Using Coin Offerings to Raise Capital for Your Business

Date : 05-08-2018

By: Roger Royse

Initial Coin Offerings (ICOs) and cryptocurrency are two of the most talked about topics in the technology industry in 2018. An ICO is an event in which a new cryptocurrency project sells a portion of its cryptocurrency tokens to early enthusiasts in exchange for convertible virtual currency (e.g., bitcoin, ether) or governmental fiat. These tokens, often called coins, are digital coupons used by new cryptocurrency startups to raise funds for their operations. The history of cryptocurrency dates to the inception of Bitcoin circa 2008-2009 and the creation of the blockchain technology. The blockchain, a subject of numerous Ted talks and blog posts, is a distributed ledger of digital transactions that developed following the economic crisis of 2008 from the need to find an alternative unhackable and trustworthy means of holding finances. ICOs came into the picture in 2013 as an alternative fundraising method for businesses with the first ICO raising approximately $500,000 worth of Bitcoin. Since then the popularity of ICOs has exploded and by 2017 a handful of companies were raising upwards of $100 million, and some as high as $250 million, from the sale of their own tokens.

If you are entertaining the idea of entering into the world of ICOs to raise money for your startup it's crucial to stay current on new regulations and opinions from many agencies. Nearly every week there is a new advisory or opinion letter by a different agency guiding companies considering issuing an ICO. While there are many uncertainties in the treatment of ICOs and their future, agencies are providing more clarity and you must consider the views of the Securities and Exchange Commission (SEC), Financial Crimes and Enforcement Network (FinCEN), Commodities Futures Trading Commission (CFTC), and the Internal Revenue Service (IRS) before entertaining an ICO.

Securities Exchange Commission

In February of 2018, the Chairman of the SEC reiterated the agency's position that typical ICO structures involve the offer and sales of securities and must register their offerings or qualify for an exemption from registration. The SEC cautioned companies looking to issue token, either directly or through an affiliate (such companies are often called "ICO sponsors") from elevating form over substance since simply calling your token a "utility token" or giving the token a minimum utility (i.e., access to a platform) is not determinative on whether the token is a security or not. The threshold question for all ICO sponsors is whether the token is a security: a highly fact-dependent analysis that brings into play long-standing SEC and judicial decisions regarding things already familiar to most of us such as corporate shares and ownership interests in partnerships and limited liability companies.

What is a Security?

In analyzing whether a token offering is subject to U.S. federal securities laws, the primary question is whether a token would be a security as provided for under the federal Securities Act of 1933, as amended (Securities Act). The definition in the statute does not list cryptocurrency, digital currency, or tokens as a type of security, which might lead one to conclude that virtual

tokens would not be subject to U.S. federal securities laws. However, due to the current unregulated nature of the cryptocurrency market and investment-like rights associated with certain blockchain token offerings, the SEC has clarified that it believes most tokens would be an “investment contract”, which is a catch-all for instruments not explicitly listed under the definition of a security but which the courts have found should be a security and subject to the regulations in federal and state securities laws.

The primary test applied to determine whether a token offering would be an investment contract meeting the definition of a security is the Howey Test developed by the U.S. Supreme Court in *SEC vs Howey*. Under the four-part **Howey Test**, a token would likely be a security if an investor [1] invests money [2] with an expectation of profit [3] derived solely from the effort of [4] others. Besides the Howey Test, the courts may also utilize the Reves Family Resemblance Test, which was developed to determine whether a note meets the definition of a security. **The Reves Family Resemblance Test** looks to the motivation for entering the transaction, whether there was a trading market for the investment, expectations of the investing public, and other applicable regulatory schemes to the offering instrument that could reduce risk to the buyer.

Token issuers who intend to sell their tokens throughout the U.S. and believe they are not subject to the SEC’s rules and regulations may still be subject to each state’s securities laws (i.e., “Blue Sky” laws). In California, for example, courts have instituted **a Risk Capital Test** that considers whether an ICO sponsor is attempting to (i) raise funds for a business venture or enterprise, (ii) through an indiscriminate offering to the public, (iii) where the investor is in a passive position to affect the success of the enterprise, and (iv) the investor’s money is substantially at risk because it is inadequately secured.

While sponsors of new token offering often develop creative arguments on why their tokens should be a utility token, the aggressive posture of regulators makes that approach very risky and the prudent assumption should be that all tokens, at least during the initial stages, will be considered securities and that companies seeking to issue tokens should either register the offering or find an exemption from registration. A simple argument of a tokens utility on a platform is not likely to overcome any presumptions of a determination as a security. As tokens change and develop more of a utilitarian function on the platform with a demonstrable use it can evaluate a token to become more difficult. Each token must be considered individually and at its stage opposed to its speculative future use.

Registration Requirements and Exemptions

If your token is a security the Securities Act requires that any offer and sale of the token must either be registered under the Securities Act, an expensive and time-consuming process far beyond the resources of most startups or covered by one of several exemptions from the registration process. Many token offerings in the US are conducted without registration by limiting offers and sales to “accredited investors”, who are presumed to assume the risk of owning the token by their net worth and income. Token offerings can be made to non-accredited investors using other exemptions; however, compliance with the disclosure requirements can be daunting and the amounts that can be raised are limited. Offerings solely to non-US investors may be done under Regulation S promulgated by the SEC under the Securities Act but precautions must be taken to ensure that the sales effort does not occur in the US. In addition, sales to foreign investors must comply with the laws and regulations in the

countries in which those investors reside.

Additional Securities Law Considerations

On March 7, 2018, the SEC issued a public statement stating that a platform that offers trading of digital assets that are securities and operates as an "**exchange**," as defined by the federal securities laws, must register with the SEC as a national securities exchange or be exempt from registration. ICO sponsors who are intending for their tokens to be traded on these secondary exchanges should conduct due diligence before making affirmative statements regarding a potential secondary market for their tokens. A company relying on security exemptions should inform prospective purchasers of a restriction on resale of their specific tokens with the exemption under which the security is being offered. ICO sponsors considering launching their own exchange should consult their legal counsel on whether registration may be required, given the SEC's recent announcements.

Financial Crimes Enforcement Network

In February of 2018, the FinCEN issued a response letter reiterated the agency's issued guidance that explicitly stated virtual currency exchangers and administrators are money transmitters and must comply with the Bank Secrecy Act and its implementing regulations. The response also clarified the agency's position that under existing regulations and interpretations, a developer that sells convertible virtual currency, including in 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 Money Service Businesses (MSBs). And the letter reaffirmed FinCEN's position that "[a]n 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." In analyzing whether a person's activities qualify them as an MSB, there is no differentiation between real or convertible virtual currency – accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the BSA regulations.

Commodities Futures Trading Commission

The CFTC regulates transactions in commodities interests aiming to protect market users, their funds, and the public from fraud, manipulation, and abusive practices. The CFTC's jurisdiction flows from the definition of a "commodity" under §1(a) of the CEA. In September of 2015, the CFTC issued a determination that "Bitcoin and other virtual currencies are encompassed in the definition and property defined as commodities." On March 6, 2018, a federal judge ruled that virtual currencies are commodities under the Commodities Exchange Act (CEA) and subject to the CFTC anti-fraud and anti-manipulation enforcement authority. According to the court, virtual currencies are "'goods' exchanged in a market for uniform quality and value." Therefore, the court reasoned that virtual currencies are within the common definition of a commodity, and the CEA's broad definition which includes "all other goods and articles…and all services, rights, and interest…in which contracts for future delivery are presently or in the future dealt in." The CFTC has long stood by the stance that virtual currencies are commodities and are subject to their jurisdictional reach, subject to some limitations as reaffirmed by the federal judge.

ICOs by Foreign Companies

The discussion above assumes that the primary business activities of the ICO sponsor are in the US; however, foreign companies will obviously have an interest in tapping into the funds available from an offering to US investors If a foreign company is looking to sell to US purchasers, they are not only going to have to comply with the rules and regulations discussed above but also the possible implications of foreign law. Discussions with foreign counsel besides US counsel are necessary to determine the laws and agencies that may be implicated by a foreign company performing an ICO.

* * *

Ultimately, all signs suggest that ICOs will be more regulated and strictly scrutinized by the variety of agencies claiming jurisdiction. Offering digital tokens to raise capital or as a product is a hot trend in Silicon Valley. Before deciding that an ICO is the way your company wishes to proceed, you should converse with experienced counsel that can advise you on the issues discussed above and the factors that should be considered in structuring the offering including the use of offshore entities. Royse Law Firm, a tax, business and corporate law firm headquartered in Menlo Park, California, has experience helping companies perform token offerings and strong relationships with foreign counsel and other advisors and consultants you will need for your offering to succeed and legal. See our *Recent Transactions* for prior representations.