PROCEED WITH CAUTION

THE CURRENT STATE OF THE EVOLVING U.S. INITIAL COIN OFFERING LANDSCAPE

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2017 registered a dizzying uptick in "initial coin offerings" or "token sales" (collectively, ICOs) as a means of funding early stage blockchain-related ventures. According to Coindesk.com's ico-tracker, ICOs raised $38 million in Q1 2017, $797 million in Q2 2017 and $1.38 billion in Q3 2017. ICOs are on track to exceed the Q3 2017 total as ICO funding exceeded $1.25 billion in October and November 2017. Needless to say, ICO offerings have now far surpassed traditional venture capital as a means for funding new blockchain-related ventures.

WHAT IS AN ICO?

An ICO is a relatively new fundraising method through which virtual tokens or coins are created and distributed using distributed ledger or blockchain technology. These tokens may be denominated in fiat currencies or, more commonly, in cryptocurrencies like bitcoin or ether. After issuance, tokens may be resold in secondary markets and have their own market value independent of the cryptocurrency used on the associated platform.

Capital raised from the ICOs may be used to fund development of associated digital platforms, networks or applications, while granting the token holder some interest in the project. In other cases, purchased tokens may be used to access the digital platform or application, or otherwise participate in the project, once it is functional.

Thus, generally, tokens fall into two categories: "securities tokens" and "utility tokens." A securities token is analogous to a traditional security like corporate stock, LLC membership interest or partnership interest. A utility token is intended to facilitate access to a product or service on the digital platform or network thus deriving value primarily from consumptive use, meaning that it may be analogized to a gift card or software license.

UNCERTAINTIES SURROUNDING ICOS

In view of an uncertain regulatory environment, the accelerated rise in 2017 of ICOs as a fundraising paradigm for blockchain-related startups has elicited some notes of caution. ICOs have drawn criticism from some who contend that ICOs make it possible for issuers to bypass the highly regulated capital-raising process that venture capitalists, banks and underwriters are obligated to follow in IPOs.

Regulators in the United States and elsewhere appear to be concerned that ICOs, which usually involve innovative and highly technical projects disclosed in white papers, risk creating informational asymmetries between issuers and investors to the extent that disclosures are not fully and fairly made. Also, because blockchain technology, broadly speaking, is still in its relative infancy, there have been instances where possibilities disclosed have not ultimately materialized as advertised—a phenomenon hardly unique to blockchain technology.

Given the lack of actionable regulatory guidance, there remains some lingering uncertainty as to whether tokens are, in fact, "securities," a classification with practical implications. If a token is deemed to be a security, then its offer and sale is regulated under federal securities laws, and registration with the Securities and Exchange Commission (SEC) is required unless an exemption is available.

Registration of a traditional underwritten public offering is time consuming and expensive, and, once an issuer becomes public, carries with it extensive reporting requirements. The most commonly used exemption is the "private placement" to accredited investors. In contrast to a public offering, in which anyone is eligible to invest, a private placement limited to "accredited investors"—wealthy individuals and institutions—does not require any specified disclosures or audited financial statements. Neither SEC registration nor an exempt offering provides the same freedom of action, lower expense and shorter time to completion as compared to an ICO not subject to SEC regulation. Consequently, whether a particular token is deemed to be a security is a threshold question. That said, regardless of the nature of the token, *i.e.* whether the offering may be subject to SEC regulation, the issuer may not make any material misstatements or omit material facts in the course of the offering.

THE DAO INVESTIGATIVE REPORT

The SEC has yet to issue formal guidance concerning the regulatory treatment of utility tokens, whether it sees a distinction between securities tokens and utility tokens, and the circumstances in which utility tokens may be deemed to constitute securities. It has, however, offered some useful insight by affirming whether a particular token is indeed a security depends on the specific facts and circumstances in play. The SEC did so in July 2017, when it issued an investigation report concerning the applicability of securities laws to tokens issued by the Decentralized Autonomous Organization (DAO)—a crowdsource venture capital platform created by Slock.it, a German entity. The DAO was a smart contract on the Ethereum blockchain that operated much like a venture fund, where tokens were sold in exchange for ether, which was then pooled. Token holders were then allowed to vote on a menu of investments to which the DAO would apply portions of pooled funds. The DAO token holders were also to share in the profits from the investments.

In its report, the SEC noted that the definition of "security" is flexible and adaptable to the variable means devised to use others' money to fund a venture with the promise of profit. Typically, the SEC focuses on the substance (and not the form) of the overriding economic realities in determining whether an instrument is a security. In analyzing the DAO tokens, the SEC invoked the four-pronged "Howey test" under which an instrument is a security if it relates to (i) an investment of money (ii) in a common enterprise (iii) with a reasonable expectation of profits (iv) to be derived from the entrepreneurial and managerial efforts of others. The SEC concluded that the DAO tokens were securities, subject to its regulation. In view of the facts presented, the SEC did not have occasion to shed light on what distinction, if any, it perceives between securities tokens and utility tokens.

EFFORTS AIMED AT MITIGATING REGULATORY UNCERTAINTIES

The persistent regulatory uncertainty has spawned efforts aimed at creating regulatorily compliant ICOs and tokens. One such effort has yielded the Simple Agreement for Future Tokens (SAFT). In the SAFT model, a clear distinction is made between pre-functional utility tokens—those issued before a platform is operational—and fully functional utility tokens—those issued after the platform is functional. The model presumes that pre-functional utility tokens likely meet all four prongs of the Howey test and are thus securities subject to regulation by the SEC. In contrast, the model presumes that fully functional utility tokens—those purchased based on a primary motivation to access or use the platform—are unlikely to satisfy all four prongs of the Howey test, making them less likely to be deemed securities and, therefore, likely beyond the regulatory reach of the SEC.

The SAFT itself is a security that is offered to U.S. accredited investors for pre-functional utility tokens. Once

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the platform successfully launches and while the SAFT is in effect, the company is obligated to issue the now functional utility tokens to the SAFT holder.

Proponents of the SAFT model believe that there is a strong argument that the now fully functional utility tokens are not securities and thus not subject to SEC regulation. They further argue that the SAFT model addresses many securities, money transmitter, tax and policy concerns based on the current legal landscape, although they cautiously note that the SAFT has yet to be scrutinized by a U.S. court or regulatory agency.

Since CoinList became the first company to use a SAFT to facilitate its FileCoin token issuance in August 2017, an increasing number of blockchain startups have followed suit or are planning to do so. In, or close to, Silicon Slopes, tZERO, a majority owned subsidiary of Overstock.com that is pioneering a distributed ledger platform for capital markets, announced a highly anticipated token sale utilizing a SAFT beginning in December 2017. ULedger, a Boise company employing blockchain capabilities for cutting-edge data integrity applications, is planning a token sale likewise utilizing a SAFT in early 2018.

As with any new effort in a regulatorily fraught arena, the SAFT model has attracted at least two criticisms—practical and philosophical. First, some view the model's apparent bright lines employed in the model to be an oversimplification because the nature of any given token is to be evaluated on a case-by-case basis, whether the network is functional or not. Second, some have objected that the SAFT model does not promote the idealized notion that ICOs are intended to "democratize" and ultimately disrupt venture capital funding, specifically by opening up deals to retail investors across the globe. That ideal, however, runs into the realization that accredited investors account for up to 80 percent of the funds raised in ICOs and also ignores regulatory realities affecting U.S. investors.

THE SEC'S FOCUS ON ICOS

On December 11, 2017, SEC Chairman Jay Clayton, issued a public statement on cryptocurrencies and ICOs. Although he did express a belief "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," the statement was largely cautionary. Notably, Clayton indicated that merely calling a token a "utility" or structuring it to provide some utility does not mean the token will not be found to be a security based on the facts and circumstances in play. He also noted that the ICO offerings he has seen promoted—he did not say which—involve securities. Confirming the SEC's increased vigilance in this area, Clayton has asked the agency to "to police this area vigorously and recommend enforcement actions" against violators.

This statement highlights the need for continued caution and careful analysis by ICO issuers in their offerings. Whether this increased regulatory focus is sufficient to chill the kind of ICO activity witnessed in 2017 remains to be seen. ■

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