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The Evolution of Token Offerings and Regulation: From ICO to STO

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INTRODUCTION

Initial coin offerings (ICOs or token offerings) are typically viewed as an alternative method of capital raises for early-stage companies through the offer and sale of a digital token or asset in exchange for either fiat money or cryptocurrency. Over $12 billion has been raised globally through August 2018, up almost 50% from the $7.4 billion raised in 2017. Entrepreneurs and both private and retail investors are becoming increasingly involved in this new avenue for raising capital, disrupting the traditional funding path from venture capital through initial public offering (IPO). And, as blockchain technology continues to become more mainstream, the capital markets will similarly evolve by broader acceptance of token sales.

Seed and venture financing can be accomplished through derivative-type instruments that provide the purchaser with the issuer's tokens, once the platform is launched. Initial raises in this space utilized a new form of investment contract called a SAFT, or Simple Agreement for Future Token. The SAFT was based on a concept that the to-be-issued tokens did not constitute a security and would be freely tradable upon creation and issuance. This analysis was met with criticism from some sectors within the legal and academic community. Consequently, this elevated the discussion by market participants and regulators over whether token issuances were in fact securities, requiring compliance with applicable securities laws in and outside the United States (U.S.).

Between 2015 and early 2017, the market for tokens received great interest from a new breed of investors seeking to capitalize on the phenomenal growth of and returns from sales of cryptocurrency. Hundreds of millions of dollars could be raised almost overnight in some cases – a result previously unheard of for start-up ventures. Regulators around the globe were relatively quiet on the topic, and there was a legitimate question as to whether tokens should be treated as securities, commodities, property or something else.

In most jurisdictions, the classification of digital assets determines how ICOs are regulated. Some countries have moved to introduce new regulation in this area (such as South Korea, the EU, Malta and the Cayman Islands), while others have banned token offerings entirely (such as China and, to a limited extent, Russia). In the U.S., both the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) have asserted authority over token transactions, with enforcement actions on the rise by the SEC, the CFTC and state regulators starting in late 2016 for cases of fraud, viewing many token sales as Ponzi schemes. Meanwhile some jurisdictions outside the U.S., such as Switzerland and Singapore, have created jurisdictional safe havens for token offerings with minimal interference from regulators.

THE APPLICATION OF U.S. FEDERAL SECURITIES LAWS

The U.S. approach to regulating digital assets has been to work within its current laws, rather than introduce new ones, as well as highlighting the risks of people involved in token offerings and trading. The SEC has stated that it would not change securities laws to cater to digital assets, and will prosecute fraudulent token offerings.

In July 2017, the SEC issued the DAO Report, relying on its investigative authority under Section 21(a) of the Securities Exchange Act of 1934 (the "Exchange Act") rather than its enforcement power. Essentially, the SEC took this opportunity to lay out a simple roadmap for the marketplace on how to sell tokens: comply with existing federal and state law. As a basis for its guidance, the SEC applied the *Howey* test to the facts and circumstances of its investigation to assess whether tokens issued by a blockchain company violated federal securities laws. Under *Howey*, a transaction may constitute a security if (a) there is an investment of money, (b) in a common enterprise, (c) with an expectation of profit, (d) primarily through the managerial or entrepreneurial efforts of others.

The DAO Report highlighted the need for market participants to assess whether the sale of a token was, in fact, a security. To conclude that a token is not a security subject to applicable federal and state law, then the token must have a pure utility function. The SEC has noted that, notwithstanding a token's use on a particular platform to access products or services or enable certain functionality, it is important to assess all the facts and circumstances relevant to the issuance in determining whether the offer and sale of a token is a security.

SECURITY TOKENS AND UTILITY TOKENS

This initial guidance from the SEC sparked a debate as to what constitutes a security token: when is a token whose primary

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purpose is to serve the functionality of the network, a security? Chairman Jay Clayton has stated numerous times at conferences and in speeches that he had not seen a token that was truly a utility, and considered that virtually every token was a security. In general:

1. Security tokens are tokens that are directly related to the growth of the platform, application or the company prior to launch. These are typically seen as being within the purview of securities regulations in most jurisdictions. Notably, if a purpose of the token sale is to create market interest in the platform or application and/or to create a trading platform for the tokens, then it is likely to be considered a security.

2. Utility tokens have, as their primary purpose, a consumptive purpose, that is, some sort of use in the project selling the token, whether to "unlock" or access certain features or functionality on the platform or to use as a form of scrip or barter for goods and services on the platform. A token typically cannot be considered a utility until the platform or application has been fully developed and launched.

In a speech at the Yahoo! Finance All Markets Summit in San Francisco, California on June 14, 2018, William Hinman, the Director of the SEC's Division of Corporation Finance, caught the market's attention when he laid out parameters for whether a token should be considered a security:

1. "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?

2. 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?

3. 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?

4. 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?

5. 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?

6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?"

Hinman emphasized that tokens and other digital assets can function more like a consumer item than a security, and laid out a list of factors to prompt thinking by issuers and their advisors on this matter in order to commence an informed dialogue with the SEC. These factors are included here because of their significance in evaluating the nature of the token:

1. "Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?

2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?

3. 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?

4. 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?

5. Is the asset marketed and distributed to potential users or the general public?

6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?

7. Is the application fully functioning or in early stages of development?"

THE EVOLUTION OF THE STO

As regulatory guidance has evolved since early 2017, two key impacts have been recognized. The first is that the days of the "Wild West" (as the ICO market was widely referred to in 2016 and 2017) are over for all savvy market participants. It has

become clear that, in the U.S. and most other jurisdictions, compliance with existing applicable law is required. Second, is the distinction between a security token and utility token, which has also resulted in the evolution of the ICO to a "STO," or security token offering.

The STO now takes many forms, but it typically effected as a private placement in reliance upon available exemptions from applicable federal and state securities in the U.S. and applicable securities laws in other jurisdictions. In the U.S., for example, STOs rely upon the Regulation D and Regulation S safe harbors. With a more sophisticated institutional and strategic investor moving into this market, concerns about one-year restrictions on trading or transferability have been broadly dismissed. Such restrictions have become accepted globally as part of the maturing market.

The other approach being commonly pursued by issuers for a STO is through a Regulation A+ offering, requiring that offering materials be "qualified" with the SEC, or a fully SEC-registered initial token offering. While SEC staff have commented at various conferences that a number of Regulation A+ and fully-registered offerings are currently being reviewed confidentially by the Staff, to date none have been qualified or, in the case of a fully-registered offering, declared effective. This is just a matter of time, as issuers and their counsel work through the multitude of custody, settlement and other issues associated with these transactions, and licensed digital custodians and other service providers fill a burgeoning market need.

SEC INTRODUCES FINHUB

As digital assets gain broader acceptance, the SEC continues to look for new ways to work with investors and other market participants on issues such as capital formation and financial services. To this end, the agency recently announced the launch of the Strategic Hub for Innovation and Financial Technology (FinHub), which aims to make it easier for fintech start-ups – including those launching token offerings – to navigate the legal implications of their products. FinHub will act as a central point for the securities regulator to interact with entrepreneurs and developers in the financial technology world, in particular with groups focusing on distributed ledger technology (DLT), automated investment advice, digital marketplace financing and artificial intelligence. The new division will also collaborate with other regulators, both domestic and international, on work that involves emerging technologies. FinHub will be run by the SEC's senior advisor for digital assets and innovation, Valerie Szczepanik, and be staffed by SEC officials who have previously worked on fintech-related issues, according to the agency.

Commenting on FinHub, SEC Chairman Jay Clayton said, "The FinHub provides a central point of focus for our efforts to monitor and engage on innovations in the securities markets that hold promise, but which also require a flexible, prompt regulatory response to execute our mission."

STATE REGULATORS STEP IN.

In the absence of a specific set of federal regulations addressing token issuances (apart from existing securities laws) states remain free to introduce their own rules and regulations. However, based on recent enforcement action by many states' Attorneys General (for example, Alabama, Delaware, Maryland, New York and South Carolina are playing a greater role in providing guidance and/or initiating enforcement actions in this area), a NASAA survey (https://medium.com/blockchain-for-law/state-laws-recognize-impact-of-blockchain-on-legal-sector-6749d71fc982) of state regulators shows that 94 percent believe there is a "high risk of fraud" including cryptocurrencies. As a result, the states are looking to the suitability of such investments by investors to determine if unfair and deceptive and more susceptible to fraud. For example, in 2015, New York became the first state in the U.S. to regulate virtual currency companies through state agency rulemaking. In July 2017, the National Conference of Commissioners on Uniform State Laws voted to approve a model act providing for the regulation of digital currency businesses at the state level. While this "Regulation of Virtual Currency Business Act" remains voluntary on a state-by-state basis, a version of which was introduced (but not yet passed into law) in 2018 in Connecticut and Nebraska, and certain provisions of which have been adopted in Hawaii.

There have been recent enforcement activities involving digital currency exchanges, including cease and desist orders, in California, Delaware, New York, South Carolina and Texas. Based on recent research, the following states have legislation, executive orders, and/or regulations in force relating to the use of blockchain technology and "smart contracts": Delaware, Maryland, Nevada, New Hampshire, Tennessee and Wyoming. Some states have enacted and/or have pending laws/regulations relating to blockchain technology and/or smart contracts: Arizona, Connecticut, Illinois, Ohio, Vermont and Washington. This legislation appears to be primarily for recordkeeping purposes. Other enacted and/or pending legislation: A California law makes it illegal to buy or exchange a raffle ticket for any kind of cryptocurrency. In September, Assembly Bill No. 2658 amended the Government Code to define blockchain and requires the state to appoint a blockchain working group, and Senate Bill 838 amends the California Corporations Code to authorize privately-held corporations, among other things, to use blockchain technology to record and track the issuance and transfer of stock certificates.

- Colorado recently passed legislation that will facilitate the sale and transfer of digital tokens in Colorado. Upon the governor's signature, which is expected by March 8, 2019, the Colorado Digital Token Act (Digital Token Act) will become law, but will not become effective until Aug. 2, 2019. Under the Digital Token Act, Colorado businesses will be permitted to effect transactions involving the sale and transfer between certain persons of digital tokens

secured through a decentralized ledger or database, with a focus on the production, distribution, and consumption of goods (also known as a "cryptoeconomic system"), as opposed to the current centralized internet platforms and applications that serve as intermediaries of such transactions in cryptocurrencies. Not only will these transactions be exempt from the securities registration requirements under the Colorado Securities Act (CSA), but persons dealing in these digital tokens will be exempt from the securities broker-dealer and salesperson licensing requirements under the CSA. However, the exemption will not be self-executing; it will require a notice filing with the Colorado Securities Commissioner prior to any offer, sale, or transfer of the qualifying digital token to satisfy the exemption.

- Delaware has a pending initiative authorizing registration of shares of Delaware companies in blockchain form.
- Illinois has authorized the use of blockchain for real estate records.
- New York currently uses a "Bitlicense" to regulate digital currency within the state.
- Oklahoma's legislature determined that a seller who accepts Bitcoin does not take it free of an existing security interest.
- Vermont recognized blockchain as evidence.
- Wyoming has enacted a series of regulations designed to exempt "utility tokens" (also known as "open blockchain tokens") from the state money transmission laws provided (i) the token must not be offered as an investment; (ii) the token must be exchangeable for services and goods; and (iii) the token issuer or developer must not deliberately make efforts to find a secondary market for the token. Under this new bill, (i) an "open blockchain token" is excluded from the definition of a "security"; (ii) developers or sellers of the digital tokens will not be deemed an "issuer"; and (iii) the digital token will not be subject to securities registration provided it meets the qualifying provisions of the exemption The "Utility Token Bill" was signed into law in March 2018, and exempts "utility tokens" from the state's securities laws, provided the issued token and its issuer meet certain other requirements. By House Bill No. 19, Wyoming amended its Money Transmitter Act to provide an exemption for "virtual currency" and defined the term under Section 40-22-102(a)(xxii) as "any type of digital representation of value that: (A) Is used as a medium of exchange, unit of account or store of value; and (B) Is not recognized as legal tender by the United States government." Wyoming also passed legislation authorizing corporations to create blockchains to store records, and amended its Money Transmitter Act to exempt virtual currency from licensing requirements.

Meanwhile, in August 2018, the North American Securities Administrators Association (NASAA) announced it had expanded the number of ICO investigations from 70 active cases in May 2018, to 200 active cases, as part of its "Operation Cryptosweep." The result of this sweep, to date, is at least 46 enforcement actions involving ICOs or cyptocurrency-related products. In October 2018, the Conference of State Bank Supervisors (CSBS) filed a lawsuit against the Office of the Comptroller of the Currency (OCC) challenging its national bank charter for fintech companies.

WHAT'S NEXT FOR TOKEN OFFERINGS?

Regulators and governments are working hard to bring clarity to the digital asset market. While universal adoption may not happen in the near future, it is clear that over the course of 2019, new regulation is probable that will bring digital assets and the blockchain more squarely into the regulatory fold.

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