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ICOs: What are they and what does the future hold?

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The tokens we're all so interested in these days aren't metal and don't clink. Instead they are... what, exactly? In metaphysical terms, they are sometimes talked about as if they are the gateway to a future that challenges well-established past norms. In physical terms they're a set of code. In functional terms, well, it depends. And that's the challenge.

—SEC Commissioner Hester M. Pierce
in Remarks before the Medici Conference on May 2, 2018

Initial Coin Offerings (ICOs), or token sales, have been making headlines as they become more common and draw scrutiny from regulators. The SEC's recent lawsuit alleging section 10b-5 violations against the Centra ICO and its much-publicized cease-and-desist order against the Munchee ICO are examples that demonstrate it is clearly paying attention to ICOs and intends to exercise regulatory oversight.¹ This article will help explain what ICOs are and where they fit in the capital-raising landscape, outline some of their economic benefits, and provide thoughts on what the future holds from a regulatory and litigation perspective.

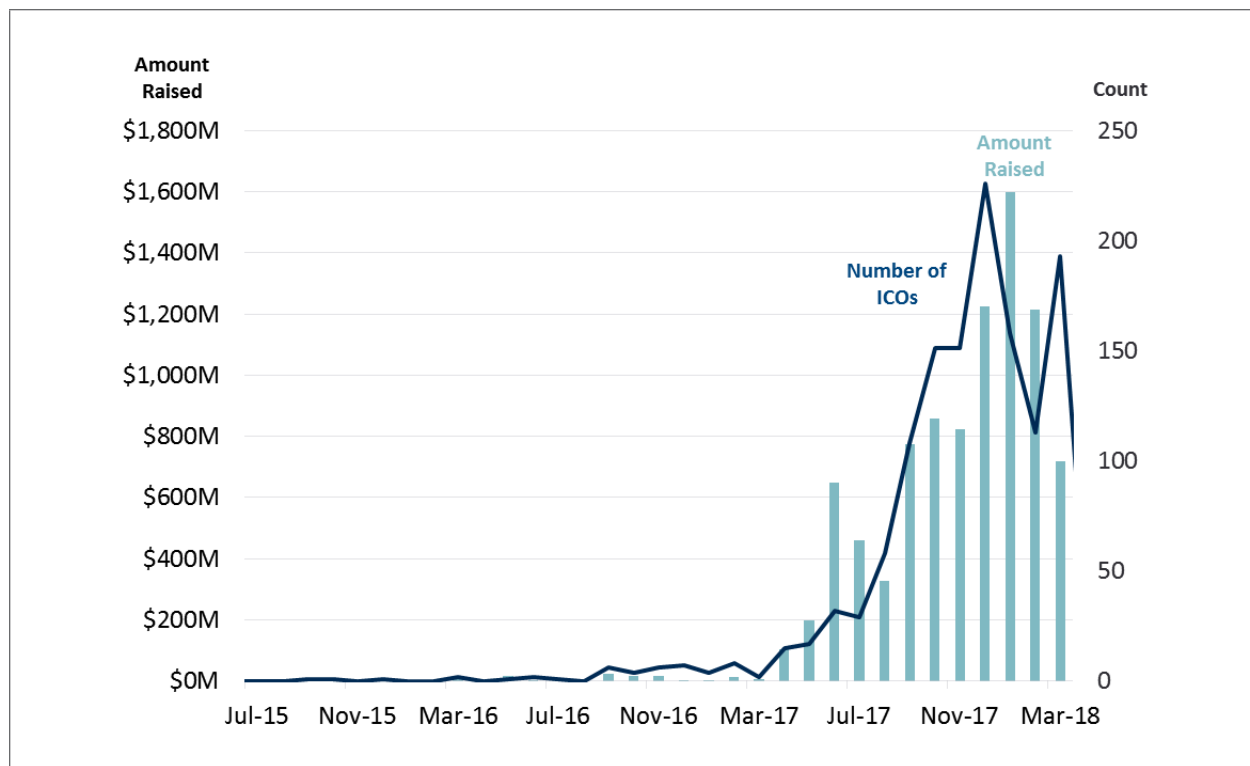
I. How do ICOs work?

ICOs are a relatively new method of entrepreneurial funding, with some of the first examples dating back to 2013 and 2014. Since about 2016, ICOs have proliferated and drawn much attention from the tech industry, investors, financial community, and regulators. The rapid growth of ICOs is illustrated in Figure 1.

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1 Securities and Exchange Commission vs. Sohrab ("Sam") Sharma and Robert Farkas ¶2, April 2, 2018, available <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-53.pdf>. Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, December 11, 2017, available <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

Figure 1: ICOs – Number and Aggregate Amount Raised per Month (July 2015 – March 2018)



Source: TokenData

In an ICO, a company seeks to raise funds for its business or a project by selling digital tokens to investors. The investors buy the tokens with another form of virtual currency, usually Bitcoin or Ether and are granted rights that are recorded on a blockchain network.²

The token itself is a cryptographically secured record that can be assigned various economic, voting, participation, consumptive, or utilization rights. The Ethereum blockchain network, a favorite for launching ICOs, has created a token standard known as ERC20 that allows anyone to issue a token inexpensively with relatively simple code.³

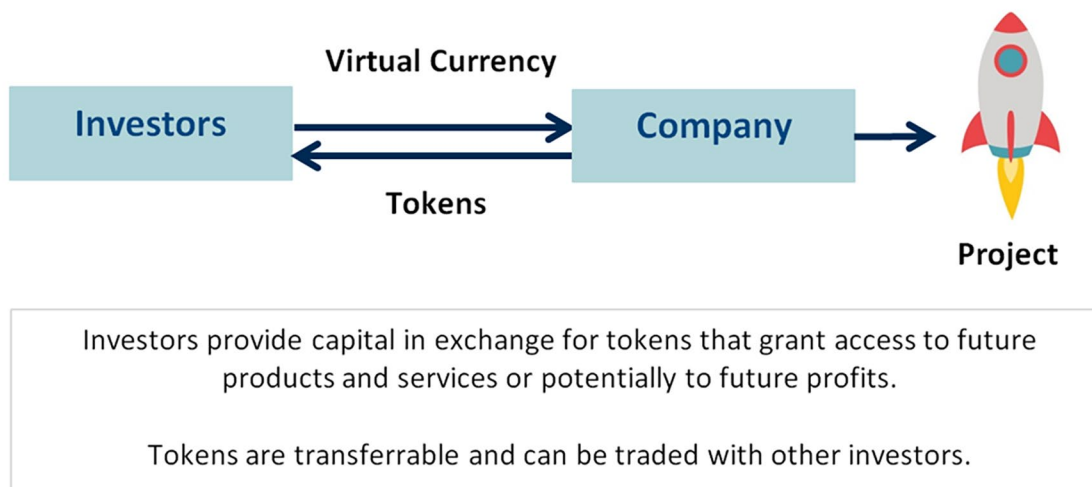
Most companies employing ICOs are in a start-up phase and use the sale of tokens to fund development of their digital platform and services. Tokens that grant the investor access to the company's products or services are usually referred to as utility tokens. Tokens that grant the investor economic rights (which may include a share of future profits and voting or other corporate governance participation) are usually referred to as equity or investment tokens. The SEC has taken the position that ICOs involving tokens that provide an ownership stake must comply with securities laws.⁴

² Blockchain is a technology that enables a continually expanding list of records (or blocks). As time passes, newer blocks are linked securely to older blocks providing a full history of transactions that took place on the blockchain.

³ "Create your own CRYPTO-CURRENCY with Ethereum," Ethereum, available <https://www.ethereum.org/token>

⁴ "SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities," Securities and Exchange Commission press release, July 25, 2017, available <https://www.sec.gov/news/press-release/2017-131>. See also Simon Goldstein, "All Eyes on Ripple as it Faces Lawsuit – is XRB a Security?" August 5, 2016, available <https://www.>

Figure 2: Token Offering



The process of going from conception to ICO proceeds like this:

Figure 3: Whitepaper to ICO



As a precursor to an ICO, some companies have recently been raising an initial round of capital through a Simple Agreement for Future Tokens ("SAFT"). The proceeds are used to develop the network and technology to create the token. Under a SAFT, the company accepts funds (fiat currency) from an investor in exchange for documentation that provides access to the tokens if and when they are created.⁵

After tokens are issued, they can be traded freely on any number of digital token exchanges - similar to how securities trade on traditional exchanges. The token value is set initially by the issuer based on what it thinks the venture is worth at its current stage. Then, after exchange trading begins, the value is established by market participants based on supply and demand. At the time of this writing, some of the bigger token exchanges by dollar volume of trading are Bitfinex, Bithumb, Bittrex, and HitBTC.

financemagnates.com/cryptocurrency/news/eyes-ripple-faces-lawsuit-xrp-security/

⁵ An SAFT is different from a Simple Agreement for Future Equity (SAFE), which allows investors who put cash into a startup to convert that stake into equity or tokens at a later date.

II. Where do ICOs fit in the fundraising spectrum?

The name ICO – initial coin offering – immediately brings to mind a more familiar and well understood form of capital raising, the IPO, or initial public offering. ICOs and IPOs are quite different along a number of dimensions, however. For one thing, IPOs entail the issuance of common stock. An IPO is generally undertaken by more mature companies with histories of revenue, if not profit. IPOs provide founders and early investors an opportunity to cash out. ICOs, on the other hand, are usually undertaken by earlier stage companies often as an alternative to venture capital (VC) funding, and are generally not presented as an opportunity for founders or early investors to cash out. ICO proceeds are typically used to build the company infrastructure, often well in advance of demonstrated economic viability.

The profiles of ICO issuers and investors are also generally narrower than those in IPOs and other forms of financing. Most ICOs are pursued by companies engaged in blockchain-based business models, though that is starting to change.⁶ Raising capital by token sales is a natural technical and philosophical fit for these kinds of companies. Similarly, ICO investors are individuals and entities that are willing and able to participate in the virtual currency ecosystem. Critically, these investors have access to a virtual currency that may be required to buy the tokens. VC firms themselves are increasingly investing in ICOs as ICOs represent the only means of participating in many of these early-stage blockchain businesses. Many have viewed the participation of reputable VC firms as a stamp of credibility for the business ventures that issue tokens.⁷

Utility token investors are further specialized. They are likely to consume the product or service the company intends to offer or at least expect the value of the utility tokens to increase over time. Utility token investors are often willing to be early adopters of the token seller's technology. They can showcase the value of the products and services to other investors and influence future use. In contrast, IPO investors may have no connection to the products or services provided by the firm raising capital.

ICOs and IPOs operate under dramatically different regulatory regimes – at least for now. Companies raising money through an IPO are subject to U.S. securities laws, which require offers and sales of security instruments to be registered with the SEC and extensive public disclosures.

The question of what constitutes a security, with all its attendant regulatory oversight, is a legal one. Regulators still look to the well-publicized 1946 Supreme Court decision in *SEC v. Howey* for guidance (the *Howey Test*). This case defined a security as an investment in a common enterprise with the expectation of profits solely through the efforts of another. Tokens often don't fit neatly into the traditional definitions, however, and as a result, ICOs have thus far been subject to

⁶ “Establishing Company to Sell 10% of Its Shares in an Ethereum Based ICO,” Trustnodes, available <https://www.trustnodes.com/2018/02/21/established-company-sell-10-shares-ethereum-based-ico>

⁷ Darren Heitner, “Why VCs May Be Climbing Aboard the ICO Train,” *Forbes*, 2017, available <https://www.forbes.com/sites/darrenheitner/2017/11/03/why-vcs-may-be-climbing-abroad-the-ico-train/#349745bf58af>

minimal regulatory oversight. The same is true for the secondary market exchanges for tokens.⁸ This is starting to change with the SEC's recent actions, but it has been said that ICOs are operating in the "wild west" of finance."⁹

Figure 4 highlights some of the similarities and differences between ICOs and other means of raising capital.

Figure 4: Approaches to Raising Capital

Approach	Company Stage	Median Capital Raised	Voting and Ownership Rights	Security Registered with the SEC	Accredited Investors
Crowdfunding (e.g. Kickstarter)	Concept	< \$10,000	No	No	No
Angel Investment	Concept to Early	\$25,000	Yes	No	Yes
ICO	Concept to Early	\$4.5 million	Sometimes	Evolving	Sometimes
Venture Capital	Early to Late	\$6 million (early) \$30.75 million (late)	Yes	No	Yes
IPO	Mature	\$118.6 million	Yes	Yes	No

Sources: Kickstarter, Wharton and Angel Capital Association Study (2017), Token Data, Crunchbase, Ernst & Young.

III. What are the economic benefits (and costs) of ICOs as they currently exist relative to other forms of fundraising?

So why do companies choose to raise money through token sales rather than more traditional financing arrangements like VC? There are a number of economic benefits that token sales provide, for both the firm and the investor.

⁸ FinCEN issued a letter on March 6, 2018, that stated, "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." This indicates that FinCEN views token exchanges as money services businesses (MSB), which is a defined category of business subject to regulatory requirements.

⁹ Randolph A. Robinson, II, "The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings," Harvard Law School Forum on Corporate Governance and Financial Regulation (January 2018), available <https://corpgov.law.harvard.edu/2018/01/18/the-new-digital-wild-west-regulating-the-explosion-of-initial-coin-offerings/>

First, token sales are relatively quick and inexpensive to roll out. Total costs range from less than \$100,000 to a few hundred thousand dollars, depending on the scale of marketing effort and legal fees which make up the bulk of costs.¹⁰ In terms of timing, some companies have gone from concept to token sales in as little as three months.

Further, unlike venture capital investments that often require board seats and voting rights, token sales allow startups to raise funds without much influence ceded to the investors. From the company's perspective, this may be viewed as a positive feature that allows the founders to manage as they see fit.

From an investor perspective, token sales provide the opportunity to invest in early stage startups to a broader group of investors. Traditionally, early stage investment opportunities have been reserved for deep pocketed venture capitalists and accredited investors. Token sales have opened up these investment opportunities, at least some of them, to individuals anywhere in the world. Some have called this the "democratization" of investment.¹¹

In addition, tokens can be bought and sold on secondary market exchanges after the initial sale, which represents a liquidity advantage relative to traditional angel investors and venture capital firms. Historically, investments in early stage companies have been highly illiquid without any means of exiting except through some kind of negotiated agreement.

Despite the benefits, token sales carry a fair amount of risk for both the seller and the investor. Numerous examples of hacking and scams have fleeced both companies and investors, like the DAO ICO, where hackers initially stole \$50 million¹², the CoinDash ICO where \$7 million was lost¹³, and the BeeToken ICO where a phishing scam cost investors \$1 million.¹⁴ Perhaps most critically, ICOs thus far have not been subject to the disclosure requirements of SEC-registered securities. Instead of a prospectus, details on the issuing company and business model are described in whitepapers with varying levels of detail, auditing, and transparency. As a result, it can be challenging for ICO investors to make truly informed investment decisions. *The Wall Street Journal* recently analyzed 1,440 digital coin offering materials and found 271 with red flags that included plagiarized investor documents, promises of guaranteed returns or fake executive teams.¹⁵ Also, the anonymous nature of individual transactions means that token sales have the potential to be abused by money launderers, unless voluntary AML (anti-money laundering) protocols are implemented by the seller.

10 Merunas Grincalaitis, "What it takes to create a successful ICO? How expensive it is? Your complete guide," Medium, 2017, available <https://medium.com/@merunasgrincalaitis/what-it-takes-to-create-a-successful-ico-how-expensive-it-is-your-complete-guide-35912722351e>

11 Randolph A. Robinson, II, "The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings," Harvard Law School Forum on Corporate Governance and Financial Regulation (January 2018), available <https://corpgov.law.harvard.edu/2018/01/18/the-new-digital-wild-west-regulating-the-explosion-of-initial-coin-offerings/>

12 Matthew Leising, "The Ether Thief," Bloomberg (June 2017), available <https://www.bloomberg.com/features/2017-the-ether-thief/>

13 Ari Levy, "Fraudsters just stole \$7 million by hacking a cryptocurrency offering," CNBC (July 2017), available <https://www.cnbc.com/2017/07/17/coindash-website-hacked-7-million-stolen-in-ico.html>

14 Nikhilesh De, "Bee Token ICO Stung by \$1 Million Phishing Scam," Coindesk (February 2018), available <https://www.coindesk.com/bee-token-phishing-scam/>

15 Shane Shifflett and Coulter Jones, "Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud," *The Wall Street Journal*, May 17, 2018.

IV. What does the future hold for ICOs from a regulatory and litigation perspective?

The regulatory landscape for ICOs is changing rapidly. Since the second quarter of 2017, the SEC has drafted a memo finding that the DAO ICO met the conditions to be considered a security based on the Howey Test, issued a cease-and-desist order against the Munchee token sale, and filed a complaint alleging section 10b-5 securities violations against Centra based on its ICO. The SEC, in an attempt to alert investors about the potential for ICO fraud, has also recently set up a fake ICO website to show how easy it is to scam investors (www.howeycoins.com). Then, on June 8, 2018, SEC Chairman Jay Clayton declared on CNBC that all tokens used to raise funds for a venture that came with an expectation of profit should be classified as securities.¹⁶

Utility tokens which offer both consumption and investment attributes currently exist in a grey area where traditional definitions of a security are difficult to apply, however. Guidance will undoubtedly clarify over the next year or two as to how specific token attributes fit into the security classification framework.

Regulatory authorities both in the U.S. and elsewhere are signaling that the industry, secondary market exchanges, and investors will see greater levels of regulatory oversight going forward. All indications are that there will be more enforcement actions and possibly even SEC-registered tokens at some point in the near future.

It seems plausible that investors may bring Section 11 and Section 10b-5 securities class action litigation against token issuers based on similar allegations leveled against publicly traded companies (i.e., material omissions, false and misleading statements). The economic analysis of any harm in these cases will allow for novel methods of calculating damages as the actual trading records for each investor (price, time, and volume) should be stored on the underlying blockchain network and denominated in virtual currency.

Finally, expect wider adoption of Know-Your-Customer (KYC) protocols and AML enforcement to combat the money laundering potential of anonymized token sales. As, Jamal El-Hindi, acting director of the Treasury Department's Financial Crimes Enforcement Network (FinCEN), stated, "We will hold accountable foreign-located money transmitters, including virtual currency exchangers, that do business in the United States when they willfully violate U.S. anti-money laundering laws."¹⁷

Securities litigators and financial experts should therefore be prepared for rapidly evolving technology, industry practice, and regulatory oversight in the months and years ahead with respect to ICOs and token sales.

¹⁶ "Breaking News: SEC Chairman Declares All ICOs As Securities," CryptoCoin.News, available at <https://cryptocoin.news/videos/breaking-news-sec-chairman-declares-all-icos-as-securities-15119/>

¹⁷ United States Department of Treasury, Fincen Fines BTC-e Virtual Currency Exchange \$110 Million for Facilitating Ransomware, Dark Net Drug Sales, available <https://www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110-million-facilitating-ransomware>

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