

Can an Initial Coin Offering (ICO) Comply with US Law?

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Promises of Distributed Ledger Technology

- What the internet did for communication, the blockchain or similar technology can do for finance. The internet does not allow for sending of originals only copies; great for communications, but not for commerce.
 - *“Bitcoin gives us, for the first time, a way for one Internet user to transfer a unique piece of digital property to another Internet user, such that the transfer is guaranteed to be safe and secure, everyone knows that the transfer has taken place, and nobody can challenge the legitimacy of the transfer. The consequences of this breakthrough are hard to overstate.”* Marc Andreessen, Developer of Mosaic
- The intentional corruption of data may become a much larger issue than the release of data, which a distributed ledger can be ideal to tackle.
 - *“the value that [organizations] see and gain from [blockchain] is being able to cryptographically prove to third parties that they're not manipulating data; no one in their company has manipulated any data — intentionally or accidentally; no hackers have changed any state. So it's simply about increasing the robustness of that institution. It's a security and transparency innovation when we use it there.”* Adam Ludwin, CEO of Chain
- The ability to transact and store value without an intermediary has almost unlimited promise.

Brief History of Digital Asset Sales or ICOs

- From 1998-2009, attempts were made to create cryptocurrencies. These attempts, such as B-Money and Bit Gold, never took off.
- Bitcoin mining began in 2009.
- In 2010, Bitcoin was valued for the first time.
- The first token sale was held by Mastercoin in July 2013.
- Ethereum's token sale was in 2014, raising \$2.3M in two hours.
- Since Ethereum's sale, ICOs have taken off particularly in 2017
- 2018 has seen increased caution with the realization that most ICOs are securities and many involve fraudulent activity.

Current ICO Market

- In 2017, about \$4 billion was raised to fund over 200 ICOs.
- Since the beginning of 2018, over \$6.3 billion has been raised by close to 200 ICO's in just Q1.
- Top three (by amount raised) in 2017:
 - Filecoin (\$257M): blockchain-based data storage
 - Tezos (\$232M): blockchain to compete with ethereum or bitcoin
 - EOS (\$180M): another blockchain in development to compete with ethereum
- By far the largest ICO of 2018 was Telegram:
 - Telegram claims to have raised \$1.7 billion in a pre-sale of tokens.

One Way to Think of ICOs

If you're having trouble picturing it: Imagine that a friend is building a casino and asks you to invest. In exchange, you get chips that can be used at the casino's tables once it's finished. Now imagine that the value of the chips isn't fixed, and will instead fluctuate depending on the popularity of the casino, the number of other gamblers and the regulatory environment for casinos. Oh, and instead of a friend, imagine it's a stranger on the internet who might be using a fake name, who might not actually know how to build a casino, and whom you probably can't sue for fraud if he steals your money and uses it to buy a Porsche instead. That's an I.C.O. –

Kevin Roose, The New York Times

Examples of “Interesting” ICOs

- WePower: Enabling green energy producers to raise capital by issuing tradable energy tokens.
- Medichain: Medical big data platform whose tokens can be used to buy personal medical data services and storage.
- LOOMIA: A hardware device that turns clothing into data-collecting and identity tools. The LOOMIA TILE give users ownership over their data and the ability to sell their personal data to brands/third parties.
- Jesus Coin: Decentralizing Jesus. Jesus Coin can be used to buy sin forgiveness.

Which Regulations Does an ICO Need to be Concerned About?

- This presentation primarily discusses federal securities regulation, as enforced by the SEC.
- There are a number of other legal issues as well:
 - Commodity Futures Trading Commission (CFTC) regulation
 - Investment Company Act of 1940
 - Investment Advisers Act of 1940
 - Know your client and anti-money laundering rules
 - State securities laws
 - Money transmitter laws
 - State and federal tax laws

What is a “Security”?

- The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. 15 U.S.C. §77b(a)(1).
- The Supreme Court laid out a 4-prong test in *SEC v. W.J. Howey Co.*:
 - It is an investment of money
 - In a common enterprise
 - With an expectation of profits
 - That are derived from the efforts of the promoter or third party.
- The key question: is the holder of the contract acting as an investor and expecting financial benefits based on the work of a third party?

Are all Tokens Securities?

“I have yet to see an ICO that doesn’t have a sufficient number of hallmarks of a security”

SEC Chairman, Jay Clayton

Recent SEC Enforcement Actions and Policy Statements

- On July 25, 2017, the SEC released The DAO report.
- On September 25, 2017, the SEC announced the Cyber Unit, an initiative in the Enforcement Division to focus on cyber-related misconduct, including ICOs that violate securities law.
- In a hearing before the Senate Banking, Housing, and Urban Affairs Committee (Feb. 6, 2018), SEC Chairman Clayton stated that the SEC is concerned with how to categorize cryptocurrencies and related ICOs.
- On March 7, 2018, the SEC released a statement on potentially unlawful online platforms for trading digital assets.
- Since Fall 2017, the SEC has been sending subpoenas to those involved in the ICO market and targeting most new ICOs.

The DAO

- The DAO was created to operate as a for-profit fountain to create and hold assets through the sale of DAO Tokens to investors, that would then be used to fund “projects.” The holders of DAO Tokens would share in anticipated earnings from the projects as a return on their investment, or they could re-sell the tokens on a secondary market.
- After DAO Tokens were sold, a hacker stole approximately 1/3 of The DAO’s assets. In response, a work-around was created where DAO Token holders could opt to have their investment returned to them.
- In response, the SEC investigated and issued a [report](#). In the report, the SEC found that:
 - DAO Tokens are securities under the Securities Act and the Exchange Act, under the definition of “investment contract.”
 - The DAO should have registered its offering or qualified under an exemption.

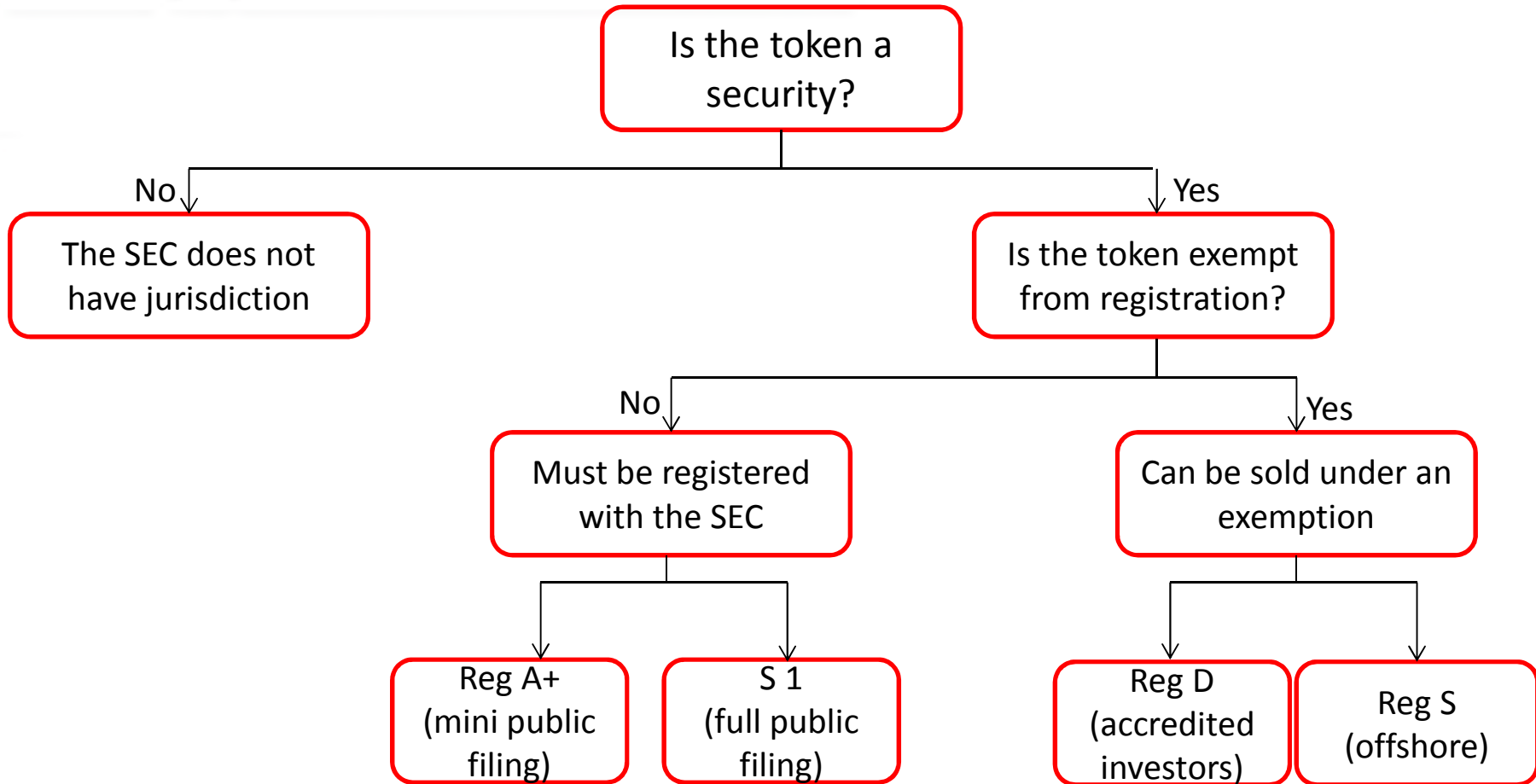
Munchee, Inc.

- Created an iPhone app for people to review restaurant meals.
- Issued an ICO to raise \$15M in capital to improve the app and recruit users. Munchee posted a White Paper describing the MUN tokens to be sold, the offering process, how Munchee would use the offering proceeds to develop its business, the way in which MUN tokens would increase in value, and the ability for MUN token holders to trade MUN tokens on secondary markets. The White Paper said that the offering “did not pose a significant risk of implicating federal securities laws,” without providing additional analysis.
- SEC filed a cease and desist order on Dec. 11, 2017, alleging that the tokens were “investment contracts” under *Howey* and that Munchee violated the Securities Act by failing to register the offering or qualifying for an exemption.

Key Takeaways from SEC Enforcement Actions and Policy Statements

- The SEC thinks that virtually all tokens are securities, and it thinks that all applicable securities laws, rules and regulations apply to tokens and token platforms.
- If it looks like a security, e.g. publishing prospectuses on the Internet and actively soliciting investors, the SEC will treat it like a security.
- Virtual currencies can be considered “investment contracts” (*The DAO*).
 - 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)
- Online security trading venues using virtual currencies may have to be registered as broker-dealers or exchanges (*In re BTC Trading, Corp. and Ethan Burnside; The DAO*).
- In the SEC’s view, ICOs are high-risk, ripe for fraud and Ponzi schemes, and exposed to hacking risks.
- “Utility” tokens: The SEC believes that tokens which have been sold are still securities regardless of any “utility”.

How to Sell a Token as a Security



So Let's Just Sell All Tokens as Securities

- Viable option if you just want to raise money ...
- However, there are issues related to a lack of exchange infrastructure, though this is being addressed by innovative companies, such as Templum and Krakan.
- In the long term, the blockchain advantages of issuing tokenized securities are immense and can revolutionize the venture market. In the short term, it's mostly about hype and the ability to gain access to additional groups of investors.

Life as a Security. . .



If it's a security:

- Needs to be sold by broker dealers
- Secondary trading must be on an exchange
- Custody rules
- Insider trading (10b-5)
- Like walking around with all of this luggage . . . forever

Can a Token Not be a Security?

- The SEC has made it fairly clear that it does not consider Bitcoin to be a security.
- A token is not a security if it can be classified as a product, a function or a currency.
 - As in rewards points, casino chips.
 - Having a “utility” function does not prevent a token from being considered a security.
- The key criteria for a token not to be a security is for it to have the attributes of bitcoin in that the tokens are not sold (anywhere!).
 - Our recommendation is to obtain a “no action letter” or other legal comfort from the SEC for any such token issued even if the token is not sold.

Potential Remediation of Existing Security Tokens

- The market is coming to the realization that that all ICO tokens, including ETH, are considered by the SEC to be unregistered securities not sold pursuant to an exemption.
- “It’s a ‘come to the lord’ moment,” said Richard Levin, a lawyer at the firm, Polsinelli “...firms in the digital asset community ...are now coming to terms with the fact that they are subject to regulators”... [NY Times, April 19, 2018](#).
- There have been a number of proposals for safe harbors for existing currencies. [One](#) “suggests that digital tokens should generally be exempt from securities laws if they achieve “full decentralization” or “full functionality.”
- Another more realistic proposal would allow companies six months to remediate an unregistered offering.
- It is far from certain that the SEC will agree to any safe harbor that exempts tokens from securities laws.

Hybrid Ideas. . . That Generally Don't Work

- SAFTs- Sell a security in a startup that becomes a non-security “product” once the network launches.
 - No, the SEC will consider it as one offering.
- Sell the token offshore and sell only to accredited investors in the US.
 - No, as this is still selling an unregistered security.
- Sell the token to some people and give away to others.
 - All of the tokens are likely to be considered securities.

Ideas for Non-Security Tokens

- Only give the token away as a reward for a service or deed.
- Issue a note that will be repaid in a non-security token.
 - The non-security token will have to have not been sold anywhere.
 - Might also work with having the non-security token paid as a dividend.
 - Should work under existing laws but should obtain an SEC no action letter.
- Issuer will sell tokens and will agree to comply with certain security laws for a set period of time.
 - This will need SEC approval and possibly a formal change in rules.

Doesn't Wyoming Allow ICOs?

- Wyoming has the smallest population of any state in the US.
- There are twice as many cows as people in Wyoming.
- Unless one plans to only sell tokens to residents of Wyoming this law is of little practical value for ICO issuers.



What About Just Avoiding The US?

- Although this is very popular right now we don't recommend it.
 - Could in theory work under "Regulation S".
 - Other countries also have laws that consider tokens to be securities.
 - Avoiding the US is easier said than done.
 - Plaintiff's lawyers can buy a share under a fake name.
 - Spillover advertising in the US.

Will Blockchain Technology Circumvent the Need for Regulation?

- Trying to bring power to the people often leads to the opposite.
- The traceability of the bitcoin ledger makes autocracy of particular concern.



Roles and Risks of Professionals

“Market professionals, especially gatekeepers, need to act responsibly and hold themselves to high standards. To be blunt, from what I have seen recently, particularly in the ICO space, they can do better.” SEC Chairman, Jay Clayton

- Lawyers should be upfront about whether securities laws apply, and clearly explain if and when they do.
- Accountants need to think about how to classify the tokens and adhere to existing accounting standards.

Contact

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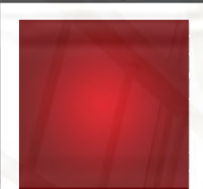
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