Market Trends 2018/19: Blockchain Security Token Offerings

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This article addresses 2018–2019 trends in distributed ledger/Blockchain capital funding, including the legal framework for capital formation using distributed ledger/Blockchain technology to enable offerings of coins, tokens, and other rights (digital assets) for which limited and varying legal guidance exists. Blockchain technology is a chain of blocks of discrete bit-lengths containing information embedded in computer code which, when connected to other blocks, constitutes a trusted distributed ledger technology application. Blockchain technology can be molded into technological, financial, social, business, and legal applications through computer code with embedded smart contracts, smart assets, and other features supporting verification, creation, and/or recording of transactions involving private or public parties. This note highlights current regulation in the United States for Blockchain-related offerings of digital assets.

In 1778, two years into the U.S. Revolutionary War, an 800 link, 35-ton iron chain was forged, assembled into at least 53 blocks of nine links (plus connector) each, and strategically strung across the Hudson River at West Point. That chain’s use was essential to both blocking of the British forces and shipments and the creation of a country which later birthed 150 years of rapid world economic growth. Yet today, and despite individual country variations, world annual economic growth may languish at a bleak 2% average rate for our, our children’s, and their children’s lives if noted economist and author Thomas Piketty’s 2013 forecast in Capital in the 21st Century proves prescient. Against this backdrop, crowdfunding in its various iterations, regulatory reductions, and tax and securities law changes offer modest, better prospects, particularly when coupled with technological innovations. One such innovation involves a new type of chain—a technological one used to record, verify, and/or create transactions—which is distributed in blocks of cryptographically verified computer code known as Blockchain, as well as other distributed ledger technologies (such as DAG, directed acrylic graphs). Blockchain, including one of its offspring, cryptocurrencies and coin offerings and other uses, are transforming business and consumer beliefs about currency and trade, and shall continue to offer various emergent behaviors and generally beneficial economic and social effects increasing world GDP average growth rate.

Blockchain token and other offerings first appeared around 2013 with the staged initial coin offering (ICO) by Mastercoin—an early Blockchain protocol. 2017 and early 2018 saw an explosion of Blockchain-related offerings tempered, since then, by enforcement activity reining in prohibited activities. 2019, perhaps ironically, has become the year of enterprise endorsement of the technology with major financial institutions and industry players leading the charge—not what early adopters envisioned.
Blockchain's promise is the potential for profound economic and social transformation and wealth creation through, among other results, eliminating the need for many trusted third parties and generating emergent behaviors from self-executing smart contracts embedded within the blocks or other distributed ledger technologies (such as the Tangle network which eliminates the need for so-called miners who cryptographically verify individual transactions). For simplicity, Blockchain is used herein to mean all distributed ledger technology, and although the capital funding phenomenon is worldwide, this article addresses only the existing U.S. legal framework.

Blockchain – Digital Age Trading and Finance

Blockchain technology has been called a revolution, akin to the development of the internet, with unlimited potential. One of these is to fundamentally reconstruct and decentralize the financial services industry by privatizing and securing confidential data while lowering uncertainties in trade and economic transactions through consolidated and permanent registries. Blockchain has entered the global lexicon, though the technology is still in early adoption and proof of concept stages by business in general, and is not widely used by individuals as consumers other than through the purchasing and trading of digital assets (such as cryptocurrencies).

So, then, what are the legal and business risks of Blockchain transactions? While a disruptive wave of ICOs have raised in excess of $31 billion for formative (or fictitious) businesses from January 2016 through June 2019, the bulk was in the first six months of 2018. With a regulatory crackdown beginning in late 2017, 2019’s monthly average has been in the $200 million per month range with the exception of Bitfinex’s $1 billion private raise in May 2019. Regulatory enforcement activity and legal uncertainty during 2018, having stemmed the free flow of digital-asset-related capital in the U.S., caused many innovators to launch startups in non-U.S. jurisdictions. The ICO has since been replaced in the U.S. by the STO (security token offerings), which is conducted primarily in reliance on private offering exemptions not requiring U.S. Securities and Exchange Commission (SEC) permission or direct involvement, thus enabling the development of a potentially robust primary market for digital assets. What presently hinders U.S. based digital asset capital markets is the remaining legal uncertainty of the viability of secondary trading markets and little precedent guiding fund-raising using the registration and small offering machinery of our securities laws, including Form S-1 registrations and Regulation A+ “mini-registrations” each requiring SEC involvement and qualification. Market participants attempting to break the ice to access the public markets are currently tasked with a lengthy comment process or simply forced to restructure. Blockstack PBC, a Blockchain software platform where developers can build applications, was qualified in the first Regulation A+, Tier 2, token offering, July 10, 2019, listing $1,500,000 in legal fees in its Form 1-A filed with the SEC and was qualified following a 10-month process. Blockstack initially filed its offering through a different entity and ultimately restructured the offering through a public benefit corporation. Similarly, YouNow, Inc. qualified its Props Tokens through the Regulation A+, Tier 2 process on July 11, 2019, intending to issue the tokens as rewards to users of its apps, along with a secondary distribution of tokens by Props Public Benefit Corporation as grants to persons who contribute significantly to the development of the network. Legal fees for YouNow are listed as $1,400,000, along with audit fees of $200,000.

What Is a Blockchain?

Blockchain technology in its most distilled form is a type of distributed digital ledger technology or recording of data sets and transactions and the foundation for transfers of value. Blockchain has become a tagline for its use as a digital ledger in which transactions made in bitcoin or other cryptocurrencies (i.e., mediums of exchange that are digital, alternative, or virtual currencies) are recorded chronologically and publicly. According to the SEC, Blockchain is another term for an electronic distributed ledger that is disseminated to participants in a virtual organization allowing parties (in theory, and to varying degrees in practice) to transact business securely and privately without third-party intermediaries. Blockchain technology, with its use of cryptographically hash-linked blocks in one organizational model, may enable participants in decentralized autonomous organizations (DAOs) to govern and operate without formalized incorporation or organization, functioning through preprogrammed code running on numerous nodes or computers connected and operating in, for such purposes, ad hoc networks. A DAO is online and considered autonomous because the code of the DAO may only be altered if 51% or higher percentage of the members of the DAO agree to the coding change. The DAO is considered decentralized because participants can acquire tokens to participate in these systems and then later sell or exchange their tokens without the need for any trusted third party (such as a bank or other clearing or verifying authority).

A cryptocurrency using Blockchain (such as bitcoin and ether) may be acquired by interested parties by fiat currency and, if applicable to the particular cryptocurrency through a process called mining (though such mining is not needed using DAG technology). Mining is the process of adding a verified
transaction block to the distributed ledger. This results in the miner receiving the applicable formula-established amount of tokens (such as bitcoin or ether) in return for providing the verified proof of work. Cryptocurrency may also be purchased directly from the issuer in an initial or subsequent coin offering or, after issuance, directly from their owner or through any cryptocurrency exchange which has agreed to act in such capacity (and which, in today’s regulatory regime, may or may not have appropriate licensure to do so).

In 2018–2019, as the business and consumer markets for cryptocurrencies have broadened, taxation of digital assets now poses practical problems. IRS Regulatory guidance, at this time, is limited to the basic rule of Notice 2014-21, issued by the IRS, providing that cryptocurrencies are property for federal income tax purposes and consequently resulting in taxable dispositions for gain or loss. Taxation of digital assets is beyond the scope of this paper, however, the authors note it is necessary to fully understand the technology and structure underlying a transaction involving the digital assets, to determine the tax classification of an asset, whether a stock or commodity (and whether one eligible for ordinary or long or short-term capital gain or loss), and its tax implications, whether a sale, lease, or service. An update from the IRS is below in “Other Developments.”

Most recently, on July 8, 2019, the SEC’s Trading and Markets Division in conjunction with the Office of the General Counsel of FINRA (Financial Industry Regulatory Authority) published a (long-awaited) joint staff statement on broker-dealer custody of digital assets and specifically noting the statement does not change existing law. (https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities) While noting that they are in the receipt of applications from new market participants to become broker-dealers authorized to trade in digital assets, the statement highlights and discusses many issues relevant to all persons involved or to be involved in digital assets which are, or may be found to be, securities; a thorough reading of this statement is essential. The statement spans a host of issues including, amongst others, the custody and non-custody of digital asset securities, the Consumer Protection Rule, financial responsibility rules, complexities of safeguarding assets, regulatory approvals needed for existing broker-dealers engaging in material digital asset securities for the first time, and the lack of coverage under SIPA (Securities and Investor Protection Act of 1970) unless the security meets the definition of a “security” under SIPA (which is different than under the Securities Act of 1933 by, in general, limiting it to securities which are subject to a filed and approved registration statement).

Limitless Applications for Blockchain

Applications for Blockchain technology are developing across an array of industries, both financial and nonfinancial. 2018–2019 has seen significant enterprise collaborations making progress developing models and standards, while lowering risks to individual enterprises, including the Hyperledger consortium, Mobility Open Blockchain Initiative (MOBI) and the Enterprise Ethereum Alliance. Following are but a few examples:

- Facebook – the social media giant, in association with more than 25 large international corporations, announced the proposed development of a digital currency, Libra, that users could use to make secure payments, including through the social media network
- JP Morgan Chase – a Blockchain platform available through the Azure Blockchain Service, designed to integrate with Microsoft’s cloud platform
- Cargill – building a food source tracking system to address food contamination issues
- Starbucks – testing a coffee bean to cup tracking system to trace the origins of a customer’s coffee and aimed at connecting these coffee drinkers with coffee farmers around the globe
- Depository Trust & Clearing Corp – implementing a new system for custodianship, with records for securities accounts to be moved to AxCore, providing access to a single real time trade ledger

As enterprise consortia focus on Blockchain solutions to enhance business processes, the technology itself has in 2018–2019 increasingly outpaced the development of cryptocurrencies.

Killer App of Blockchain – Bitcoin and Ether (and Other Virtual Currencies)

Blockchain technology entered the public awareness due to a burgeoning market for cryptocurrencies. Bitcoin economic transactions, in particular, have been called the first “killer app” of Blockchain technology and has been the catalyst for distributed ledger innovation and design. Cryptocurrencies exist in many forms, with the earliest cryptocurrencies being virtual currencies purporting to operate like coin and paper legal tender, such as bitcoin (and later ether and ripple). Virtual currencies are not, to date, issued by any country’s government although Japan, in 2018, began to accept bitcoin as legal tender. They are created and memorialized in digital ledger systems and are used by some vendors and consumers for trading goods and services.
Bitcoin
The phenomenal growth of the most well-known cryptocurrency, bitcoin, raised awareness of uses of Blockchain technology and fueled its growth. The first bitcoin transaction occurred in January 2009 on the heels of the 2008 financial crisis in part due to distrust of traditional financial authorities and anti-establishment sentiments. Bitcoin was initially designed to act as a secure peer-to-peer decentralized payment system. Despite having no government recognition as fiat capital (except in Japan) and a designed limitation on supply, bitcoin surged with a market capitalization of in excess of $240 billion (i.e., valued as one bitcoin equals as high as $19,783.21) in December 2017 (contrasted with a bit over $200 billion as of July 2019). Bitcoin is a scarce asset due to the finite number of bitcoins that are capable of being created (a maximum of approximately 21 million) under its coding structure (with about 85% mined to date and with all anticipated to be mined by 2140) with somewhat under four million bitcoins believed missing or lost. The speculation is that miners, by being the first to cryptographically hash a block and thereby “minting” a code-fixed number of automatically issued new bitcoins, will no longer be needed after 2140, although verifications will continue through transaction fees to be charged for each transaction. Bitcoin’s market correction during 2018—falling below $6,000—has resurged during the second quarter of 2019 exceeding $11,000. Bitcoin’s market capitalization accounts for over 50% of the total cryptocurrency market.

Ethereum
The Ethereum platform market is younger than bitcoin and developed preternaturally after its 2015 live launch. The Ethereum cryptocurrency is called ether and was initiated following an initial offering of 60 million units of ether raising $18.5 million. Ethereum’s website describes ether as:

A necessary element—a fuel—for operating the distributed application platform Ethereum. It is a form of payment made by the clients of the platform to the machines executing the requested operations. To put it another way, ether is the incentive ensuring that developers write quality applications (wasteful code costs more), and that the network remains healthy (people are compensated for their contributed resources). See https://www.ethereum.org/ether.

This market is considered to have more utility and flexibility of use than bitcoin, allowing the execution of smart contracts and serving as a problem-solving development platform for a range of industries. The Ethereum platform describes itself as focused on the creation of decentralized markets, “store registries of debts and promises,” and moving funds in accordance with past instructions, all without an intermediary or counterparty risk. Ether is currently capped at 18 million ether released per year, although the rate of issuance is expected to change over time. In April 2018, the founder of Ethereum proposed capping the maximum supply of ether to 120,204,432 (double the amount of the original issuance) to ensure the economic sustainability of the platform over time.

2018–2019 Trends in Blockchain Capital Formation

The ICO disruption in the capital markets slowed in the U.S. mid-year 2018, punctuated by federal and state regulatory pronouncements and enforcement actions focusing primarily on fraud and the failure to register digital asset offerings with the SEC and state securities commissions.

The regulatory climate in 2019 strikes a balance between regulators’ desire to allow the creative processes necessary to technological innovation, and forbearance while intervening strategically to maintain the integrity of the financial markets. Notably absent from the SEC in early 2019 was guidance relative to secondary trading markets (which would allow securities professionals such as broker-dealers, investment advisers, and custodians of digital assets to best comply with the framework of existing securities laws). Notwithstanding the limited formal guidance, a handful of secondary trading platforms have developed. tZero, the trading platform subsidiary of Overstock, and SharesPost, a FINRA registered self-clearing broker-dealer, were each approved by the SEC as an alternative trading system or ATS for digital assets, which is a marketplace exempt from registration as an exchange. This is progress; however, the aftermarket needs of our growing digital economy have not yet been met. Additionally, the July 8, 2019 SEC/FINRA joint statement noted above, while addressing and providing needed clarity did not, and could not, address many issues and risks. Time—measured in years—will be needed before the niche of engaging in digital asset securities is sufficiently refined to provide comfort to many industry participants. And yet, the benefits which the niche portends may be well worth the risk of engagement, a decision which each potential participant will, in conjunction with such person’s qualified advisers, need to make.

Other key securities law guidance and actions in 2018 and to date, 2019, include the following some of which are expanded upon further below:

- In re Tomahawk Exploration. The SEC deems a token airdrop as a sale of securities.
- William Hinman, Director of the Division of Corporation Finance at the SEC gave the “When Howey Met Gary”
speech at the June 2018 Yahoo conference in San Francisco opining “the economic substance of the [token] transaction always determines the legal analysis, not the labels.”

• FinHub is established as a center of contact to allow market participants to interact directly with the SEC Staff.


• Gladius Network, LLC settlement regarding following an issuer self-reporting and willingness to take remedial steps.


• In April 2019 and July 2019, the SEC Staff issued the first token no-action letters first to TurnKey Jet, a charter jet company, tokenizing redeemable gift cards for charter jet services, and then to Pocketful of Quarters, Inc., an online video gaming company, issuing its “Quarters” as in-game app currency to video gamers, developers, and influencers.

Blockchain Funding – Trends in Offerings of Digital Assets

Blockchain technology offerings, previously known as initial coin offerings and initial token offerings (ICOs) and more recently, security token offerings (STO), emerged as analogs to the social media donation and charitable crowdfunding popularized by Kickstarter and, for investment contracts, the resulting crowdfunding legislation and SEC rulemaking legally formalized under the JOBS Act.

ICOs were born in 2016 and 2017 as somewhat of an exclusive club for technology investors with specialized training or education, as well as access to information, about building systems, platforms, and applications for relevant markets. Later, in 2017 and early 2018, the ICO phenomenon quickly became the center of attention for speculators with no awareness of, or with a conscious disregard for, securities or other legal requirements (propelled in part by success stories of digitally disruptive companies in taxi services and consumer retail which grew on such a philosophy).

ICOs, Interrupted

The unregulated ICO wild west slowed following the SEC release of its DAO investigative report warning issuers of cryptocurrencies that offerings may be subject to U.S. federal and state securities laws (The DAO Report), which is available at https://www.sec.gov/litigation/investreport/34-81207.pdf. The DAO Report cautioned market participants that the sale of tokens must be analyzed under the test created in SEC v. W.J. Howey Co., 328 U.S. 293 (1946) defining an investment contract as involving the investment of money, in a common enterprise, with an expectation of profits from the efforts of management or other third party.


In a series of enforcement actions beginning with the Munchee action, during 2018 and 2019, the SEC Staff applied the Howey test to offerings of digital assets to determine when an arrangement or instrument may constitute an investment contract, which is a particular type of security.

In the Matter of Munchee, Inc.

In December 2017, having scrutinized an ICO sale of subscriptions for purported utility tokens, the SEC issued a cease-and-desist consent order (the Order) In the Matter of Munchee, Inc., preemptively halting the distribution of tokens to fund a restaurant review app for use with iPhones as an unregistered sale of securities. The SEC observed that Munchee targeted purchasers of digital assets reasonably expecting profits from a rise in value due to the creation of a Munchee ecosystem resulting from Munchee’s efforts and those acting on its behalf. The Order held that the sale of subscriptions was of an unregistered security in violation of the Securities Act. The Order notes that even if the so-called MUN tokens had a practical use at the time of the offering, such focus would not preclude a finding that the sale of subscriptions constituted the sale of an unregistered security. The SEC’s analysis turned on the classification of MUN tokens as investment contracts, focusing on, among other factors, Munchee’s general solicitations touting the opportunity to profit and promising to develop a secondary trading market within 30 days of the conclusion of the offering. While many legal commentators have stressed the need for centralized or directed management (as opposed to a distributed autonomous organization) in order to find an investment contract constituting a security, the Order, perhaps strategically, cites the language of United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) (Forman) which does not mandate such a conclusion. The Forman decision holds that it is the entrepreneurial or managerial efforts of others which govern whether something is a
security. The holding would not seem to dictate a difference in result dependent upon whether an issuer actively managed or aided in the development of an ecosystem or whether profits emerge from the independent entrepreneurial efforts of others (which is a characteristic of emergent systems) participating in distributed autonomous organizations.

Contemporaneously with the Order, the SEC chairman Jay Clayton issued a statement on cryptocurrencies and ICOs, noting that, no ICOs had been SEC registered and no exchange-traded funds containing cryptocurrencies had been registered, and that offerings of coins or tokens occur outside U.S. borders. He stated he asked the SEC’s Division of Enforcement to police and vigorously enforce violations of the federal securities laws in this arena foreshadowing a handful of enforcement actions in latter 2018 and 2019, some of which are set forth below.

**Tokenized Securities**
If the token, coin, or other digital asset purchased provides an ownership interest in equity, or a future right or conversion right to own a stake in a common enterprise or receive returns based upon the traditionally defined managerial work of others, the digital asset will generally be considered a security under the traditional Howey test described below.

**Regulation D – Primary Exemption for STOs**
Tokenized securities are now most often sold in STOs under Regulation D of the Securities Act, and Rule 506, requiring no SEC involvement other than the filing of a Form D report (which report is required though not a condition to the exemption). Issuers must be aware that tokens have not yet been expressly included in the federal securities law definition of “covered securities” and, thus, are not preempted from state securities registration except to the extent exempted, such as being sold under Regulation D.

Currently, issuers in STOs are required to comply with state securities or blue sky laws in states where the tokenized securities are offered and sold, and secondary (non-issuer) sellers of the tokens must comply with the state blue sky laws in resale transactions to the extent such token constitutes a security.

**Howey Factors and the 2019 Framework**
The SEC has, over the past year, now made it abundantly clear, in the Hinman speech “When Howey Met Gary” (Hinman Speech) and in other public statements, that labeling a digital asset, a token, would not take it out of the purview of the U.S. securities laws, and, perhaps more importantly suggested, that a promoters’ or third party’s efforts driving the expectation of a return is critical to the Howey analysis. As had been anticipated, the FinHub staff of the SEC solidified the Hinman speech by publishing in April 2019, its Framework for “Investment Contract” Analysis of Digital Assets, available at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets, (2019 Framework) incorporating some of the considerations from the Hinman Speech and more, describing features of an offering and factors that could be dispositive that an issuer is offering an investment contract and thus subject to securities laws. Some of the more critical factors relating to the involvement of an active third party (AP) are below; however, the authors note that some of the factors may be afforded more weight and be more controlling than others and are fact and context specific:

The 2019 Framework provides, in part, efforts of the AP are critical and focuses on two key issues: (1) Does the purchaser reasonably expect to rely on the efforts of an AP? Are those efforts “the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise” as opposed to efforts that are more ministerial in nature? The 2019 Framework defines the AP as “is responsible for the development, improvement (or enhancement), operation, or promotion of the network particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.” (2) Has the network/enterprise been fully developed and become operational?

A way to think about it is, perhaps, to answer this question: Has the network become, effectively, a self-organizing system/network of sufficient critical mass for which the applicable digital assets have a value directly correlated and limited to their current use of and in the network? If the answer is yes, then it would seem not to be a security. If the answer is no, it is most likely to be security. Regardless of whether the answer is yes or no, a detailed factual and legal analysis is always needed.

The 2019 Framework—to be used when making such a detailed analysis—provides among other listed factors, if the below facts are present, the digital asset is likely to be an investment contract under Howey:

- Where the network or the digital asset is still in development and the network or digital asset is not fully functional at the time of the offer or sale, purchasers would reasonably expect an AP to further develop the functionality of the network or digital asset and also the AP promises further developmental efforts in order for the digital asset to attain or grow in value.
• Essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users or decentralized network.
• An AP creates or supports a market for, or the price of, the digital asset.
• AP has a lead or central role in the direction of the ongoing development of the network or the digital asset, and especially where an AP plays a lead or central role in deciding governance issues, code updates, or how third parties participate in the validation of transactions that occur with respect to the digital asset.
• Among other factors, an AP has a continuing managerial role in making decisions about or exercising judgment concerning the network or the characteristics or rights the digital asset represents.

**SEC Actions Focus on Failure to Register**

During 2018 and 2019, the SEC selectively exercised its powers of enforcement in an evenly measured manner. In August 2018, the Staff sent a message to the market in the action *In re Tomahawk Exploration* that token airdrops or gifts of tokens may constitute a Section 5 sale of securities under the Securities Act. Here, the SEC affirmed that by gifting tokens to generate interest in the ICO, the issuer Tomahawk received economic value in the form of online marketing and the creation of a public trading market, despite not receiving capital in exchange for the tokens.

In two other actions, the SEC focused on organizations issuing or dealing in digital assets which are clearly securities which have failed to register under the Securities Act. In the matter of *TokenLot, LLC et al.*, the first SEC order charged an unregistered broker-dealer operating in the cryptocurrency space (Token Lot Order) and *In the Matter of Crypto Asset Management, LP*, a SEC order was issued against an unregistered hedge fund.

The TokenLot Order involved a platform described as an “ICO Superstore” facilitating the purchases of digital assets in an ICO. The order is an example of the SEC’s stated “functional approach” considering the circumstances in assessing unregistered digital activities in whether the definition of broker or dealer is met, regardless of a party’s self-description of its activities or the technology used to provide the services. On the same day as the TokenLot Order, the SEC instituted cease-and-desist proceedings against a hedge fund whose primary purpose was investing in digital assets finding the fund and its managers violated Sections 5(a) and 5(c) of the Securities Act for failure to register securities and had improperly failed to register the fund as an investment company under the Investment Company Act of 1940 (ICA), and also finding both respondents had violated the anti-fraud provisions of the Investment Advisers Act of 1940 for untrue statements or omissions to investors or prospective investors in a pooled investment vehicle.

Self-reporting paid off for Gladius Network, LLC, a Blockchain-enabled cybersecurity services firm. In February 2019, the SEC published the order *In re Gladius Network, LLC*, charging Gladius with a violation of Section 5 involving its failure to register digital assets with the SEC following a capital raise yielding $12.7 million in ether. Demonstrating its willingness in taking prompt remedial steps, Gladius cooperated with the investigation. The SEC’s press release stated it did not impose a penalty as part of the cease-and-desist order because the company self-reported the conduct, agreed to compensate investors, and will register the tokens as a class of securities on Form 10 under the Exchange Act.

**Utility Tokens**

Certain models of the ICO sold or presold tokens with utility or product-like rights and features. These may include rights to vote or contribute labor, as well as rights to access, mine, and license the Blockchain technology at hand. Federal and state regulators, legislative groups, Blockchain industry groups, U.S. law firms, and securities practitioners now generally concede that in some situations token sales used solely to purchase products, services, or mining rights in enterprises under development should not (provided they are not directly, indirectly, or implicitly marketed using their potential as investments) be considered securities under U.S. federal laws based on the Howey legal framework. The theory behind this thinking is that the token value is derived from speculations in the token’s asset class and consumer uses in the related network, rather than an expectation of future profits from those involved in the management of the enterprise. In the case of utility tokens that are purchased mainly for consumer-like uses (e.g., for bartering, trading, coupons, or in payment for services, products, or network fees), the Howey test profit motive arguably may not exist or may be secondary to the consumptive nature of the transaction. Utility tokens may provide membership rights, loan collateral, or redeemable coupons for goods and services. Utility tokens, in some cases, may act as currencies in a functional network.

The **2019 Framework** additionally provides that if the following characteristics of use or consumption, are present, the more likely the digital asset is a utility token, and the less likely the Howey test is met (having reached or provided what might be viewed as a critical mass):

- The distributed ledger network and digital asset are fully developed and operational.
present decentralized states of these cryptocurrencies. The digital assets' creation and structure is designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development of its network.

- Prospects for appreciation in the value of the digital asset are limited; its value will remain constant or even degrade over time.
- For a digital asset referred to as a virtual currency, it can immediately be used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency.

By way of example, bitcoin and ether are generally not considered to be investment contracts or securities based on recent statements of representatives of the SEC given the present decentralized states of these cryptocurrencies.

TurnKey and Pocketful of Quarters No-Action Letters

In April 2019, the SEC Staff publicly acknowledged and granted no-action relief to the first utility token in TurnKey Jet, Inc., SEC No-Action Letter (TKY NAL), TurnKey Jet, Inc. headquartered in West Palm Beach, Florida, proposed to offer and sell Blockchain-based digital assets in the form of “tokenized” jet cards to facilitate air charter payments and travel arrangements efficiently through a Blockchain-based settlement system.

- The tokens would be marketed in a manner that emphasizes the functionality of the token, and not the potential for the increase in the market value of the token.
- The SEC Staff issued a second no-action letter in July 2019 to Pocketful of Quarters, Inc. (POQ NAL), an online video gaming company (POQ), allowing the company to issue its “Quarters” to video gamers as a “universal gaming token” without registration. The Quarters have an unlimited supply and fixed price, and unlike in TKY NAL are also exchangeable by certain developers and influencers for ETH although no exchanges are to occur outside the Quarters platform. The conditions outlined in the POQ NAL mirrored those in TKY while also adding an additional condition that the Quarters could only be exchanged by the game’s developers and influencers (with approved accounts) for ETH at predetermined exchange rates. Additionally, the POQ NAL stipulates developers and influencers with special exchange accounts must undergo Know Your Client / Anti-money Laundering reviews initially and on an ongoing basis.

Fortunately, and in line with the creation of FinHub and helpful to practitioners, the SEC now emphasizes a coordination between the SEC Staff and market innovators to develop solutions to difficult legal questions within the Howey framework that will allow socially beneficial advancements. Practitioners may receive further guidance from the FinHub staff related to structuring the token, features of the digital asset and operation of the network to determine if seeking a no-action letter may be warranted under the circumstances.

Certainly, this is only the beginning of the utility token story. The TKJ NAL met with some commentary that the staff no-action letter imposed conditions on what was clearly a non-security. At the least, some experienced securities practitioners may take comfort from TKJ and POQ that the SEC has been willing to exempt stored value digital assets under certain conditions and advise their clients accordingly.

Simple Agreement for Future Tokens or Equity (SAFTE)

The Simple Agreement for Future Tokens or Equity (SAFTE) was proposed in 2016–2017 as a compliant investment contract to facilitate the initial funding of Blockchain-based offerings made to accredited investors. The SAFTE, as generally structured, is a derivative instrument designed to effectuate the future issuance of tokens in order to obtain the financing needed to fund a tech product or system prior to its development or commercial launch, and may represent a promise for future tokens at a fixed price: in effect, a simple promise to issue a certain number of tokens based upon the happening of one or more future events. The SAFTE agreement may be structured so that investors
receive these tokens if and when the network launches. The SAFTE (or similar investment structure) could also be used to raise funds for further network or other related development with tokens to issue at a future time based upon the happening of certain events. In each setting, the SAFTE may be a forward contract regulated by the Commodity Futures Trading Commission (CFTC), if no exemption from such regulation exists, and, thus, network developers should seek legal counsel in the careful drafting of these instruments if considered for use. From an investment standpoint, one would need close scrutiny to help determine whether such investment has value, and, if so, what that value is (and its believed present and future bases to make any determination about its place as a small part of an investment portfolio). The SAFTE, analogous in structure to the crowdfunding SAFE (Simple Agreement for Future Equity) should not—ever—be characterized as standard, simple, or safe. The SAFTE framework of preselling tokens has generated skepticism in the legal community on several grounds including oversimplification of securities laws. This framework, if followed, is likely, in most settings, to result in a heightened risk to investors, token price manipulation, and fraudulent trading practices. At the same time, a SAFTE agreement is the security being offered by Blockstack in its Regulation A+ offering, with tokens delivered over time when and if the agreement milestone is met. The milestone, in the case of Blockstack, is an operational network with token functionality as determined by the company in its sole discretion.

State Law Developments

The legal landscape governing Blockchain technology is evolving constantly. As of July 2019, state legislation granting legal validity to Blockchain-based distribution (and in some cases, smart contracts) has been passed in multiple state jurisdictions. A compendium of state law is beyond the scope of this writing; however, the state law focus during 2018–2019 is the passage of laws addressing the application of state money-transmitter laws to virtual currencies, treatment of digital assets under state securities laws, and the recognition of Blockchain records under corporate laws. Some noteworthy mentions include, without limitation, the passage of a state regulatory sandbox for FinTech businesses in Arizona, and Delaware’s corporate laws recognizing Blockchain corporate records, with bills and resolutions related to Blockchain pending in Illinois (pending Blockchain Technology Act provides for permitted uses of Blockchain technology and limitations on local government to restrict the technology), and California (pending bill authorizes a county, until Jan. 1, 2022, to issue certified copies of marriage records by means of Blockchain technology, as defined, and would exempt those records from the required physical properties and features in the provisions of current law), and elsewhere as this list is changing monthly. Globally, financial regulators are, on a weekly basis, issuing penalties, official permissions, regulations, and other missives related to cryptocurrency transactions. Nearly all state jurisdictions have now addressed the growing digital economy in some respect, including at the least legislation establishing task forces and initiatives to study the respective jurisdictions needs for the growing digital economy balanced with consumer protections.

Rocky Mountain Utility Token Law

Wyoming, Colorado, and Montana are the leading state jurisdictions carving out a utility token exemption (in Wyoming and Montana) and a digital asset transactional exemption (in Colorado) from their state securities statutes.

Wyoming Utility Token Act

Advocates for the sweeping Wyoming legislation embracing financial technology over the past year have called the state “the Delaware of digital asset law.” In addition to other laws, the “Wyoming Utility Token Act–property amendments,” in 2018, established a new asset class under the state’s law, defining “open blockchain tokens with specified consumptive characteristics [as] intangible personal property.” The utility tokens do not require an exemption from federal securities laws, and the legislation states that:

The open blockchain tokens governed by this act do not constitute securities because a person who is sold a consumptive open blockchain token cannot receive a cash payment or share of profits from a developer or business, but will instead receive a fixed amount of consumable services, content or property.

Colorado Digital Token Act

The Colorado Digital Token Act (Colorado Act) is scheduled to become effective August 2019, under which legislation 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. Transactions under the Colorado Act will be exempt from the securities registration requirements under the Colorado Securities Act (CSA), and those persons dealing in these digital tokens will be exempt from the securities broker-dealer and salesperson licensing requirements under the CSA.

Montana Bill Titled “Generally Revise Laws Relating to Cryptocurrency”

Montana is the third Rocky Mountain state to pass legislation which became effective July 1, 2019, exempting Blockchain-
based tokens from securities laws so long as the tokens have a “primarily consumptive” purpose, defined as having a primary aim to “provide or receive goods, services, or content including access to goods, services, or content. The bill provides that tokens that qualify for the exemption must be available no more than 180 days beyond its date of sale or transfer, and initial buyers of the tokens are not permitted to transfer the token until its consumptive purpose is available.

**Key Initial Steps to Prepare and Raise Capital and Launch a Blockchain Technology Venture**

To ensure the success of a Blockchain technology business, consider the following actions mission critical prior to the commencement of the STO:

1. Consult with and ensure the availability of a dedicated team of developers with prior experience in Blockchain coding and web development.

2. Prepare a legitimate and comprehensive white paper describing the planned development of the technology business, including a persuasive case for the economic and/or social benefits of (and need for) the to-be-developed network, solution, product, platform, or service and try to understand the Howey test and 2019 Framework as they will be fundamental to step 4. Unless a business plan and issuance can be compliant with both (which is believed by the authors to be infrequent, at best) expect that the money to be raised must be fully compliant with all securities laws and will be expensive to put together and very uncertain of success, at best.

3. Incorporate or organize the business in a state, such as Delaware, with statutory recognition or pending legislation for Blockchain protocols and smart contracts. For example, the recently revised Delaware General Corporation law makes it possible for entities to place shareholder records such as issuances, sales, and redemptions on a computer-based distributed ledger.

4. Consult with a seasoned securities attorney in the planning stages of the capital raise to evaluate the technology which supports the digital asset, and have counsel evaluate the project vis-à-vis the Howey test and the 2019 Framework to determine the factors likely to be controlling.

5. Employ a multidisciplinary approach in building a team of legal advisors with the securities, technology, and tax structuring considered at the outset. In that vein, developers of Blockchain-based networks should be aware of potential regulation under the following additional state and federal laws:

   - Technology and intellectual property laws
   - Cybersecurity and privacy laws
   - FinCen and state money-transmitter business laws
   - Commodities laws
   - FTC and business opportunity laws
   - Tax laws
   - Banking laws

**Market Outlook**

Blockchain technology advanced during 2018–2019 with a view to transforming business processes and is now increasingly differentiated from the development of underlying cryptocurrencies supported by the Blockchain. It is likely that many visionary research and development companies formed around or inspired by distributed ledger technology are currently stifled by the lack of clear guidelines from the multiple regulators that have expressed or exerted authority in this area. Distributed ledger technical impediments such as scalability, cybersecurity, privacy, custody of assets, mining processing time, and integration of systems will continue to be a significant focus for both STO and non-STO tech firms.

The SEC and the U.S. regulatory community will continue to exercise some restraint where warranted and provide relief from enforcement actions and settlements to issuers self-reporting prior violations for failure to register, in the absence of fraud or misrepresentations.

Following Munchee, STOs are now regularly conducted as a private placement transaction (requiring compliance with all mandated disclosures) under Regulation D with no interaction with the SEC other than a required Form D filing. The small-cap and middle markets now have the SEC qualifications of two token issuers under Regulation A+ allowing a limited size offering available to the general public to move forward, further detailed below. Both the Blockstack PBC and YouNow offerings will serve as valuable templates for innovators waiting to act, or who might have otherwise fled to other jurisdictions. If state legislative action is coordinated to follow similar policies and approaches to exemptions and registrations, again, small-cap and middle markets will be more likely to undertake public market capital raises in the U.S.

The TKYNAL and PoQNAL guidance coupled with the 2019 Framework will assist issuers in gray areas. Determining when a digital asset, which may have begun its life cycle as an investment contract, has evolved into a non-security utility token or some other form of non-security
virtual currency or commodity is but one example. This difficult question of when a network is decentralized and management efforts (or efforts of the AP and in the context of the Howey analysis) are no longer relevant will remain a complex facts-and-circumstances analysis aided, yet not resolved, by the evolving contours of potential regulatory safe-harbors, future no-action letters, and the inevitable case law to follow. Definitive answers in other areas, such as secondary markets, digital asset custody, and the applicability of the spectrum of other SEC, FINRA, and the alphabet ménage of other regulatory bodies’ mandates, will require time, money, and patience to sort through.

The recent July 2019 SEC approved Blockstack PBC Reg A+ and YouNow, Inc. securities offerings—at a legal cost approximating $1.5 million on a $28 million raise and $1.4 million on a $50 million raise, respectively—provide useful indirect guidance on how to navigate—and perhaps structure—various aspects of an STO and, in measuring a client’s business plan and operations against it, as a form of check in determining whether a given token is a security. For those not yet familiar, Blockstack, attuned to the heightened consumer interest in online privacy and user control of user generated data and in contrast to Google’s, Facebook’s, and other centralized networks approach, seeks a first-mover-of-scale advantage through an operational decentralized network which provides a decentralized approach to today’s market-dominant centrally controlled browsers and social networking, email, word processing, and a host of other applications. It utilizes open source coding permitting developers and consumers to develop—through smart contracts and otherwise—what seems to be one of today’s compelling propositions: user-controlled decentralization of needed, useful, and beneficial applications for which the current centralized offerings provide not. Whether Blockstack’s network—and business model—will rapidly expand through whatever capital is raised from its A+ offering is unknowable. What is knowable is that Blockstack and YouNow’s investment in a costly legal and regulatory process to define, address, and refine its business model and methods in order to withstand SEC scrutiny of the many thorny issues it was required to solve are the same ones likely to be involved with most STOs. The efforts of these pioneers will be of much benefit to every future issuer of an STO.

**Other Developments**

In 2018, the New York Department of Financial Services (NYDFS) filed a three-count complaint against the U.S. Comptroller of the Currency (OCC) (Lacewell v. Office of the Comptroller of the Currency et. al., 18 Civ. 8377, Southern District of New York) in efforts to preclude the federalization of what it argued was an historically exclusive state function through contesting the OCC decision (OCC Decision) to begin accepting applications for special purpose bank charters to financial technology (FinTech) companies. The OCC moved to dismiss. In early May 2019, the Southern District of New York ordered that the third (10th Amendment based) count be dismissed, yet permitted the other two counts to proceed. Of the latter counts, one count sought a finding, and an injunction precluding OCC Decision implementation, that the OCC Decision exceeded the OCC’s authority under the 1863 (and now known as) National Bank Act, arguing that such Act, to apply, required monetary deposits (which FinTech companies have maintained they do not accept), and one to declare null and void the promulgating regulation purporting to authorize such special purpose charters. New York seeks to ensure its, and therefore all other U.S. states, maintain a significant role and effective control of non-depository FinTech companies which deal in virtual or cryptocurrencies.

On July 26, 2019, the IRS issued a news release (https://www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts) in which it announced that by the end of August 2019, more than 10,000 taxpayers will have received notices reminding, and/or educating, of federal tax obligations with regard to virtual currency, citing various tax publications, and providing links to various references including the forms of the three flavors of letters presently being sent. As has been noted in the popular press, recordkeeping and reporting requirements can be significant including for all periods dating from 2013 for all taxpayers engaged in virtual currency transactions. Penalties for noncompliance, including criminal prosecution, can be substantial.

**A Summary**

In the decentralized ledger world, much has changed in the past 18 months since our last update; much more is to come. The SEC has and is deftly trying to optimize along the regulatory spectrum between laissez-faire and definitive GDP-throttling regulatory exhaustiveness. Its (and other regulators’) balancing act will require continual adjustments of regulatory mechanisms if many of the promises of Blockchain are to be achieved. Currently modest, Blockchain’s prospective effects on world GDP, according to a Gartner consultancy forecast, should result in $180 billion in value by 2025 and $3 trillion by 2030 (noting that $3 trillion would then be roughly 3% of the world’s then probable annual GDP). Cisco has reportedly forecasted that by 2027, 10% of future GDP-related transactions will utilize Blockchain for storage (inclusive, presumably, of recording and/or conducting transactions). Blockchain and other technological
rollouts (e.g., artificial intelligence, cloud computing, internet of things, and biological and others), while having an initial modest dampening effect on GDP to the extent net displaced workers are not absorbed at the same or greater positive GDP effect, the leverage of Blockchain (and other such wide-scale tech adoptions) provided through total factor productivity gains should seemingly have a significant positive sustainable effect on all countries’ GDP growth. If it does, this effect may tend to reverse the steadily increasing income and wealth gap of the past 40 years. While it remains to be seen whether Blockchain, coupled with other technological advances, will prove Piketty’s 2% annual world GDP growth average as too low, it should be clear that the world’s businesses will be adopting Blockchain and will need Blockchain-knowledgeable business legal counsel to navigate such progress’ waters. The issuance of tokens (or analogs) will be integral to many prospective wide-scale uses. Seeking no-action letter guidance may, depending upon the cost-benefit/risk analysis, be warranted in, among others, situations in which (though simplifying) tokens do not effectively equate to an escrowed gift card amount capable of immediate use for discrete existing services. The involvement of experienced counsel to design or reshape digital assets—and to work, where warranted, cooperatively with the SEC’s counsel through FinHub—makes good business sense.

Rebecca G. DiStefano, Shareholder, Greenberg Traurig, P.A

Rebecca G. DiStefano concentrates her diverse practice in securities regulation, corporate finance, and mergers and acquisitions law and serves on the Greenberg Traurig Blockchain Task Force. Rebecca counsels public and private companies in areas including private placements, registrations, Regulation A+ qualifications, and crowdfunding under the JOBS Act of 2012 and the Securities Act of 1933. Related to these transactions, she advises companies and their boards regarding attendant corporate governance best practices, fiduciary duties, continuing disclosure and reporting requirements of Regulation A+ and the Securities Exchange Act of 1934, as well as helping clients navigate cross-border and blue sky issues, secondary trading issues and the initial and continued listing of corporate securities. Additionally, she structures and organizes for clients non-U.S. regulated investment vehicles including private equity funds, funds of funds, and hybrid funds. Rebecca regularly represents her clients before the U.S. Securities and Exchange Commission and FINRA and is experienced structuring ESOP transactions and counseling ESOP-owned companies and ESOP trustees (both prior to and subsequent to the ESOP purchase).

Rebecca frequently speaks and authors on recent trends in U.S. Capital Markets, post-JOBS Act financial regulation, and related Blockchain & Cryptocurrency developments. Since 2013, she has been devoted to improving lives of children and adults diagnosed with diabetes through JDRF advocacy in Florida and in Washington D.C. and is a member of the JDRF Ride-to-Cure Team. Rebecca has been listed in The Legal 500 United States, 2009, and The Best Lawyers in America, for Corporate Law, from 2016-2019.

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Bill provides business strategic business legal counsel to small and middle-market companies and their owners. He guides business owners in the decisions and implementations involved with buying, funding (including various securities offerings), growing, and selling companies, as well as the structuring (including tax structuring), pricing, and negotiating of these transactions. Amongst other professional activities, he authored two chapters for Mergers and Acquisitions Handbook for Small and Midsize Companies, edited by West and Jones (New York: Wiley, 1997) and co-authored an IICLE handbook chapter on Illinois/Delaware/Nevada Corporations. He has repeatedly been the lead co-author of and taught Management and Leadership Structures for LLCs and Corporations (Illinois and Delaware) to attorneys for the Illinois Institute of Continuing Legal Education, intermittently teaches the legal portion of the certification program (CM&AA ™) for merger and acquisition advisors to the lower middle-market, and has made numerous presentations concerning, amongst others, investment crowdfunding, closely held businesses, mergers and acquisitions, Illinois and Delaware limited liability companies, Regulation D securities offerings, and fiduciary duties.

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