landscape will not last forever. Ultimately, there will surely be some form of regulatory oversight. This is arguably much-needed, for despite the liberties enjoyed by those working check-and-balance-free, it is those liberties that are giving rise to so much social aggravation in the industry, whereby one party attempts to ruin another's reputation based on nothing more than heresy and subjective opinion, or where a group of traders decide to attack the product or market of a competitor without exercising restraint over the extent of their actions. Still, until that day, digital assets remain in legal limbo, somewhere between cash, a security and an everyday consumer product (the regulation as it will be applied will probably be done so with these coordinates in mind, once it comes around).

DAO structures are not just an inefficient method of raising capital, they are legally an unnecessary extra risk. DAO structures require that a certain sum of money is raised for a project from the general public in the form of cash or cash-like assets such as Bitcoin, and that as it is raised it is placed in a specific wallet. A management team then administers the cash raised like

any other management team raising capital by issuing equity, except, because the cash is raised via the DAO structure, none of the rules of accountability apply to such management executives. Clearly, this is neither a tenable or desirable case.

Since Monkey Capital – the precursor to Monkey – began its own ICO process in July 2017, I have assiduously avoided the employment of a DAO structure. In fact, in the original White Paper, I suggested an alternate structure to the DAO, that being a Value Coeval, so named after the namesake value configuration of the Blockchain I developed in 2014 as part of an early study of digital asset valuation. Contrary to the DAO, the Value Coeval was designed not to bypass securities law, but to legally circumvent it by ascribing responsibility of ownership of the capital raised to a specific party.

Thus, the Value Coeval had a third party which administered payments and receipts from the project to both management and investor alike. A Russian copycat fund management set-up later employed this exact model and successfully managed to find a US legal firm to give them the all-clear on the structure's non-security status. Actually, all I did was to employ a share-denominated Limited Partnership in place of the project's "decentralised" structure, and in doing so I had in effect created a

structure more decentralised and legally-viable than any other to date.

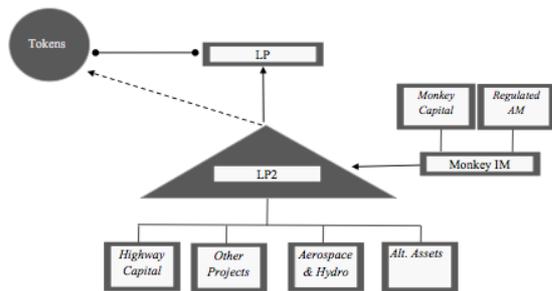
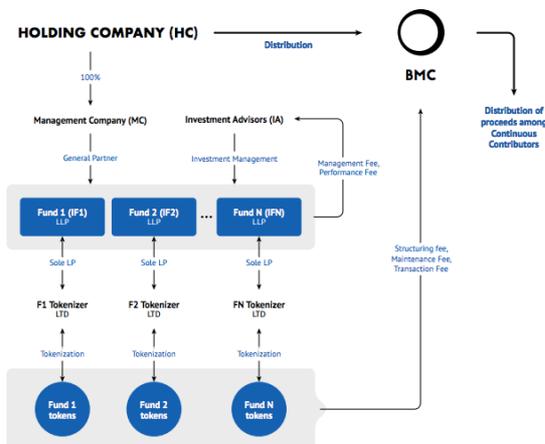


Fig. 4: In the diagram above, the structure that underlies the process of asset administration outlined in Fig. 2 is detailed for more clarity.

Above: the original legally-viable model developed by the author for the Monkey Capital ICO, and the copycat equivalent developed by Black Moon Crypto a month later (below) that ultimately received an all-clear on the Howey Test (bottom).

FIGURE 3  
Blackmoon Crypto structure and the distribution of BMC tokens



analysis, that results in an “investment contract” and security as opposed to a simple contract instrument.

4. Solely from the Efforts of Others. In the past, courts have been flexible with the word “solely,” such that, in addition to the literal meaning, it also will include significant or essential managerial or other efforts necessary to the success of the investment. See e.g., SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482-83 (9th Cir. 1973); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) (holding that where promoters retain immediate control over the essential managerial conduct of an enterprise, rather than remote control similar to a franchise arrangement, this element is met); but see Hirsch v. Dupont, 396 F. Supp. 1214, 1218-20 (S.D.N.Y. 1975), aff’d, 553 F.2d 750 (2d Cir. 1977) (indicating that solely should have literal application).

(a) We analyze the “expectation of profits” and “solely from the efforts of others” factors below:

(i) The expectation of profits resulting from the purchase of a BMC token would primarily relate to whether the holder receives (i) rights and/or (ii) investment interests. While non-security token holders may receive money or other forms of financial incentives by virtue of holding the token, we believe that any such incentives are derived through their own efforts, rather than through a passive investment (as would be the case with a blockchain security token).

(ii) Essentially, each of the rights allows the nonsecurity blockchain token holder to utilize, contribute to or license the use of the system in various ways, none of which would be considered a passive investment. Rather, we see the non-security blockchain token holders as active participants, like franchisees or licensees. If BMC token holders have rights to validate transactions in the BMC network, to perform certain other useful tasks for the benefit of the network, to act as individual investment advisors, and to generally actively participate in network operations and derive active income from their efforts, then there is no expectation of profits solely from the efforts of others.

Transcription of opinion given by Velton-Zegelman

Thus, the employment of a potentially illegal form of fiduciary evasion is not prerequisite when it comes to raising capital for an ICO. However, neither is it necessary to raise capital in the way in which it is currently done either. Here, I am of course talking about the method of capital raising known popularly as the “Dutch Auction” method, where a project is made open for funding for a specific time period during which investors make contributions in coins and tokens and receive back (usually via smart contract) some form of alternate tokenised capital-utility.

Since the very start of my involvement with the ICO process, I have stood firmly in opposition to the Dutch Auction method of capital raising. That is because it is wholly-insufficient for project financing. For a start, no sort of valuation is predetermined about the project in advance when this kind of capital raising method is employed.

This fact alone should be enough to deter even the more risk-prone of investors from contributing to such schemes, for if the managers of a project don’t understand how much their project is worth, how will they ever know the appropriate amount of capital (or as the case may be, capital-utility-value) to return the initial contributors participating in the Dutch

Auction? They cannot and thus all projections, plans and warranties made by the management must therefore be considered to be from the outset either false or negligent claims.

Second, the Dutch Auction is open to considerable risk of theft. Time and again, Dutch Auction capital raises have shown themselves to involve some sort of successful or partially-successful attempt by hackers to access a wallet containing large sums of crypto in the form of would-be investor contributions.

Third, Dutch Auction raises are impractical from a capital markets listing standpoint. Specifically, either the project is listed at cash value following the raise, or any initial rise in the value of the tokens purchased at the ICO is likely to be followed by sharp sell-offs.

There is no attempt whatsoever by those holding Dutch Auction raises to utilise the capital for business growth projections; rather, the emphasis seems to be on pilfering the coffers of the wallet at the ICO by the DAO-enabled unaccountable management team.

If all this begins to sound like pretty hair-raising stuff, that is because it is. Dutch Auction capital raises are a redundant way to go about value creation. Yet they are central to the employment of the DAO. This co-dependence of the DAO on the Dutch Auction method of raising capital

(or on similar variants of it as proposed by Vitalik Buterin, which ultimately amount to the same end result) means that as long as ICOs are pushed in the direction of decentralised management structures or in the direction of glorified crowdfunding campaigns, the two are more or less inseparable unless either you register the token for sale as a security and employ the securities exemption act that Monkey Capital did during its ICO, or you develop a more sophisticated SPV-enabled centralised actively-managed value proposition to deliberately circumvent in a legal way the SEC securities regulations. However, what if Dutch Auctions were not employed in ICOs at all? What if, instead of raising capital via a crowdfunded pre-project raise, a capital raise was conducted on market.

It is my strong contention that this was the greatest discovery that Monkey made during the Summer 2017 ICO process, and the one for which throughout the month of August, its competitors tried their hardest to make it pay most dearly for.

It is this, which is to say, the forthcoming rise of the market-based ICO, which will therefore be the subject of the subsequent paper in this series.  $\Phi$