Client Update

Blockchain Tokens and Initial Coin Offerings: New Year, New Perspective

Sales of blockchain tokens in so-called initial coin offerings ("ICOs")[1] exploded in 2017. According to CoinSchedule, a website that tracks ICO (or digital token sale) data, the total amount raised in ICOs in 2017 was $3,700,682,293, which compares to $96,389,917 raised in 2016.[2]

Perhaps not surprisingly, 2017 was also a year of increasing focus by U.S. regulators on ICOs. The Securities and Exchange Commission (the "SEC") launched a new Cyber Unit and took its first significant enforcement actions against promoters of ICOs.

As the calendar opens on a new year, it seems appropriate to revisit and assess the SEC's statements and actions in the cryptocurrency and ICO space in the past year, as well as consider potential developments for the coming year. We will focus particularly on the SEC's key enforcement actions involving ICOs and the most recent statement of the SEC Chairman regarding cryptocurrencies and ICOs.

While the SEC continues to indicate that each case should be evaluated based on all of its facts and circumstances, the combination of circumstances that allows for an ICO issuer to conclude that its tokens are not securities is, as a practical matter, narrower now than previously believed. This will likely lead to a decrease in ICO activity in the United States.

It is also likely that the upcoming year will see many regulators, including the SEC, continue to tighten their overall supervision of the ICO market. But regulations across multiple jurisdictions may lead to fragmentation of the blockchain token market, thereby stifling the potential social benefits of blockchain technology.

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[1] While we prefer the terms "token sale" or "token launch" to "ICO," references to initial coin offerings/ICOs have become common in the industry and among regulators. Accordingly, we will use the ICO terminology in this update.

[2] CoinSchedules' cryptocurrency ICO stats are *available at* https://www.coinschedule.com/stats.html.

STATEMENT OF THE SEC CHAIRMAN

In a recent public statement, SEC Chairman Jay Clayton shed further light on the SEC's position regarding cryptocurrencies and token sales.[3] The statement addresses both main street investors and market professionals.

Cautions for Investors

For investors, Mr. Clayton offered words of caution regarding the international reach of the cryptocurrency and ICO markets.

> Your invested funds may quickly travel overseas without your knowledge. As a result, risks can be amplified, including the risk that market regulators, such as the SEC, may not be able to effectively pursue bad actors or recover funds.

This aspect of ICOs, which frequently is an inevitable consequence of the application of blockchain technology, has likely prompted a number of national regulators to step up oversight of the ICO market. Transactions on the blockchain are immutable, frequently do not involve any intermediary subject to regulation by a national or other governmental authority and do not recognize any kind of political border. A non-U.S. issuer can easily sell tokens into the United States and all the proceeds can leave the reach of a U.S. regulator instantly, possibly leaving investors and U.S. regulators no means to address the consequences of misconduct by such issuer.

Cautions for Market Professionals

For market professionals, Mr. Clayton references the "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO" (the "DAO Report")[4] and subsequent enforcement actions. In this context, he states:

> A change in the structure of a securities offering does not change the fundamental point that when a security is being offered, our securities laws must be followed.[5] Said another

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[3] Public Statement, *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017), *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11. The Chairman of the Commodity Futures Trading Commission (the "CFTC"), J. Christopher Giancarlo, issued a statement on the same day commending SEC Chairman Clayton's statement and noting that the SEC and the CFTC are in regular communication on issues surrounding cryptocurrencies and initial coin offerings. Press Release, *Giancarlo Commends SEC Chairman Clayton on ICO Statement* (Dec. 11, 2017), *available at* http://www.cftc.gov/PressRoom/PressReleases/giancarlostatement121117.

[4] SEC Release No. 34-81207 (Jul. 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-131.

[5] In a footnote included in the statement, Mr. Clayton confirms that this does not necessarily mean that an ICO of a token that is a security must be done on a registered basis. An ICO that is a security can be structured so that it qualifies for an applicable exemption from registration, such as Regulation D under the U.S. Securities Act.

> way, replacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance.

Mr. Clayton notes that merely calling a token a "utility" token or structuring it to provide some utility does not mean that the token is not a security. He also notes that it is especially troubling when promoters emphasize the secondary market trading potential of such tokens.

While making it clear that he believes many ICOs do involve the offer and sale of securities, Mr. Clayton concedes that the answer to the question of whether a given token is a security depends on the particular facts. He goes on to provide a brief example:

> [A] token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come.

Mr. Clayton's cautions extend as well to exchange operators and broker-dealers, who could be liable for operating exchanges, systems or platforms on an unregistered basis in violation of the U.S. Securities Exchange Act of 1934 if the relevant tokens or related products constitute securities.

In remarks made on January 22, 2018 at the Securities Regulation Institute, Mr. Clayton reiterated his position that gatekeepers, such as securities lawyers, accountants and other market professionals, need to act responsibly when advising clients in this area.[6]

REVISITING THE DAO

In light of Mr. Clayton's references, it may be useful to revisit the DAO Report. Issued in July 2017, the DAO Report was the SEC's first warning shot in respect of blockchain tokens and their treatment under U.S. federal securities laws.

The DAO was an example of a decentralized autonomous organization, a term used to describe a virtual organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO operated as a for-profit entity to create and hold ether (or ETH) through the sale of DAO tokens, which ETH would then be used to fund projects. The holders of DAO tokens were to share in earnings from these projects by voting on the projects and earning rewards. They could also re-sell DAO tokens on a number of web-based platforms.

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[6] Speech, *Opening Remarks at the Securities Regulation Institute* (Jan. 22, 2018), *available at* https://www.sec.gov/news/speech/speech-clayton-012218.

In the DAO Report, the SEC analyzed the DAO tokens under the so-called *Howey* test and found that they were a form of "investment contract," and thus securities, for purposes of the U.S. federal securities laws. 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.[7] The SEC determined that:

- Investors in The DAO invested money in the form of ETH, which constituted a contribution of value as contemplated by *Howey*.
- Investors who purchased DAO tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise. The SEC stresses that the promotional materials informed prospective purchasers that The DAO was a for-profit entity the objective of which was to fund projects in exchange for a return on investment, and DAO token holders stood to share in potential profits from those projects.
- Investors' profits were to be derived from the managerial efforts of others. The SEC's analysis focused on this point. The SEC concluded that investors in The DAO, whose expectations were primed by the marketing of the DAO tokens, reasonably expected the founders (as well as the pre-selected curators who were charged with identifying projects to put up for a vote of DAO token holders) to provide significant managerial efforts after The DAO's launch. The founders and curators were critical in monitoring the operations of The DAO, safeguarding investor funds and determining whether proposed projects should be put for a vote. As a result, investors had little choice but to rely on their expertise.

While The DAO platform was created and operated on a blockchain, it effectively retained a traditional operational structure. It had no physical place of business in the real world, but it was controlled and managed by the founders and a group of curators selected by the founders. There was no true decentralization in the operation of this cyber world organization—the participants in The DAO ecosystem were not given full control over any investment decision or any asset monitoring or disposition. Giving full control to all such participants would probably have rendered The DAO platform unworkable. However, it is possible that the SEC would have reached a different conclusion had the platform operated on a truly decentralized basis without the involvement of any trusted person. It was relatively easy to conclude that DAO tokens were securities.

SUBSEQUENT DEVELOPMENTS—ICOS INVOLVING FRAUD

In September 2017, the SEC announced that it had exposed two ICOs (RECoin and DRC World) purportedly backed by real estate and diamonds.[8] In December 2017, the SEC announced that it

[7] SEC Release No. 34-81207, *supra* note 6, at 11; see also *SEC v. Edwards*, 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

[8] Press Release, *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds* (Sep. 29, 2017), *available at* https://www.sec.gov/news/press-release/2017-185-0.

had obtained an emergency asset freeze to halt an ICO (PlexCorps) that raised up to $15 million from thousands of investors by falsely promising a 13-fold profit in less than a month.[9] In each case, the SEC charged the relevant companies and related parties with violations of the anti-fraud and registration provisions of the U.S. federal securities laws.

These examples present relatively easy cases for the SEC if the allegations prove to be correct. Each case involves significant allegations of fraud. Moreover, the case for viewing the respective tokens as securities is straightforward, given that each of the tokens is purportedly backed by, and subject to increases in value based on, underlying assets of the relevant company.

MUNCHEE—AN ICO INVOLVING NO ALLEGATION OF FRAUD

On December 11, 2017, the SEC issued a press release and an accompanying order regarding Munchee Inc.[10] Munchee agreed to halt its ICO after being contacted by the SEC, and it consented to an order in which the SEC found that the tokens offered by Munchee constituted securities under the U.S. Securities Act of 1933.

MUN Tokens

Munchee was in the process of conducting an ICO of MUN tokens. The MUN tokens were available for purchase in the United States and worldwide. They were described as "utility" tokens that would represent the right to use or access Munchee's services. Munchee was seeking $15 million to improve an existing iPhone app centered on restaurant meal reviews and to create an ecosystem in which Munchee and others would buy and sell goods and services using the MUN tokens.

Munchee's Promotion of the Tokens

The SEC's summary of Munchee's activities focuses largely on the promotional activities of Munchee and associated persons. In particular, Munchee and such persons heavily promoted the potential for the MUN tokens to increase in value. Such promotion included, among other things:

- indications in the MUN white paper that MUN tokens would increase in value as a result of increased participation in the Munchee "ecosystem";

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[9] Press Release, *SEC Emergency Action Halts ICO Scam* (Dec. 4, 2017), *available at* https://www.sec.gov/news/press-release/2017-219.

[10] Press Release, *Company Halts ICO After SEC Raises Registration Concerns* (Dec. 11, 2017), *available at* https://www.sec.gov/news/press-release/2017-227. See also *In the Matter of Munchee Inc.*, SEC Release No. 33-10445 (Dec. 11, 2017) (cease and desist order), *available at* http://www.sec.gov/litigation/admin/2017/33-10445.pdf.

- statements by Munchee and its agents (in the white paper, on the Munchee website and elsewhere) emphasizing that Munchee would run its business in ways that would cause MUN tokens to rise in value (including the use of a "tier" plan in which the amount paid for a Munchee app review would depend on the amount of holdings of MUN tokens and references to Munchee's intention to "burn" tokens in certain circumstances—taking them out of circulation);
- statements by Munchee that it would work to ensure that MUN holders would be able to sell their MUN tokens on secondary markets and that Munchee would buy or sell MUN tokens using its retained holdings in order to ensure there was a liquid secondary market in the tokens;
- publication by Munchee of a blog post highlighting its expectations that the MUN tokens would increase in value over time, as well as statements (and endorsements of statements by others) touting the opportunity to profit; and
- targeting by Munchee and its agents of marketing efforts at persons interested in investing in Bitcoin and other digital assets (and not at current users of the Munchee app, restaurants or other likely or potential users of the app).

Application of the Howey Test

The SEC concluded that the MUN tokens were investment contracts, and therefore securities, under *Howey*. Since it was easy to demonstrate the investment of money and the existence of a common enterprise, the SEC focused on investor expectations of profits to be derived from the efforts of others and noted that:

- Purchasers of MUN tokens had a reasonable expectation of profits from their investment in the Munchee enterprise. The proceeds were intended to be used by Munchee to build an ecosystem that would create demand for MUN tokens and make them more valuable. Munchee was to revise the Munchee app so that people could buy and sell services using MUN tokens and was to recruit partners such as restaurants willing to sell meals for MUN tokens. In addition, Munchee highlighted that it would ensure that a secondary market for MUN tokens would be available shortly after completion of the offering and prior to the creation of the ecosystem.
- Investors' profits were to be derived from the significant entrepreneurial and managerial efforts of others—specifically Munchee and its agents—who were to revise the Munchee app, create the ecosystem that would increase the value of the MUN tokens and support secondary markets.

Although not necessary to its conclusion, the SEC points out that even if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security. The SEC makes it clear that, in its view, the analysis is still based on all of the facts and

circumstances of the particular case. The fact that tokens have some function or utility at issuance is not sufficient to conclude that such tokens are not securities.

First Bite at Munchee

Munchee is significant because it is the first published SEC enforcement action relating to an ICO without any allegation of fraud. The *Munchee* facts might be viewed as particularly egregious given the emphasis placed by the promoters on the investment value of the MUN tokens rather than on the use case for those tokens and the assurance of the ability to trade the MUN tokens on secondary markets as a means for token holders to realize on their investment.

In our view, the SEC focused on two key factors in the order: (i) the strong emphasis by Munchee and its agents on the potential profits of an investment in the MUN tokens, both in the white paper and other social media outlets and in the token design itself, and (ii) the inability to use the MUN tokens for any purpose for a substantial period of time.[11]

With respect to the first point, based on the SEC's view in *Munchee*, a conservative stance for a token that is intended to be a utility (or non-security) token would be for the token seller and its agents to avoid promoting the investment value of the tokens or the ability of purchasers to derive (or share in) profits from the purchase and sale of the tokens. In addition, the seller should not endorse, sponsor or otherwise facilitate any such promotion of investment value. Based on the SEC's conclusion in *Munchee*, an ancillary point is that sellers and their agents should not provide assurances that a secondary market will develop so that buyers can realize on investments.

With respect to the second point, although the SEC has not publicly stated that tokens that have no function at the time of creation and distribution cannot be utility tokens (rather than securities), a reasonable approach for now may be to refrain from issuing tokens until they have meaningful functionality and otherwise have "survived" a facts and circumstances analysis under *Howey*.

Further Bite at Munchee

Munchee may ultimately prove not to be the best precedent. A lopsided set of factors aimed at promoting the value of the MUN tokens as an investment allowed the SEC to conclude that purchasers were necessarily purchasing MUN tokens as an investment and not for use on the Munchee app.

[11] The white paper for MUN tokens indicates that the integration of the MUN tokens into the Munchee app would not occur until at least the second quarter of 2018.

The fact that a purchased asset has the possibility of increasing in monetary value over time does not necessarily indicate that the purchaser's primary motive is the realization of profit. If a token purchaser reviews the technical proposals of a project and decides that a platform may provide significant utility to it *in the future*, should the fact that there is *any* expectation of a possible monetary profit necessarily mean that the purchaser is purchasing the token with an "expectation of profit" from the "efforts of others" under *Howey*? Or is that just one factor that should be measured against significant use possibilities for the token—whether immediate or in the future? The SEC's analysis based on the weight of the *Munchee* facts is likely to push the market toward answering that first question affirmatively when there may be more nuanced circumstances to consider.

Moreover, a digital asset is not a wasting asset, unlike most tangible assets. If the maximum quantity of a digital asset is capped (which can be based on valid reasons other than increasing the asset's value) and the digital asset proves to have some functionality, the value of that asset is very likely to increase. But this does not mean that anyone who acquires that asset is doing so primarily with an expectation of profits.

If Munchee had offered tokens in a Regulation D offering and those tokens subsequently became functional and widely used, then would those tokens continue to be treated as securities? That would lead to an odd situation, as such tokens by their nature are intended to be fungible with one another—with each token providing some defined functionality on a given platform without the need to restrict or classify tokens based on the circumstances of their issuance. Should a holder of tokens who is a restaurant patron be required to confirm that the restaurant is an accredited investor?

It is possible to argue that tokens that were not functional at issuance transform from securities into something else when they become functional, despite no precedent for such a construct of which we are aware. But where would the transformation line be drawn? At the earliest time when the token acquires some minimal functionality? If not, who would get to determine whether a transformation took place and what, if any, other investment characteristics would need to fall away?

We contend that the mere fact that an issuer of tokens facilitates secondary trading markets for the tokens should not be a deciding factor. Although the existence of an active secondary market for tokens is likely to increase their value by creating improved opportunities for liquidity, there are other valid reasons for secondary markets. For example, a user of a token on a platform may ultimately determine that the platform no longer provides the same level of utility and may want to sell the tokens. It is also worth noting that the existence or possibility of a secondary trading market or facility was not a factor in *Howey*, and many assets that are clearly securities have no (or very little) secondary liquidity. Unless an issuer of utility tokens continues to release new tokens as demand increases, those who desire to access goods or services provided on the relevant platform have no other practical way of accessing them other

than through secondary trading markets. Accordingly, absent factors that demonstrate that the purpose of securing a secondary market is to provide purchasers with profit opportunities from an investment in the tokens, efforts of issuers to secure secondary markets for tokens should not end the analysis.

We are not asserting that the SEC took an incorrect position in *Munchee*. The facts in *Munchee* were particularly bad. We hope that more nuanced cases will provide the SEC with an opportunity to clarify its views and create a more refined set of guidelines for market professionals in the blockchain space to digest and apply in practice.

FURTHER DELIGHTS OR STOMACH ACHES—WHERE NEXT FOR BLOCKCHAIN REGULATION?

The recent statements of the SEC Chairman and the SEC's actions demonstrate that ICOs are likely to be a continuing focus of the SEC for the foreseeable future. The willingness in *Munchee* to step outside the bounds of fraudulent activity is a significant indicator of a tighter regulatory environment for ICOs that the SEC deems to constitute unregistered security offerings. We anticipate that the SEC may also step up its review of tokens issued in previously completed ICOs, as well as its focus on secondary trading platforms for tokens.

Increased enforcement activity by state securities regulators is also likely. The Massachusetts Securities Division recently initiated an enforcement action against a Cayman Islands company (Caviar) operated by a Massachusetts resident, alleging among other things that the sale of tokens offering quarterly dividends from a pooled investment fund constituted an unregistered sale of securities.[12]

Failed or floundering ICOs may also generate more in the way of private causes of action. Two putative civil class actions against The Tezos Foundation and related parties, one filed in the San Francisco County Superior Court and one filed in the United States District Court for the Northern District of California, demonstrate that disappointed investors may not hesitate to bring actions against ICO promoters that purportedly made claims stressing the investment potential for tokens while failing to comply with securities laws.[13]

These developments, along with cryptocurrency trading and ICO restrictions in certain foreign jurisdictions (e.g., China, South Korea and France) and rather hasty regulatory efforts in others (e.g., Russia), may result in a highly fragmented regulatory environment in the year ahead. This is likely to hinder (or at least slow the pace of) further development of the blockchain industry.

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[12] *In the Matter of Caviar and Kirill Bensonoff*, Docket No. E-2017-0120 (Jan. 17, 2018), *available at* http://www.sec.state.ma.us/sct/current/sctbensonoff/Administrative-Complaint-E-2017-0120.pdf.

[13] *Baker v. Dynamic Ledger Solutions, Inc., et al*, Case No. CGC-17-562144 (Oct. 25, 2017); *GGCC, LLC v. Dynamic Ledger Solutions, Inc., et al.*, Case No. 3:17-cv-06779-RS (Nov. 26, 2017).

WRAPPING UP

Although the SEC's position on ICOs has not yet been tested in the courts, its increased focus on ICOs is likely to have a dampening effect on ICOs targeted at U.S. purchasers—both through a decrease in the number of ICOs in the United States and a decrease in the flow into the United States of tokens offered in ICOs conducted outside the United States. Given the unsettlingly high number of ICOs that have been actual or alleged scams, this would not be a bad result.

Unfortunately, the blockchain industry and its gatekeepers have largely failed to police against bad actors without the intervention of regulators. The fundamental idea underpinning blockchain technology—replacing a trusted third party with a consensus based on cryptographic proof—has not yet fully come to fruition in real world applications. Disparity in computing power, information and technological sophistication makes it difficult to achieve true decentralization. These factors also contribute to a high possibility of fraud and other bad acts on the part of promoters and operators of platforms.

On the other hand, blockchain technology is widely viewed as having the potential to generate a tremendous amount of social benefits. The current regulatory framework is not quite consistent with the premise of this technology, as it is largely based on a centralized ledger system. Society as a whole may need to consider whether the pre-existing regulatory regime is appropriate for the emerging new economic order (or, according to some enthusiasts, the new social order) unfolding with the use of blockchain technology.

Imagine that a person or group of persons whose pseudonym was Satoshi Nakamoto launched a Bitcoin offering in 2008 based on a groundbreaking, but less than 10-page white paper. It would have been a shame if the offering had been shut down in the United States. Since the technology itself is still in its early stages of development and application, it is difficult for any national government to implement a regulatory system that protects investors and consumers and also promotes technological developments. Perhaps the U.S. federal regulators should consider collectively implementing a pilot program for a regulatory sandbox similar to the ones implemented in a number of other countries.

Please do not hesitate to contact us with any questions.

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