

Initial Coin Offerings: SEC and Other Regulatory Guidance on Registration of Blockchain Tokens as Securities

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INITIAL COIN OFFERINGS: RECENT SEC GUIDANCE ON REGISTRATION OF BLOCKCHAIN TOKENS AS SECURITIES

NOVEMBER 7, 2018

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Roadmap

Digital tokens, including cryptocurrencies and token sales, present a variety of challenging legal issues.

Today's briefing:

- 1 Introduces the basics of blockchain, smart contracts and digital tokens
- 2 Explains certain offerings of, and instruments and products tied to, digital tokens
- 3 Highlights regulators' evolving views of digital tokens and token sales

This presentation should not be construed or relied upon as legal advice or investment advice. Token sales and the applicable regulatory frameworks continue to evolve.

Part 1:

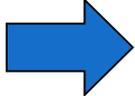
BLOCKCHAIN BASICS

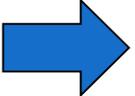
What Is a Blockchain?

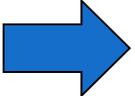
- An immutable, decentralized ledger
- Key characteristics that differentiate a blockchain from traditional distributed databases:
 - Transactions authenticated and tracked via nodes on network
 - Cryptographic techniques prevent tampering or manipulating transactions
 - Can be public (anyone can participate) or permissioned (only authorized participants)
 - Application-agnostic (not limited to digital currencies)
- Popular blockchains today include the payment network Bitcoin and the smart contracts platform Ethereum, which create and track transactions in bitcoin and ether

Blockchains Can Take Many Forms

Depending on the objectives of a given project, blockchains can be structured so that they are:

 **Public**

 **Permissioned**

 **Private**

Blockchain: Sample Use Cases

- Store of value
- Real estate (e.g., Sweden, Cook County, Illinois, refugees)
- Asset tracking/supply chain management (e.g., Everledger, Walmart, Chronicled)
- Securities ledgers (e.g., Delaware)
- Voting systems/prediction markets
- B2B transactions using smart contracts

Cryptocurrencies

- Popular focus is on the use of blockchain technology as **store of value**, often referred to as **digital currencies**, **virtual currencies**, or **cryptocurrencies**
- Value of tokens built on these blockchains has rapidly increased (and decreased, and increased, and so on) over the past year



“Smart Contracts”

“An automatically executing computer program that is linked to a distributed ledger.

When triggering variables arise that are coded within the “smart contract,” the program executes and the resulting transactions are automatically digitally executed.”

Smart Contracts: Sample Use Cases

- Settlement and clearing systems that are globally distributed and comply with reporting requirements
- Trade finance (e.g., letters of credit)
- Asset finance
- International remittances
- Corporate loan syndications
- Post-trade settlement exchanges
- Internet of Things applies across many use cases

Additional Use Cases

- Financial trades execution upon occurrence of pre-agreed events
- Swaps & derivatives
- KYC/AML checks
- Medical records
- Supply chain and food provenance
- Solar energy sales
- Art sales
- Real estate transactions
- Loans and escrow pre-defined payment/release events
- Royalty payments to content generators based on usage or downloads
- “Time share” contracts on standard terms
- Insurance payouts
- Many other ambitious use cases have been proposed

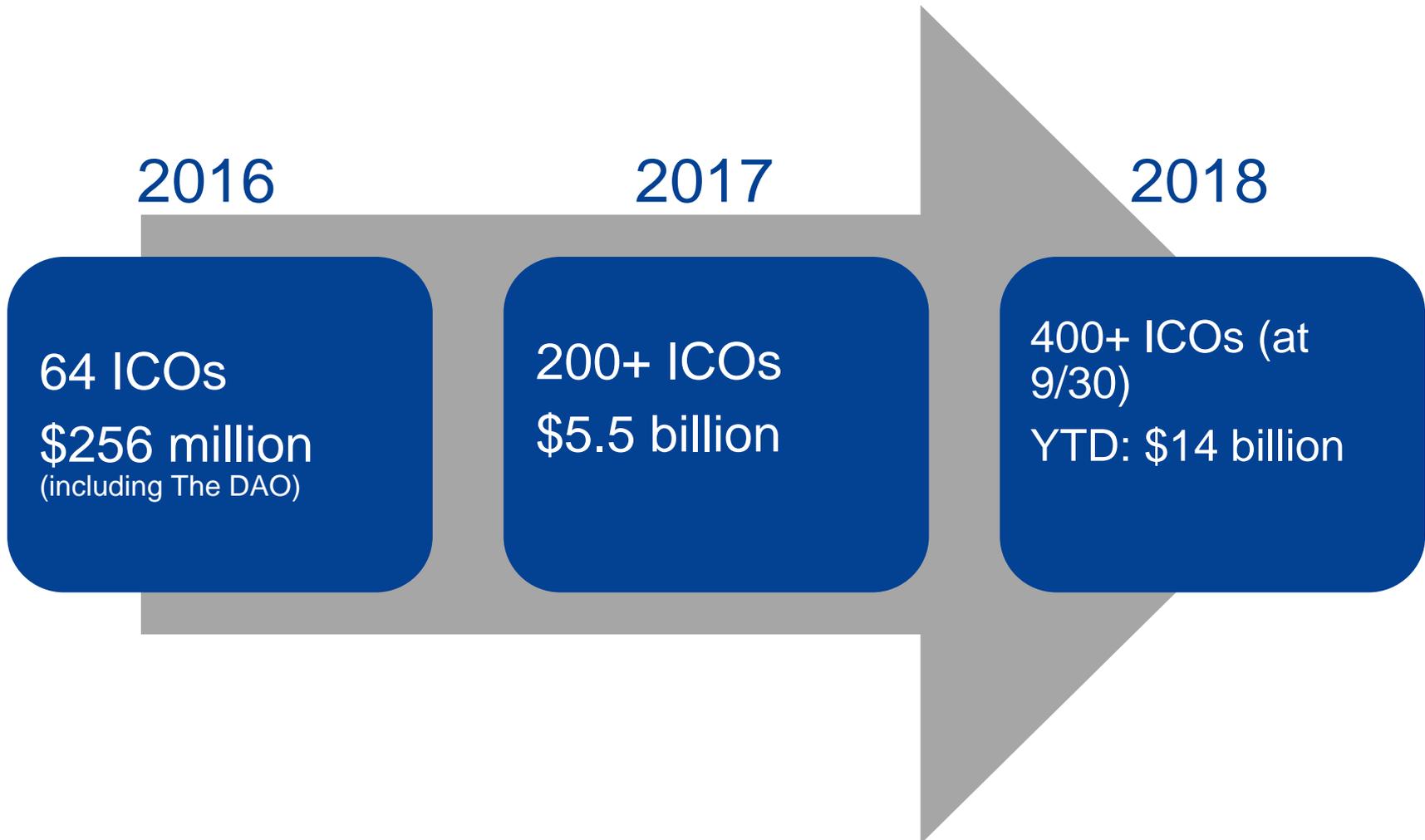
New World Ahead: Opportunities & Challenges

- Blockchain and digital identities (Estonia)
- Anonymity vs. transparency
- Data oracles and input standards
- Immutability vs. “editing” the blockchain
- Interplay between “digital” assets and “real world” assets

PART 2:

BLOCKCHAIN TOKEN SALES

Growth of ICOs



Traditional VC vs. Digital Token Sales

Traditional Early-Stage Venture Capital (VC) Funding:

- Subject to negotiation
- Subject to traditional due diligence
- Dilutes founders' equity
- Cedes some control
- Traditional “closing”
- Limited number and types of investors
- Traditional vehicles and equity securities (i.e., convertible notes, preferred stock, etc.)

ICO Funding (excluding Pre-Sales):

- Not typically subject to negotiation
- Whitepaper (although some purchasers may do more diligence and some sellers provide more disclosure)
- Does not require diluting founders' equity
- Does not require ceding control to purchasers
- Closing via smart contracts
- Potentially many purchasers (and multiple types of investors)
- New types of vehicles and token types (which still may be securities)

Utility Tokens

Many are application-specific and have non-incidental utility with respect to the platform or system selling the token, such as rights to:

- Program, develop or create features for the system or to “mine” things that are embedded in the system
- Access or license the system
- Charge a toll for such access or license
- Contribute labor or effort to the system
- Use the system and its outputs
- Sell the products of the system
- Vote on changes to the system’s features and functionality

Security Tokens

- **Tokenized Debt or Equity** -- Some token sellers have simply moved traditional types of securities to blockchain-based ledgers
- **Other *Howey* Tokens, i.e., Utility Tokens with Economic Features** -- More often, developers have created utility tokens with certain additional features that are similar to traditional securities, such as:
 - Redemption at specified times for a portion of net revenues
 - Right to a pro rata portion of a percentage of revenues from contracts entered into on the platform
 - Coupons bearing interest
 - Right to participate in other investment opportunities

Token sellers may create securities inadvertently, whether through promotional activities, economic realities of a token, or otherwise

Security Tokens

- **Tokens to be Sold as Securities** – In some cases, “security token” is used by market participants to refer to a token that will be treated as a security and sold in compliance with securities laws, regardless of its features.
- **Tokens with Built-in Compliance Architectures** – Tokens with software protocols to ensure they are traded and used in compliance with securities laws, e.g., that can’t be traded until 1 year holding periods expire.

*The decision to issue a “utility” token as if it is a security does not necessarily imply that economic features can be added without consequence: **not all securities are treated equally.***

PART 3:

SELECT REGULATORY DEVELOPMENTS

Regulation of Digital Tokens

Q: Will U.S. law regulate digital tokens as:

- Securities?
- Commodities?
- Currencies?
- Property?
- Something else?

A: ALL OF THE ABOVE

SEC Overview

- *Howey* Test
- The DAO Report
- Munchee Cease and Desist Order
- Chairman's Statement
- Hinman Speech

SEC View: The *Howey* Test

SEC will apply the investment contract test set forth in the Supreme Court's 1946 *Howey* case

To be an investment contract, all 4 factors must be met:

- An investment of money (or valuable goods or services)
- In a common enterprise
- With a reasonable expectation of profits
- Profits expected based on the efforts of others

SEC View: The DAO Report

The DAO Report (Jul. 25, 2017)

Select takeaways:

- U.S. securities law applies when tokens are marketed or sold to U.S. persons, regardless of token seller location
- Digital tokens may be securities under the *Howey* test based on the specific facts and circumstances
- Even a decentralized autonomous organization can be an “issuer”
- Platforms on which digital tokens are traded may be securities exchanges

SEC View: Munchee

Munchee Cease and Desist Order (Dec. 11, 2017)

Select takeaways:

- A self-described utility token still may be a security, even if the token is fully “functional” at the moment of sale
- Manner of sale may make a token a security
 - SEC considered issuer’s whitepaper, social media and other marketing efforts
- Post-Munchee, more token sales are being structured as sales of securities, with the intent to comply with U.S. securities laws

SEC View: Chairman's Statement

Chairman Clayton's Statement to U.S. Senate (Feb. 6, 2018):

- “I believe every ICO I’ve seen is a security.”
- ICOs have “borne the hallmarks” of securities offerings, sometimes unintentionally
- “Merely calling a token a ‘utility’ token or structuring it to provide some utility does not prevent the token from being a security.”
- Call to action for “gatekeepers” (e.g., lawyers, accountants, consultants) to exercise judgment

Enhanced scrutiny of:

- Token sellers that have recently changed or renamed their businesses to focus on blockchain technologies
- Regulated market participants (e.g., brokers, dealers, investment advisers, trading platforms)

U.S. v. Zaslavskiy (E.D.N.Y.)(Judge Dearie):

- Court heard arguments on May 8, 2018 about whether applicable tokens are securities

SEC View: Hinman's Speech

- **William Hinman, Director, Division of Corporate Finance, at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018):**
 - Certain tokens and other digital assets initially sold in a securities offering for purposes of U.S. federal securities law sometimes may *“be later sold in a manner that does not constitute an offering of a security”*
 - *Emphasized “that the analysis of whether something is a security is not static and does not strictly inhere to the instrument”*
 - Distinction between the token itself and the manner of sale by promoters to investors
 - *“The impetus of the Securities Act is to remove the information asymmetry between promoters and investors.”*
 - Suggested circumstances under which a token may not represent an investment contract, such as:
 - *“If the network on which the token or coin is to function is **sufficiently decentralized** – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise’s success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.”*
 - Suggested that sales of Ether in the initial Ethereum network fundraising may have been securities offerings, but that present sales of Ether are not securities transactions

SEC View: Hinman's Speech (cont.)

Factors to consider when assessing whether a digital asset is offered as an investment contract:

- Primarily, consider whether a third party – be it a person, entity or coordinated group of actors – drives the expectation of a return. That question will always depend on the particular facts and circumstances, and this list is illustrative, not exhaustive:
 - Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
 - Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?
 - Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
 - Are purchasers “investing,” that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
 - Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?
 - Do persons or entities other than the promoter exercise governance rights or meaningful influence?

SEC View: Hinman's Speech (cont.)

- **Contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security:**
 - “Again, we would look to the economic substance of the transaction, but promoters and their counsels should consider these, and other, possible features.”:
 - Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
 - Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
 - Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
 - Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
 - Is the asset marketed and distributed to potential users or the general public?
 - Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
 - Is the application fully functioning or in early stages of development?”

Fundraising Issuances

- Every sale of securities is either **registered**, **exempt** or **illegal**.
- **Form S-1 and Regulation A+** -- available registration alternatives, but so far, no filings have cleared the SEC
- **Regulation D** -- private placement exemption, but only permits sales to accredited investors
- **Regulation S** -- exemption for sales offshore, but does not permit directed selling efforts in the U.S. in connection with the offering

Compensatory Issuances

- Security tokens awarded as compensation will need to rely on Rule 701 or other available exemptions, and may be subject to Section 409A of the IRC
- Restricted tokens, token options, restricted token units (RTUs) all possible
 - Restricted tokens *without* 83(b) may be best compensation *post-ICO*
 - RTUs may be best alternative *pre-ICO*
 - Token options may be unattractive at any time
- Beware of valuation and disclosure issues

Liquidity Considerations

Resales of tokens also subject to securities laws – token holders may not be able to sell tokens purchased or received from the issuer:

- Underwriter / distributor liability
- Rule 144 holding period and disclosure requirements
- Insider trading issues
- Market manipulation

CFTC View

- Since 2015, the CFTC has asserted jurisdiction over virtual currencies, as “*commodities*”
- July 2017 – the CFTC allowed LedgerX, LLC to register as a derivatives clearing organization, allowing the company to provide clearing services for fully collateralized digital currency swaps
- December 2017 – the CFTC authorized:
 - the Chicago Mercantile Exchange Inc. and the CBOE Futures Exchange to self-certify new contracts for “bitcoin futures products”
 - the Cantor Exchange to self-certify a new contract for “bitcoin binary options”

CFTC View

CFTC v. McDonnell (E.D.N.Y. Mar. 6, 2018)(Judge Weinstein)

- Embraced the CFTC’s view of virtual currencies as commodities
- Judge Weinstein’s opinion stated that virtual currencies:
 - *“can be regulated by CFTC as a commodity”*
 - *“are goods exchanged in a market for a uniform quality and value”*
 - *“fall within the [Commodity Exchange Act]’s definition of ‘commodities’ as ‘all other goods and articles ... in which contracts for future delivery are presently or in the future dealt in.’”*

CFTC v. My Big Coin Pay, Inc. (D. Mass.)

- Defendants argue that their coins, unlike Bitcoin, are not a commodity
- As with SEC matters, question is litigated in context of fraud allegations

FinCEN View

The federal Bank Secrecy Act (“BSA”) and the implementing regulations of the Financial Crimes Enforcement Network (“FinCEN”) regulate federal money services businesses (“MSB”).

Per FinCEN regulations:

- A “person that provides money transmission services” is a MSB subject to the BSA.
- “Money transmission services” means the acceptance of currency, funds, or other value that substitutes for currency, and includes “convertible” virtual currencies.

Per FinCEN regulations:

- “The definition of a money transmitter does not differentiate between real currencies and convertible virtual currencies.”
- “Accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the regulations implementing the Bank Secrecy Act.”

FinCEN View

FinCEN Letter to Senator Wyden (Feb. 13, 2018)

“Treasury expects businesses involved in ICOs to meet the BSA obligations that apply to them.”

- Token Sellers:
 - “Generally, under existing regulations and interpretations, a developer that sells convertible virtual currency, including in the form of ICO coins or tokens, in exchange for another type of value that substitutes for currency is a money transmitter and must comply with AML/CFT requirements that apply to this type of MSB.”
- Exchanges:
 - “An exchange that sells ICO coins or tokens, or exchanges them for other virtual currency, fiat currency, or other value that substitutes for currency, would typically also be a money transmitter.”
- Other Token Sale Participants:
 - “To the extent that an ICO is structured in a way that it involves an offering or sale of securities or derivatives, certain participants in the ICO could fall under the authority of the SEC, which regulates brokers and dealers in securities, or under the authority of the CFTC, which regulates merchants and brokers in commodities. In such a case, the AML/CFT requirements imposed by SEC or CFTC regulations would apply to such ICO participants.”

IRS View

The Internal Revenue Service (“IRS”) has indicated that, for purposes of federal taxation, virtual currency is intangible personal property on which gains and losses must be recognized

BUT:

- Guidance to date is limited regarding the U.S. federal income taxation of virtual currency
- IRS Notice 2014-21:
 - Discusses only certain aspects of U.S. federal income tax treatment of virtual currencies
 - Provides guidance limited only to Bitcoin-like tokens
 - Treats bitcoin as “property” that is not currency
- Unlike “foreign currency,” there is **no *de minimis* exemption** from gain/loss recognition
 - Cryptocurrency Tax Fairness Act: A *de minimis* exemption has been proposed by Representative Jared Polis (D. Colo.) but not enacted
- April 2017 – IRS warned that taxpayers who fail to report income from cryptocurrency trading could face audit or criminal charges

NY Department of Financial Services

- Since 2015, New York has required companies engaging in digital token businesses to acquire a BitLicense from DFS
- Companies seeking a BitLicense must, among other things:
 - Appoint a dedicated compliance officer
 - Develop written compliance and anti-fraud procedures
 - Maintain minimum capital reserves
 - Pay a \$5,000 application fee
- April 2018 – DFS Superintendent Maria Vullo indicated that BitLicense is having its intended effect, stating that DFS cryptocurrency regulations: “*insure that the competition among new entrants is not a race to the bottom.*”

New York Attorney General's Office

- NY AG's Office sent letters to 13 virtual currency trading platforms (Apr. 17, 2018)
 - Requested information about:
 - Ownership and control
 - Operation and fees
 - Trading policies and procedures
 - Internal controls
 - Privacy and money laundering
- Published *Virtru Markets Integrity Report* (Sept. 18, 2018)
 - Summarized findings on:
 - Market fairness
 - Conflicts of interest
 - Security and protection of customer funds
 - Access to funds and outages

Other Risks

Valuation Volatility

- Bitcoin went from \$800 to \$19,000 to \$6,500 in 19 months

Theft

- 2014 – Mt. Gox exchange lost \$450 million in bitcoin
- 2018 – Japanese exchange Coincheck lost \$530 million in NEM tokens

Fraud

- September 2017 – SEC charges Zaslavskiy
- May 2018 – CentraTech indictment

Presenters



Alfredo B. D. Silva is based in San Francisco and represents public and private companies and investors in a broad range of corporate and securities law matters. His practice includes initial public offerings, primary and secondary offerings, private placements, preferred stock financings and public and private mergers and acquisitions. In his public company practice, he also counsels issuers on corporate governance issues, compliance with the U.S. federal securities laws and compliance with the listing standards of Nasdaq and the New York Stock Exchange. In his private company practice, he has served as company or investor counsel in venture and late-stage financings, minority strategic investments and impact investments in dozens of private companies.



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