

MARKET SOLUTIONS

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MARKET SOLUTIONS

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FINANCIAL MARKETS ASSOCIATION

Regulators Weigh in on Digital Assets, Tokens, Securities, and Derivative Instruments Used in ICOs

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The rise of blockchain technology ventures raising money preternaturally through initial coin offerings and token generation events (collectively, ICOs) is a capital formation disruptor, one which has and will continue to spawn considerable futures, fortunes, failures -- and frauds. Blockchain-based ICOs have, through 121 offerings closed during January-August 2017, raised over \$1.78 billion, with an expected amount at year-end 2017 of over \$3 billion according to publicly-available estimates. While IPOs raised about \$12 billion (and startups \$22 billion) thus far in 2017,¹ the amount raised through ICOs is impressive for a new asset class. By some sources ICOs have exceeded angel, venture capital, and seed funding reported during some months of 2017.² The shrouded world of blockchain technology and range of offerings masks identities and sourcing of investors in ICOs. It is speculated that funds have been primarily sourced from early investors profiting in cryptocurrency technologies.

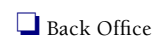
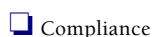
Regulators Weigh In

Many ICOs are creating significant funding for the blockchain technology startup market,

mirroring the dotcom boom of the late 1990s with its “paper millionaires.” However, critics and financial regulators such as the Securities and Exchange Commission (SEC), Commodities Futures and Trading Commission (CFTC), and Internal Revenue Service (IRS) have begun to weigh in. On July 25, 2017, the SEC issued a Report of Investigation (Investigative Report), warning market participants to exercise caution in fundraising and investments involving The DAO, a “decentralized autonomous organization” described by the SEC as a “virtual” organization embodied in computer code and executed on a distributed ledger or blockchain.³ In the Investigative Report, issuers of DAO tokens were both an unincorporated organization, The DAO and a German-based corporation, Slock-It (which then effectively controlled The DAO), which sold tokens to fund “projects.” The tokens could later purportedly be monetized by re-selling on web-based secondary trading platforms. The Investigative Report made clear that the sale of tokens could constitute an investment contract or security under the Howey test and its progeny,⁴

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Route to:



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and “stress[ed] the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.”⁵

On Oct. 4, 2017, the CFTC released a primer on virtual currencies⁶ which sought to reconcile the SEC position in the Investigative Report with the CFTC’s approach.

The primer continues the CFTC’s position, first expressed in 2015, that virtual currencies are commodities, and therefore, the CFTC has jurisdiction when a virtual currency is used in a derivatives contract or in the case of fraud or manipulation in a transaction involving interstate commerce. The CFTC concludes in the primer that “there is no inconsistency between the SEC’s analysis and the CFTC’s determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.” At an industry event on Oct. 18, recently-appointed CFTC Commissioner Brian Quintenz elaborated further on the regulatory relationship between the SEC and the CFTC in the area of ICOs. While acknowledging that much regulatory work still remains, Commissioner Quintenz said that ICOs “may start their life as a security from a capital-raising perspective but then at some point – maybe possibly quickly or even immediately – turn into a commodity.”⁷

Many platforms/exchanges for digital assets exist worldwide, some unregulated and some regulated based upon the location of the physical or virtual exchange or the location of those wishing to buy or sell tokens through an exchange. Within the last several weeks, financial regulators have banned the sale of ICOs in China and, now, South Korea, with China also banning cryptocurrency exchanges (though not in Hong Kong and some other venues it controls). Given the movements and statements of various central banks and governmental officials, international regulatory organizations, and regulated financial institutions, it is likely that permissive regulation for both ICOs and exchanges will be adopted worldwide in the future.

The number of digital cryptocurrencies and other assets now exceeds over 1,000⁸ and the legal classification of these assets is blurred given that business and technological innovation in practice has outpaced legal theories and regulatory structures.

This article explores coins, tokens, and other digital assets currently being used in offerings including virtual currencies, utility tokens, and tokenized securities.

“Many ICOs are creating significant funding for the blockchain technology startup market, mirroring the dotcom boom of the late 1990s with its ‘paper millionaires.’”

The Digital Asset Spectrum

No one template currently exists for tokens and coins offered digitally for capital formation activities. In light of the varieties and features of digital assets currently traded, purchased, and bartered, as well as the continuing evolution and development within this sector, clearly defined classifications and terminologies for the assets are premature.

However, the following classes of cryptocurrency assets have emerged based on their uses and features:

- virtual currencies (which may act as a substitute for legal or fiat currency),
- utility tokens (which may not fall within the definition of a “security” in certain circumstances, such as for the purchase of services or products), and
- tokenized securities.

Virtual Currencies (e.g., Bitcoin, Ether, and Ripple)

The first category of coin or asset distribution includes digital coins used as currencies such as Bitcoin, Ether, and Ripple, the most widely recognized digital currencies. Cryptocurrencies are digital alternative currencies that are not issued by any country’s government. Japan has recently recognized Bitcoin as a legal currency, boosting demand for the virtual coins. Cryptocurrencies are not printed or minted, but are created and

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memorialized in digital ledger systems on blockchains and used by some vendors for trading goods and services. The phenomenal growth of the most well-known cryptocurrency, Bitcoin (the blocks for which cannot exceed one megabyte until late November 2017, when new applicable technology will permit up to two megabytes), has raised awareness of uses for blockchain technology and fueled its growth.⁹

Although fiat currency may be used to purchase other cryptocurrencies, and despite sometimes substantial volatility and fluctuation in value, Bitcoin, Ether, and other similar “virtual currencies” are, in light of their wide acceptance and use today, generally not considered a security as defined under U.S. federal securities laws given their primary purpose for use as alternative currency rather than as an investment in a common enterprise.¹⁰

The IRS refers to a virtual currency, such as Bitcoin, that has an equivalent value in real currency, or that acts as a substitute for real currency, as a “convertible” virtual currency. The IRS has additionally stated that virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.¹¹ Rather, for federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.¹² This income tax classification of virtual currency as property raises significant tax reporting challenges for users of cryptocurrencies, because each time virtual currency is used to purchase goods or services, it is treated as a taxable transaction, where the currency is exchanged for the goods or services, triggering a taxable gain or loss. The IRS has not issued any further guidance since the 2014 notice, leaving many unanswered questions on the proper tax treatment of the use of virtual currencies.¹³

“The CFTC concludes...that there is no inconsistency between the SEC’s analysis and the CFTC’s determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.”

Utility Tokens

Utility tokens are frequently sold in ICOs. These tokens are sometimes services or units of services that can be purchased but may also resemble investment contracts. Under the traditional Howey test, an investment contract involves the investment of money, in a common enterprise, with an expectation of profits from the efforts of management or other third party.¹⁴

Although there is not yet a bright line test other than the Howey test, securities practitioners are, at this juncture, generally of the view that utility tokens purchased without profit motive are not investment contracts and thus not securities. Under current market practice, utility tokens are generally offered for sale once the platform or infrastructure is complete and are not sold to provide initial development funds.

The Howey test does, of course, apply to each analysis as to whether a utility token is a security, and to avoid any such treatment, the issuer must ensure that a definable amount of a specific service (or combination of product and service) is the sole value to be received and does not include a profit participation arising from the managerial efforts of others. Secondary markets can evolve for utility tokens, with increases in value principally resulting from market forces (principally supply and demand).

Tokenized Security Investments

Some digital assets used in a blockchain-based technology are considered to be securities. Utilizing the Howey test, if the investor has an expectation of profits from efforts of the managers and developers of the network, the coin, tokens, or other instruments are investment contracts, and thus, securities. This is commonly the case for “pre-sales” of tokens, where funds from token sales are used for development of the platform, infrastructure, and services prior to commercialization or product launch. Careful analysis of the rights, including profit participation,

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attaching to these tokens is key to a determination of whether compliance with federal and state securities laws is required. In the case of a security, most issuers rely on various exemptions from the applicable securities and broker-dealer registration requirements under federal and state securities laws. Where the tokens are offered and sold in a private placement, issuers may limit sales to accredited investors and rely on the covered security safe harbor for the transactional exemption under Regulation D of the Securities Act of 1933, as amended, and Rule 506 promulgated thereunder. However, such tokens have not been defined as “covered securities” for purposes of federal securities laws and, therefore, they are not preempted from state securities registration. Currently, the states generally consider the tokens as “securities” and consider such offerings as offerings of securities but not “covered securities” under National Securities Market Improvement Act (NSMIA). Consequently, compliance with state securities or “blue sky” laws is required in those states where the tokens are to be offered and sold, which may or may not subject the offerings to registration should an exemption for transactions in such “securities” be available. Compliance is also required with applicable non-U.S. securities laws if the tokens are offered and sold outside the United States. In addition, consideration must be paid to the resale market and any effort to sell such securities in secondary transactions would subject these to the applicable state blue sky laws and the applicable “non-issuer” exemptions.

A derivative instrument called a Simple Agreement for Future Tokens (or Equity) (SAFTE)¹⁵ is being used by some issuers in certain pre-sale contexts. The SAFTE, which constitutes a security, has been described as an instrument effectuating the issuance of tokens to fund a technology product or system prior to its development or commercial launch, and may represent a promise for future tokens at a fixed price. The SAFTE agreement may be structured so that investors receive tokens once the network launches.

Federal Income Tax Considerations

Tokenized Securities in an ICO

Since the IRS classifies virtual currency as property, the issuer will likely be treated as selling the tokens for the proceeds of the offering, resulting in a large taxable gain. In these circumstances, it is probable that the issuer would recognize the income in the tax year of the offering. This is unlike the issuer of shares of stock of a corporation, which would be allowed tax-free treatment for money or property received in exchange for shares of stock in the corporation.¹⁶ Consequently, unless the offering is structured in a manner to characterize the

“Many platforms/exchanges for digital assets exist worldwide, some unregulated and some regulated based upon the location of the physical or virtual exchange or the location of those wishing to buy or sell tokens through an exchange.”

tokens as “stock” in the issuer, an issuer may have a substantial income tax burden if the issuer is subject to U.S. income taxation.¹⁷ It is unlikely that an ICO for a utility token would be eligible for such tax-free treatment, and the issuer must be prepared to deal with the U.S. income tax consequences of an ICO.

Considerations for use of a SAFTE.

The SAFTE is structured to allow the issuer to take a tax reporting position that it is not required to recognize the income from the proceeds of the offering until the tokens are actually delivered to the ICO investors.¹⁸ By delaying the time for the recognition of the offering proceeds until the year the tokens are delivered to the investors, the issuer would defer the tax consequences until the tax year the tokens are delivered to investors, assuming the IRS does not challenge such “forward contract” treatment. In such a case, it would extend the time that net-operating loss deductions can be utilized to offset income tax due on future profits. However, such a reporting position using the forward contract theory is untested, and until the IRS publishes guidance, it should be assumed for tax modeling purposes that the issuer will recognize the income from the proceeds of the ICO in the year of the offering for U.S. income tax purposes.¹⁹

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Broker-Dealer Involvement in ICOs

Financial intermediaries have yet to fully insert themselves into the ICO process. As they do, they must proceed with caution. Several businesses have publicly announced the development of alternative trading platforms in partnership with broker-dealers and investment banks; however, the Financial Industry Regulatory Authority (FINRA) has yet to provide any guidance on its member firms' participation in ICOs.²⁰ Unresolved issues include: whether ICOs comprise a new business line for purposes of FINRA Rule 1017; what registrations an associated person would need to transact in ICOs; whether ICOs should be best efforts offerings or firm commitments; how to determine suitability for an investor purchasing ICOs through a broker-dealer; and whether ICO white papers are subject to FINRA advertising standards when distributed by a broker-dealer. Until there has been some guidance from FINRA, member firms are advised to obtain advice of counsel before engaging in ICO transactions.

Designing the Digital Asset

Digital assets may be classified as virtual currencies, utility tokens, or tokenized securities. These assets often contain a blend of features and characteristics making the correct legal classification and approach to regulatory compliance, without guidance, more complex. Cryptocurrency assets will continue to evolve throughout 2017 and beyond. An informed multidisciplinary approach is critical to the design of the cryptocurrency asset and the development of a credible blockchain technology white paper and key to a potentially successful ICO (or other funding) and a viable product poised for commercial growth. ■

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¹http://www.renaissancecapital.com/review/2Q17USReview.pdf?inf_contact_key=bcc17dd75b4d3fef1c8fe8f5f81fd73cbdd9764cc99467f926462f518a62e6a6.

²<https://www.cnbc.com/2017/08/09/initial-coin-offerings-surpass-early-stage-venture-capital-funding.html>.

³<https://www.sec.gov/litigation/investreport/34-81207.pdf>. Securities and Exchange Commission, Release No. 81207/ July 25, 2017 ("SEC July 2017 Release").

⁴ See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); see also *SEC v. Edwards*, 540 U.S. 389 (2004).

⁵ SEC July 2017 Release, at p. 2.

⁶ LabCFTC, A CFTC Primer on Virtual Currencies, available at http://www.cftc.gov/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf.

⁷ <https://www.newsmax.com/finance/streettalk/bitcoin-etf-exchanges-invest/2017/10/19/id/820843/>.

⁸ Bank of America Merrill Lynch Industry Overview, *Introducing cryptocurrencies – what are they good for?* October 16, 2017.

⁹ By most accounts, the first Bitcoin transaction occurred in January 2009 on the heels of the 2008 financial crisis and was steeped in anti-commercial and anti-establishment backlash. Bitcoin, one of the best-known cryptocurrencies, was initiated in 2009 by a computer developer using the pseudonym Satoshi Nakamoto.

¹⁰ Security is broadly defined under Section 2 (a)(1) of the Securities Act of 1933, as amended, to include investment contracts whereby a person is led to expect profits from the efforts of a third party. Note that embodied in the SEC July 2017 Release analysis of whether DAO tokens were securities seems to be a concept that the "managerial efforts of others" prong of its analysis is too attenuated for those cryptocurrencies for which an established market, value, and, perhaps, number of holders has been achieved, such as with Bitcoin and Ether, provided that the managerial efforts of those which may exert any control or affect profits becomes too diffuse to ascribe significant managerial efforts

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to any identifiable group. Successfully addressing design and operational challenges posed by, “managerial efforts of others” will be key for all blockchain offering issuers and counsel in both the structure of ICOs and for any trading of them.

¹¹ <https://www.irs.gov/newsroom/irs-virtual-currency-guidance>; see also IRS Notice 2014-21.

¹² *Id.*

¹³ See the letter from American Institute of CPAs to the IRS dated June 10, 2016, asking the IRS to publish additional guidance on various open questions regarding the tax treatment of virtual currencies. <https://www.aicpa.org/advocacy/tax/downloadabledocuments/aicpa-comment-letter-on-notice-2014-21-virtual-currency-6-10-16.pdf>.

¹⁴ *Supra*, n. 4.

¹⁵ At least one Form D/A amendment filed with the SEC Aug. 25, 2017 reported the SAFTE as “Other” in the type of security check-box with a description of “Sale and issuance to receive Filecoin tokens in the future via a Simple Agreement for Future Tokens (SAFTE). The report noted a date of first sale as July 21, 2017, with 154 investors and \$51.658 million sold.

¹⁶ Section 1032 Internal Revenue Code of 1986.

¹⁷ There is some support for the position that the issuer of a token could be treated in a manner analogous to that of

an issuer of a “personal seat license” (a “PSL”), even if the token is not treated as stock for federal income tax purposes. A PSL is a license issued by a professional sports team that grants the holder, *inter alia*, the right to buy season tickets. In certain cases, the rights granted to the holder of a PSL may be similar to those granted to the holder of a token used to gain access to, say, an insurance exchange. In private guidance issued this year, the Service has held that the issuer of a PSL is not required to recognize income upon issuance so long as the PSL is redeemable by the issuer. PL.R. 201722004, Jun. 2, 2017 (the “PSL guidance”). Note, however, that the PSL guidance did not address certain issues, such as the treatment of imputed interest on below-market loans, and, since it was issued privately, it may not be relied upon by taxpayers other than the taxpayer to whom it was issued.

¹⁸ The SAFTE is designed to treat the ICO as a “forward contract.” Income on a forward contract is not recognized until the transaction is closed. Under this theory of the SAFTE, the forward contract would not be closed until the utility tokens are delivered to the investors.

¹⁹ *Id.*

²⁰ FINRA provided a general warning to investors. <http://www.finra.org/newsroom/2017/initial-coin-offerings-know-risks-you-buy>.

2018 FINRA Examination Priorities

<http://www.finra.org/newsroom/2018/finra-releases-2018-regulatory-and-exam-priorities>

December, 2017

Report on FINRA Examination Findings

<http://www.finra.org/sites/default/files/2017-Report-FINRA-Examination-Findings.pdf>

Directory

The 2017 FMA Membership Directory was emailed to all current members on September 27. Here are additional updates/corrections received since its distribution.

If you are a current FMA member and did not receive (or perhaps misplaced) the Directory, contact Dorcas Pearce directly...202/544-6327 or dp-fma@starpower.net.

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