The End of the ICO Gold Rush?
The Regulatory Squeeze on Token Offerings as a Funding Mechanism for Blockchain-Related Ventures

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According to Coindesk.com's ico-tracker, "initial coin offerings" or "token sales" (collectively, ICOs) have been used to raise approximately $7.3 billion through January 2018 as a means of funding early stage blockchain-related ventures, with about $7 billion of that cumulative funding having closed in the thirteen-month span between early January 2017 and late January 2018. *See* https://www.coindesk.com/ico-tracker/. ICOs thus came of age in 2017 as the funding mechanism of choice for blockchain-related ventures, far surpassing traditional venture capital.

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 can be viewed as falling into two categories: "investment tokens" and "utility tokens." An investment token is analogous to a traditional security like corporate stock, LLC membership interests, or partnership interests. 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. Some markets for tokens may also be susceptible to manipulation by unscrupulous actors. Further, 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 that, though hardly unique to blockchain technology, has implications for investors.

For issuers, whether a token is deemed to be a "security" has 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.

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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

While the SEC has yet to issue formal guidance that puts to rest much of the uncertainty surrounding the treatment of tokens as securities and under what circumstances that may be, it has offered some useful insight when it affirmed that whether a particular token is indeed a security depends on the specific facts and circumstances in play. The SEC began to do so in July 2017, when it issued an investigative report titled "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO" (the DAO Investigative Report). The focus of the report was on the applicability of federal 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 *SEC v. W.J. Howey*, 328 U.S. 293 (1946), 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 regulation under federal securities laws.

A Leading Effort Aimed at Compliant Token Offerings and its Drawbacks

The SAFT Framework

The perceived regulatory uncertainty spawned efforts in the second half of 2017 aimed at creating regulatorily compliant ICOs and tokens. One such effort has yielded the Simple Agreement for Future Tokens (SAFT). The SAFT model was described in a white paper titled "The SAFT Project: Toward a Compliant Token Sale Framework" and released by Cooley LLP and Protocol Labs on October 2, 2017, *available at* https://saftproject.com/static/SAFT-Project-Whitepaper.pdf (last visited April 2, 2018). The SAFT model is based on the Y Combinator Simple Agreement for Future Equity (SAFE), which has been used to finance early-stage companies for a number of years.

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 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 contend 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.

Pitfalls of the SAFT Framework

The introduction of the SAFT framework by prominent market players as a potential option for compliant token offerings elicited a fair amount of discussion. One of the more cogent critical voices in the debate comes from the Cardozo Blockchain Project (an initiative of the Cardozo Law School), which released a research report titled "Not So Fast – Risks Related to the Use of a 'SAFT' for Token Sales," *available at* https://cardozo.yu.edu/sites/default/files/Cardozo%20Blockchain%20Project%20-%20Not%20So%20Fast%20-%20SAFT%20Response_final.pdf (last visited April 2, 2018).

The research report discusses a number of concerns. First, the SAFT framework's presumptive treatment of pre-functional utility tokens as securities and fully-functional utility tokens as non-securities blurs the true test of how tokens are analyzed under federal securities laws, which involves a highly fact-dependent inquiry. Second, the likelihood that token issuers under the SAFT framework will emphasize the pre-functional utility token's profit-generating potential in offerings to accredited investors may increase the risk of triggering federal securities scrutiny beyond the initial SAFT sale and extending to the fully-functional tokens after network deployment. Third, the SAFT framework apparently creates a class of early investors who may be incentivized to flip their holdings instead of supporting the growth of the enterprise, thus potentially fueling speculation and ultimately harming consumers.

In sum, while the authors of the report note that the SAFT framework may be adaptable to individual cases, they conclude that the SAFT framework fails to deliver a simplified and binary compliant token sale framework as intended. Notwithstanding these views, the report authors believe that it may still be possible to structure or pre-sell utility tokens without increasing the risk that such tokens would be deemed to be securities under *Howey*.

Recent SEC Enforcement Activity

As ICO issuers and market professionals continued to grapple with the regulatory treatment of ICOs in the latter half of 2017, the SEC began instituting enforcement actions aimed at shutting down ICO offerings that clearly violate securities laws. In the process, the SEC appeared intent on sending a signal to the ICO issuers and market professionals, including lawyers, that it is on high alert for ICO approaches that violate the letter and spirit of federal securities laws.

REcoin Group Foundation and DRC World

In a federal complaint filed on September 29, 2017, the SEC alleged that the sponsor and his companies, REcoin Group Foundation (REcoin) and Diamond Reserve Club World (DRC), duped investors into purchasing unregulated securities in the form of digital tokens backed by fictitious assets. The alleged stated purpose of each ICO was to generate returns from (i) the appreciation in value of the investments each company would make in real estate (in the case of REcoin) or diamonds (in the case of DRC) and (ii) the appreciation in value of the digital tokens themselves – including one touted as "The First Ever Cryptocurrency Backed by Real Estate" – as the companies' businesses grew and/or the demand for such tokens increased.

The complaint contended that the ICOs were purportedly styled as "Initial Membership Offerings" in an attempt to circumvent the federal securities laws, but the membership interests that were being offered to investors were "in all material respects identical to the ownership attributes of purchasing the purported 'tokens' or 'coins' and are securities within the meaning of the securities laws." According to the SEC, the defendants made false promises that suggested the two companies would have sizable returns, even as neither had "any real operations." For example, while the companies were touted as having "expert" management teams, neither had "hired or consulted any lawyers, brokers, accountants, developers, or other professionals to facilitate its investments." The complaint further asserted that investors in the ICOs received nothing in return for their investments because the companies lacked sufficient technological expertise to create and deliver digital tokens. Based on these and other allegations, the SEC obtained an emergency order to freeze the defendants' assets.

PlexCorps

On December 4, 2017, the SEC's newly formed Cyber Unit obtained an emergency asset freeze to halt the sale of the token, PlexCoin, that had raised up to $15 million from thousands of investors. In the complaint, the SEC alleged that the sponsor and his company, PlexCorps, marketed and sold securities to investors in the United States and elsewhere under a variety of false pretenses, including that PlexCoin would yield a 1,354% profit in less than twenty-nine days. The complaint sought permanent injunctions, as well as disgorgement plus interest and penalties.

The SEC's action against PlexCoin followed actions begun by Canadian regulators months earlier. In July 2017, the Quebec Autorité des marchés financiers (AMF) determined that PlexCoin was a security, relying in part on the *Howey* test. The Quebec Financial Markets Administrative Tribunal (the Quebec Tribunal), in response to the AMF's determination, ordered the cessation of PlexCoin solicitations and the shutting down of PlexCoin and PlexCorp websites. The SEC complaint noted that not only did PlexCoin's promoters defy the Quebec Tribunal, they expanded their solicitations to U.S. investors based on fraudulent and unsubstantiated representations and established banking accounts in multiple countries under misleading pretenses.

Munchee

On December 11, 2017, the SEC entered into an administrative settlement with Munchee, Inc. (Munchee) for conducting unregistered offers and sales of securities. Munchee, a California startup and blockchain-based food review service, agreed to halt its ICO and refund investor proceeds. Munchee launched an iPhone application in 2017 that allowed users to post photographs and review restaurant meals.

In October 2017, Munchee announced that it would hold a public sale of its token (MUN) through an ICO and posted a white paper on its website. Although the white paper referenced the DAO Investigative Report and stated that Munchee had done a "*Howey* analysis" and that "as currently designed, the sale of

MUN utility tokens does not pose a significant risk of implicating the federal securities laws," the SEC noted that the white paper did not provide any such analysis. The token sale commenced with the goal to raise $15 million. However, the SEC contacted Munchee the day after the sale launch, and Munchee immediately stopped selling MUN tokens and refunded all proceeds.

In determining that the MUN token was a security, the SEC noted a number of factors. First, the white paper contained statements about how the MUN tokens would increase in value and how MUN holders would be able to trade MUN tokens on secondary markets. Second, Munchee made a series of marketing statements to specific audiences – cryptocurrency investors rather than the restaurant industry and its likely customer base – relating to the future profit of buying and holding MUN tokens. Third, Munchee made statements that could be construed as indicating that token purchasers could reasonably expect profits from the efforts of others, for example, how the value of the tokens would depend on the company's ability to develop the app and build an ecosystem for the tokens.

AriseBank

On January 30, 2018, the SEC announced that it had obtained a court order cutting off AriseBank's ICO of "AriseCoin" tokens, appointing a receiver over AriseBank and freezing AriseBank's and its co-founders' digital and other assets. The SEC's complaint against AriseBank and its co-founders alleges that the ICO, in which AriseBank claimed it had raised more than $600 million and would fund the supposedly first "decentralized bank," was an illegal, fraudulent and unregistered securities offering in violation of securities laws. This court order follows a cease and desist order issued by the Texas Department of Banking weeks earlier in response to alleged regulatory violations by the Texas-based company. That order barred AriseBank from continuing to falsely imply that it engages in the business of banking in Texas and offering services to Texas residents.

The AriseBank ICO was officially endorsed by former boxing champion Evander Holyfield. While Mr. Holyfield was not named in the SEC's complaint, a prior SEC statement from November 2017 cautioned celebrities and other promoters of ICOs that they risked engaging in unlawful conduct if they promoted a token properly deemed to be a security where they failed to disclose the nature, source, or amount of compensation paid as consideration for the endorsement, among other liabilities including violations of the anti-fraud provisions of federal securities laws and the offer of unregistered securities.

SEC Chairman's Public Statements

On the same day that the Munchee administrative settlement was announced, December 11, 2017, SEC Chairman Jay Clayton issued a public statement titled "Statement on Cryptocurrencies and Initial Coin Offerings," *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 (last visited April 2, 2018). Although he expressed 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," Mr. Clayton's statement was cautionary in tone and substance. Notably, Mr. Clayton indicated that merely calling a token a "utility" or structuring it to provide some utility does not mean that the token will not be found to be 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, Mr. Clayton has asked the agency to "to police this area vigorously and recommend enforcement actions" against violators.

Further emphasizing his concerns while speaking at a Securities Regulation Institute conference in January 2018, Mr. Clayton is reported to have, once again, expressed some misgivings with attitudes and approaches by some market professionals, including those in the legal profession, in advising clients seeking to pursue ICOs. Mr. Clayton is said to have been disturbed by the conduct of some lawyers who appear to be assisting promoters to structure offerings of tokens with many key features of securities offerings all the while claiming that the tokens (ostensibly and subjectively styled as "utility tokens") are not securities in attempts to avoid regulation. Mr. Clayton is also reportedly concerned that some in the legal profession may be providing equivocal advice to ICO clients when it comes to the likelihood of regulation of tokens or ICOs. Then, clients who are willing to take the risk end up proceeding with ICOs without seeking to comply with federal securities laws.

In prepared remarks as part of his testimony before the Senate Committee on Banking, Housing, and Urban Affairs on February 6, 2018, *available at* https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%202-6-18.pdf, where he appeared alongside J. Christopher Giancarlo, the chairman of the Commodity Futures Trading Commission (CFTC), Mr. Clayton commented that the SEC does not want to "undermine the fostering of innovation through our capital markets" but cautioned that there are significant risks for investors participating in non-compliant ICOs. After discussing the steps that the SEC has taken in relation to cryptocurrencies, ICOs, and related assets, Mr. Clayton stated, once again, that he has 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 his live testimony, Mr. Clayton stated that the SEC has some oversight power in the area but is open to collaborating with Congress, other regulators, and states on additional necessary regulations pertaining to cryptocurrencies and related assets: "We should all come together, the federal banking regulators, CFTC, the SEC – there are states involved as well – and have a coordinated plan for dealing with the virtual currency trading market."

The SEC's Expanded Probe of ICOs

Indicative of the SEC's ratcheting up of regulatory pressure in the ICO arena, *The Wall Street Journal*, citing unnamed sources familiar with the matter, reported on February 28, 2018, that the SEC had issued "dozens of subpoenas and information requests to technology companies and advisors" involved in ICOs. https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266. As reported, the "scores" of subpoenas and information requests seek disclosure of details about the structure of the token sales, including pre-sales under the SAFT framework. The SEC declined to comment when approached about the story prior to publication.

Proceed with Caution.

The SEC's enforcement actions and expanded probe as well as the SEC Chairman's public pronouncements appear to emphasize the likely application of federal securities laws to the offer and sale of tokens, sometimes including those promoted as having current or prospective utility. The actions and the statement further emphasize that whether an offering involves a security does not turn on the subjective labeling of the token by an issuer as a "utility token" but instead requires an assessment of the economic realities underlying the offering. Such assessments extend beyond an examination of the rights and interests granted to token purchasers to encompass the manner of the offering, including, among other factors, how the tokens are marketed and sold, how the proceeds are used, whether there is a touting of potential increase in token value, and the promoters' promise or facilitation of secondary market trading. Accordingly, these developments highlight the need for increased caution and careful analysis by gatekeeping market professionals, particularly lawyers, in assisting ICO issuers to ensure that they are acting responsibly by steering ICO clients away from approaches that may be contrary to the spirit of federal securities laws.