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Initial Coin Offerings

This paper examines initial coin offerings and the evolving regulatory landscape governing offerings of digital assets.

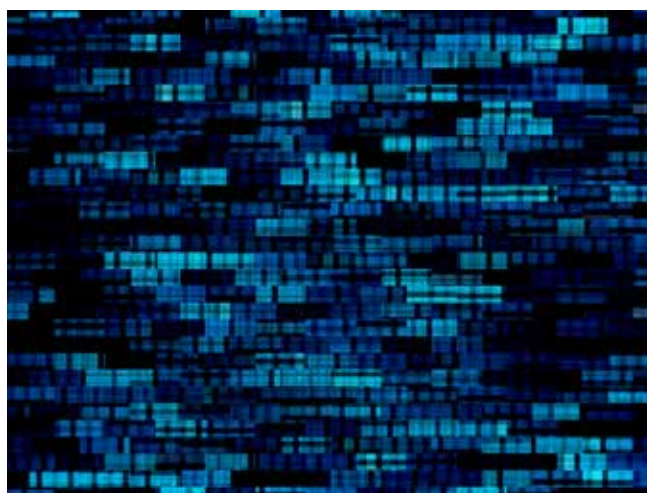
An initial coin offering (“ICO”) is the process by which an organization creates and issues crypto-coins, also referred to as tokens, that are necessary to fund and operate a specific blockchain-based application developed and run by an entity. Unlike traditional virtual currencies such as Bitcoin and Ether, crypto-coins that are offered as part of an ICO generally are not intended to be used as currency, but rather as tokens that are linked to tangible assets in the form of either (1) access to the protocols or utility of a new application, or (2) an investment/quasi-ownership stake in the application.

A central question in connection with ICOs is whether the digital asset being offered constitutes a security, making the ICO subject to the federal securities laws. The Securities and Exchange Commission (the “SEC”) has been increasingly focused on ICOs and made it clear that unregistered offerings of crypto-coins that constitute securities may be subject to enforcement action. As described below, digital assets may also be regulated as commodities by the Commodities Futures Trading Commission (“CFTC”).

The Case of The DAO

The SEC first articulated its framework for regulation of digital assets in the case of a decentralized autonomous organization called “The DAO,” which was launched via ICO on the Ethereum network in 2016.

The decentralized autonomous organization had been heralded as the “dream use case” of decentralized applications that could do away with organizational hierarchy, power “leaderless” organizations, and revolutionize crowdfunding and venture capital industries. The organization relies on consensus, rather



The Case of The DAO (continued)

than the decisions of a few executives, in order to make business decisions. Corporate governance structures are essentially hard-coded as the rules of the application, and all business decisions are made by shareholder consensus. Because these rules are hard-coded in a distributed and decentralized application where every decision and transaction is broadcast on its network, it is theoretically impossible for the shareholders in a DAO to operate outside of the rules unless they change them by a consensus vote.



At its outset, The DAO received substantial support from the crypto community, collecting the equivalent of \$150 million in Ethereum's native currency, Ether, in what was the largest ICO in history at its time. The DAO's popularity was fueled by its novel structure, which would allow any coin holder to submit a proposal that contained the information regarding a project to be funded by The DAO, the "contractors" that would be responsible for completing the various steps of the project, and the code for the "smart contract" that defines when and where funds are disbursed from The DAO as work progresses. Significantly, the proposal would also define the return, if any, that The DAO or its coinholders would receive in exchange for its funds.

The return could take many forms. For example, the project might not call for any return other than services rendered if it involved contracting for marketing or legal services rendered for The DAO itself. The project might also specify that the contractor pay The DAO a certain

fee or percentage of each product that the contractor is able to sell after The DAO funds its development. The project could even be wholly owned by The DAO itself, with its developers working as independent contractors, so that The DAO receives any profits that flow from it. After The DAO received its return from a project, coin holders could benefit by the growth of The DAO fund, the growth in value of The DAO coins on virtual currency exchanges, and/or even direct payment of Ether from The DAO, depending on the proposal.

After a proposal was submitted, all coin holders would have the opportunity to review it, and to vote on whether to fund it. If the vote passed, the smart contracts outlined in the proposal would be executed, and The DAO would begin autonomously disbursing and receiving funds in pre-defined installments as work progressed.

Though its possibilities seemed limitless, The DAO suffered from a major bug in its code, which ultimately resulted in its shuttering, and from regulatory scrutiny from the SEC.



The Case of The DAO (continued)



In July 2017, the SEC issued a “report of investigation” (a so-called “21(a) report”) in which it concluded that the crypto-coins offered in The DAO’s ICO were, in fact, securities. The SEC applied the test articulated in the 1946 Supreme Court decision of *SEC v. W.J. Howey Co.*, which requires a four-prong analysis of whether the scheme involves (i) an investment of money (ii) in a common enterprise (iii) with profits to come (iv) solely from the efforts of others. Applying the *Howey* test, the SEC concluded that the The DAO coins were securities and that the ICO constituted an unregistered offering in violation of the federal securities laws. Because of the novelty surrounding offerings of digital assets, the SEC decided not to bring formal enforcement charges, but rather to issue a 21(a) report as a caution to industry and market participants.¹

The case study of The DAO raises important questions:

- What are the best practices for launching an ICO?
- How can an organization considering launching an ICO ensure that its underlying technology will be defended against inevitable attacks?
- What government agencies are attempting to regulate ICO tokens, and how will an organization know if their token is subject to regulation?

This paper provides a brief overview of the process of launching an ICO, the considerations an organization must take in deciding to do so, and the current regulatory landscape surrounding ICOs.



Launching an ICO



Launching an ICO

There are a number of methods available for launching a new crypto-coin in an ICO. The most rudimentary method, which was used to launch the Ether coin, involves creating an entirely new blockchain network (in Ether's case, Ethereum), and offering a certain amount of that blockchain's "pre-mined" coin in exchange for either fiat currency or another virtual currency (in Ether's case, Bitcoin).²

Most ICOs, however, are performed by utilizing "smart contracts," self-executing transactions whose conditions are coded into programmable blockchain networks that allow for developers to build applications on top of the distributed ledger platform. The majority of ICOs have been launched by building decentralized applications ("Dapps") on top of the programmable Ethereum network.

Although the code needed to securely program Ethereum ICOs is technically complex, the workflow for an Ethereum ICO is fairly straightforward, and operates as follows:

- An investor sends a specified amount of Ether to a key connected to a smart contract.
- The Ethereum network verifies that the conditions for the contract are met.

- The smart contract releases the Ether to the offering organization, and releases the corresponding amount of the token being offered to the purchaser.
- The Ethereum network records the transactions on the blockchain. The offering organization can then keep the Ether that it receives, or exchange it for fiat currency or other virtual currencies.

Although it is technically possible to launch an ICO on the Ethereum network in less than 30 minutes by using widely available token creation tools,³ a sophisticated ICO must consider several factors in order to ensure its viability and security and maximize its potential to reach the issuing organization's fundraising and adoption goals.⁴

- Identify the framework of a viable and valuable technology that the coin will be used to fund, as well as the particular significance of the coin within the parameters of that technology.
- Prior to any public communication or marketing efforts, engage with legal counsel in order to ensure that the coin will comply with relevant regulatory guidelines. Even a slight pivot in the strategy used to market or offer the coins might mean the difference between a token sale or a regulated securities offering.

Launching an ICO (continued)

- Draft a whitepaper that details the technology and the coin, how the technology will be implemented, and why the technology provides an advantage over other technological solutions already on the market, while making sure that the whitepaper does not engage in puffery or otherwise mislead.
- Develop a marketing plan for the coin, both by creating a website for the project and by communicating with potential and existing users on already-existing media like GitHub, Reddit, Telegram, Slack, or internet forums dedicated to blockchain or crypto-development. It is important to note, however, that any such public communications could be subject to the federal securities laws.
- Develop the token, ensure that the smart contracts used to offer it are secure via both internal and third-party security audits, and launch the ICO.
- Continue efforts to boost adoption by performing additional marketing, offering community support, and potentially lobbying to have its coin listed on the many exchanges where users can trade in their coins for other coins, virtual currencies, and fiat currencies. It is recommended that those seeking to list coins on exchanges carefully examine and attempt to comply with the rules and regulations of these exchanges.

The intended use of a crypto-coin can essentially be split into two separate categories, which have significantly different uses and potential regulatory structures: (1) utility tokens, and (2) security tokens. It should be noted, however, that the line between these categories is not always clear, and designating a crypto-coin as one or the other to maneuver around regulatory structures can be problematic.

Utility tokens, also known as appcoins, bestow upon the holder some kind of use within the Dapp. Filecoin, for example, is a utility token that grants the holder access to a certain amount of storage in a still-in-development decentralized file storage platform.

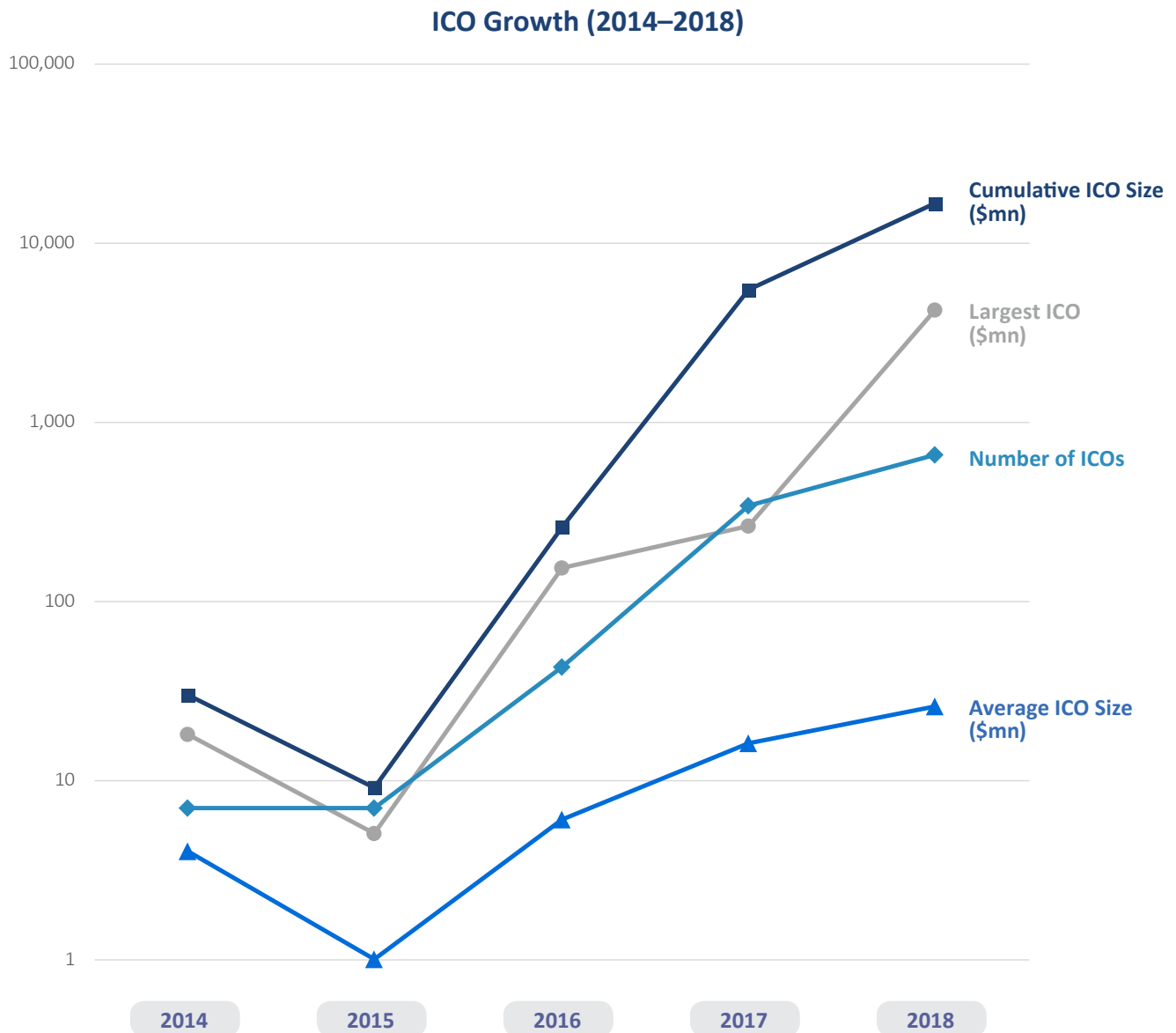


Security tokens, as their name suggests, grant the holder an investment or quasi-ownership stake in the Dapp or the issuing organization, and may even pay dividends, share profits, pay interest, or allow the group of holders to invest in other tokens or assets. Security tokens are more difficult to define than utility tokens, and utility tokens may even be considered security tokens if they share enough elements in common with a security token, according to the relevant regulating authorities.⁵



Launching an ICO (continued)

Over the past several years, ICOs have grown in both number and size. As of this writing, crypto asset media and information services company CoinDesk reports that ICOs raised over \$16.7 billion in 2018 alone, as compared to \$5.4 billion in 2017, \$256 million in 2016, \$9 million in 2015, and \$30 million in 2014.⁶



In June 2017, startup Block.one launched an Ethereum ICO to fund its then-still-in-development EOS blockchain network, which promises to function as a more powerful competitor to Ethereum with more Dapp functionality and increased scalability. When the ICO closed in June

2018, EOS had raised nearly \$4.2 billion worth of Ether, making it the largest ICO of all time. The EOS blockchain network went live on June 14, 2018,⁷ and EOS promptly converted the Ether raised during its ICO to cash over the next month.⁸

Regulatory Landscape

Regulatory Landscape

The regulatory landscape governing ICOs continues to evolve. Currently, there is no single regulatory or other central authority regulating ICOs and numerous agencies have brought enforcement actions to regulate ICOs, including the SEC, the CFTC, the Federal Trade Commission (“FTC”) and the Department of Justice (“DOJ”).⁹

As described above, ICOs share characteristics with both securities and commodities and have therefore drawn significant scrutiny from both the SEC and the CFTC. These agencies have emerged as the main enforcement agencies for ICOs and virtual currencies. The SEC and CFTC have not yet issued formal rules regulating ICOs. However, recent enforcement actions have made clear that the SEC and CFTC are actively using existing laws and regulations to police ICOs.

Securities and Exchange Commission

Following The DAO report, the SEC has underscored that the *Howey* test will be applied to digital assets and that unregistered ICOs involving securities will be subject to enforcement action.



In June 2018, the Director of the Division of Corporation Finance, William H. Hinman, delivered a speech in which he discussed the *Howey* test at length, and remarked that the status of digital asset transactions may shift over time as their networks become decentralized and the efforts of third parties “are no longer a key factor for determining the enterprise’s success.” Notably, Director Hinman specifically applied these concepts to Bitcoin and Ether, concluding that they, as currently constituted and in a vacuum, would not be considered securities subject to SEC regulation.¹⁰

In March 2019, SEC Chairman Jay Clayton confirmed that the SEC’s official policy is to apply the *Howey* test as articulated in The DAO 21(a) report and concurring with Director Hinman’s analysis of the shifting nature of digital asset transactions (although Chairman Clayton did not specifically say whether he agreed with Director Hinman’s conclusion that Bitcoin and Ether are not securities).¹¹

On April 3, 2019, the SEC staff published a “Framework for ‘Investment Contract’ Analysis of Digital Assets,” which provides a further roadmap for applying *Howey* to digital assets in order to analyze whether a digital asset is an investment contract and whether offers and sales of a digital asset are securities transactions.¹²

The SEC’s Enforcement Division has brought a number of cases involving unregistered ICOs following The DAO report.

Munchee Inc., No. 3-18304 (Dec. 11, 2017)¹³

- On December 11, 2017, the SEC announced a settlement with Munchee Inc., which was ordered to cease and desist its ICO. The SEC’s settlement with Munchee was the first non-fraud ICO registration case.
- Critically, in promoting the ICO, Munchee emphasized that the company would create an ecosystem, coupled with the company’s own efforts, that would increase the value of its “MUN tokens.” As a result, purchasers of the MUN tokens would have a “reasonable expectation that they would obtain a future profit from buying MUN tokens if Munchee were successful in its entrepreneurial and managerial efforts to develop its business.”¹⁴
- Relying on the *Howey* test in its Cease and Desist Order, the SEC determined that MUN tokens were securities, even though the token had a practical use at the time of the offering, and that Munchee’s ICO

Regulatory Landscape (continued)

violated Section 5(a) of the Securities Act because the tokens were unregistered.

- The SEC did not impose a penalty or include undertakings from Munchee, in part, because it stopped its offering before delivering any tokens and promptly reimbursed investors.

TokenLot, LLC, No. 3-18739 (Sept. 11, 2018)¹⁵

- On September 11, 2018, the SEC announced a settlement with TokenLot, LLC and its owners for charges that they acted as unregistered broker-dealers. TokenLot was a self-described “ICO superstore” where investors could purchase digital assets, including digital asset securities during or after an ICO. The company received compensation based on a percentage of the proceeds raised in the ICOs, subject to a guaranteed minimum commission.
- According to the SEC’s Cease and Desist Order, TokenLot and its owners promoted the company’s website as a means to purchase digital tokens during ICOs and to engage in secondary trading. Some of the digital tokens the company handled included securities according to the SEC, but neither the company nor its owners were registered as broker-dealers.

AirFox, No. 3-18898 (Nov. 16, 2018)¹⁶ and *Paragon Coin, Inc.*, No. 3-18897 (Nov. 16, 2018)¹⁷

- On November 16, 2018, the SEC announced settlements with AirFox and Paragon Coin Inc., both of which issued unregistered digital tokens through ICOs. Both companies marketed the tokens as part of a plan to create an ecosystem that would increase the value of the tokens and as an opportunity to obtain future profits from the company’s efforts. These are some of the hallmarks of an offering of securities, particularly in light of the SEC’s settlement with Munchee, Inc.

- These are the first SEC cases imposing civil penalties solely for ICO securities offering registration violations. Both companies will be required to pay \$250,000 in penalties, compensate harmed investors, and register their tokens as securities.

SEC v. Kik Interactive, No. 19-cv-5244 (S.D.N.Y., filed June 4, 2019)¹⁸

- On June 4, 2019, the SEC charged Kik Interactive Inc. for conducting a \$100 million securities offering of digital tokens without registering their offer and sale as required by U.S. securities laws.
- The SEC alleged that Kik sold its “Kin” tokens to the public, and at a discounted price to wealthy purchasers, raising more than \$55 million. At the time of the filing of the SEC’s complaint, Kin tokens were trading at about half of the value that public investors had paid in the offering. Furthermore, the SEC alleges that Kik marketed the Kin tokens as an investment opportunity, telling investors that rising demand—driven by Kik’s efforts—would increase the value of Kin.
- The SEC seeks a permanent injunction, disgorgement plus interest, and a civil penalty.

In light of SEC enforcement actions, some companies have opted to work with the SEC to register their filings or self-report already initiated unregistered ICOs.

Gladius Network LLC, No. 3-19004 (Feb. 20, 2019)¹⁹

- On February 20, 2019, the SEC announced a settlement with Gladius Network LLC arising from its failure to register an ICO under federal securities laws.
- In late 2017, Gladius raised approximately \$12.7 million in digital assets to finance its plan to develop a network to defend against cyberattacks and enhance delivery speed.

Regulatory Landscape (continued)

- The company self-reported its failure to register to the SEC in the summer of 2018, expressed an interest in taking prompt remedial steps, and cooperated with the investigation. As a result, the SEC did not impose a civil penalty.
- The company agreed to return funds to investors who purchased tokens in the ICO, register its tokens as securities pursuant to the Securities Exchange Act of 1934, and will file required periodic reports with the SEC.

Blockstack (July 10, 2019)

- On July 10, 2019, the SEC approved a \$28 million offering under Regulation A+ for Blockstack, a blockchain startup, to sell bitcoin-like tokens. The Blockstack offering represents one of the first SEC-approved token offerings on the market. The company worked with the SEC for over ten months to obtain approval for the sale.²⁰

Offerings of digital assets can also be structured as private placements, exempting them from the usual SEC registration requirements.

Commodity Futures Trading Commission

Recent decisions in actions brought by the CFTC provide that virtual currencies are commodities under the Commodity Exchange Act (“CEA”). Utilizing the definition of virtual currencies as commodities, the CFTC has begun to exercise its authority to prosecute fraud and manipulation actions in markets where these currencies are traded in interstate commerce or as futures.²¹



CFTC v. My Big Coin Pay, Inc., et al., No. 18-cv-10077 (D. Mass. Sept. 26, 2018)²²

- The CFTC alleged that defendants operated a fraudulent virtual currency scheme in which they solicited customers to purchase a virtual currency—My Big Coin—by making false and misleading claims about its value, usage, trade status, and financial backing and misappropriated over \$6 million from investors.
- Defendants filed a motion to dismiss in May 2018 on the grounds that the CFTC lacked jurisdiction to bring claims because My Big Coin was not a commodity governed by the CEA.
- On September 26, 2018, the Court held that the CFTC had sufficiently alleged that My Big Coin was a commodity under the CEA because it “is a virtual currency and it is undisputed that there is futures trading in virtual currencies.”²³
- The Court supported the CFTC’s broad reading of “commodity,” holding that the definition “includes a host of specifically enumerated agricultural products as well as ‘all other goods and articles ... and all services rights and interests ... in which contracts for future delivery are presently or in future dealt in.’”²⁴

The CFTC relied on a similar decision handed down in *CFTC v. McDonnell, et al.* in March 2018.²⁵

- There, the Court held that the CFTC had standing to bring an action regulating virtual currencies because they “are ‘goods’ exchanged in a market for a uniform quality and value” and “fall well-within the common definition of ‘commodity’ as well as the CEA’s definition of ‘commodities’ as ‘all other goods and articles ... in which contracts for future delivery are presently or in the future dealt in.’”²⁶

Regulatory Landscape (continued)

These preceding cases demonstrate the CFTC's broad authority to enforce the CEA with respect to virtual currencies and digital assets, including those issued through ICOs.

The Token Taxonomy Act

In December 2018, U.S. Representatives Warren Davidson (R-Ohio) and Darren Soto (D-Florida) introduced bill H.R. 7356, the "Token Taxonomy Act," which would amend a number of statutes in order to reduce Federal Regulation of crypto tokens.²⁷ The Token Taxonomy Act was never enacted, but Representative Davidson reintroduced it in April 2019, with several changes to expand the definition of "digital tokens," clarify jurisdictional questions, and strengthen consumer protection initiatives.²⁸

As currently drafted, the Token Taxonomy Act would, among other reforms:

- Exempt "digital tokens" from statutory definitions of "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934.
- Provide a "reasonable and good faith belief" safe harbor provision to ensure that coin issuers will violate securities registration laws if the SEC determines that their coins are securities.
- Supersede state laws relating to crypto regulation (but not fraud), but preserve the jurisdictions of the CFTC and the FTC.
- Amend the Internal Revenue Code to provide for consideration of "virtual currency."

Looking Ahead: Compliance

While the SEC and the CFTC have emerged as the primary regulatory and enforcement agencies with respect to ICOs, they are not alone. The DOJ, FTC, and state agencies are similarly scrutinizing virtual currencies and ICOs. Compliance may become increasingly complicated as more agencies exercise concurrent jurisdiction over ICOs and virtual currencies.

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