

Regulatory Heat On ICOs Expected To Intensify In 2018

By Tom Zanki

Law360, New York (January 1, 2018, 3:04 PM EST) -- As regulators draw battle lines and assert jurisdiction over initial coin offerings, experts expect scrutiny over the novel but booming capital-raising method to escalate in 2018 despite certain legal ambiguities.

So-called ICOs — whereby startups raise capital by selling digital tokens to investors through blockchain platforms while providing far fewer investor protections and disclosure than standard securities offerings — soared in 2017, mostly outside the realm of regulators.

The regulatory environment changed in July, when the U.S. Securities and Exchange Commission issued guidance after investigating an ICO, declaring that it will regulate such offerings that have the hallmarks of traditional securities on a case-by-case basis. The SEC subsequently pursued a string of enforcement actions, aided by a newly formed cyber unit.

While the legal terrain is far from settled, experts expect regulators to step up oversight of ICOs in 2018.

"We are likely going to see an increasing hum of enforcement actions from the SEC clarifying what the appropriate boundary is for these token sales," said Aaron Wright, associate clinical professor of law at the Benjamin N. Cardozo School of Law at Yeshiva University.

ICO issuers sell digital tokens to investors to help fund certain projects in exchange for digital currency or fiat currency. The tokens can represent access to a company's services or an equity interest that can be traded on the secondary market through various online platforms.

The SEC has targeted issuers who market the prospects that their token will appreciate in value, evidenced by its Dec. 11 shutdown of a \$15 million ICO by online food review company Munchee Inc. The regulator claimed that Munchee neither registered its offering nor obtained a qualifying exemption even though its offering had the ingredients of a securities sale, emphasizing that Munchee promised investors its token would soar in value as its app became more popular.

Many lawyers found the Munchee case important, saying the SEC action answered certain questions while raising new ones.

Unlike previous enforcement actions against ICOs, the SEC did not allege fraud or pursue further penalties against Munchee, but focused on the company's failure to register its offering. The SEC

specifically took issue with Munchee's claim that its offering involved the sale of "utility tokens," digital tokens that provide access to a company's product or services, and therefore did not risk violating securities laws.

Because Munchee touted the investment potential of its tokens as tradeable products on secondary markets, the SEC concluded that meant investors could reasonably expect to profit from the purchase, satisfying an important element of what constitutes a securities offering.

"That's probably a lesson going forward: If people want to claim to be utility tokens, don't emphasize secondary market trading," said Morgan Lewis & Bockius LLP partner David Sirignano, who focuses on corporate finance and securities regulation.

Josh Klayman, who leads Morrison & Foerster LLP's blockchain and smart contracts group, said the the most illuminating portion of the Munchee case was that "manner of sale" matters.

"I am expecting, personally, that we will see more enforcement actions now that are not just limited to fraud," Klayman said.

Lawyers cautioned that the Munchee case left unanswered how regulators would respond if a company completed a similar offering without stressing the investment value of its tokens. Munchee had also promised purchasers that they could use their tokens to buy future goods and services on the company's platform, the SEC said, which are characteristics of a "utility token."

"Does that mean that if you are creating a true utility token without mentioning any speculative investment opportunities, that that will pass muster with this SEC?" said Stephen Obie, a Jones Day partner specializing in securities and commodities law compliance.

The SEC said the Munchee order was based on its own past guidance published in a July report on a German group known as the DAO, for "decentralized autonomous organization," that used blockchain technology to raise about \$150 million last year.

In the DAO report, the SEC said a token can be considered a security if it satisfies all four parts of the so-called Howey test, named for a 1946 Supreme Court decision that determined what is an investment contract. The Howey test says an investment contract involves a person investing money in a common enterprise, expecting profit that is derived mainly from the efforts of others.

Token sales that satisfy Howey criteria should either be registered or their issuers should obtain a qualifying exemption, the SEC has said. To date, the agency said no ICOs have been registered.

Lawyers point out that while SEC guidance has provided some clarity to a new and evolving landscape, no definitive judicial decisions have been issued on ICOs. One case making its way though court includes blockchain startup Tezos, which was hit with a class action from investors who allege the company's \$232 million ICO amounted to an unqualified securities offering.

"For much better clarity here, you would like to see a court weigh in to apply the Howey test to this new technology," Obie said, arguing that because ICOs are linked to potentially universal digital currencies, Howey test factors may not be adequate.

The boom in ICOs has coincided with the meteoric rise of digital currency bitcoin, which in mid-

December surpassed \$19,000 per coin, a 19-fold increase from last Jan. 1. The past year also saw digital currencies, which like ICOs operate on blockchain technology, migrate toward the mainstream, as bitcoin futures began trading on Chicago exchanges.

In terms of ICOs, 234 offerings raised nearly \$3.7 billion through mid-December, according to website Coinschedule. By comparison, more than \$50 billion has been raised through traditional venture capital, according to CB Insights, showing that token sales are becoming more visible component of capital raising.

As ICOs grow, regulators are focusing on their lack of safeguards. Though the name sounds similar to IPO as in "initial public offering," ICOs are often sold on the basis of a "white paper" describing a company's business plan rather than a registration statement. SEC chairman Jay Clayton said in a Dec. 11 speech that, with ICOs, "there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation."

Regulators around the world are also getting more active in ICO oversight, albeit not in total harmony, adding uncertainty to a global phenomenon. Jurisdictions like Canada are taking a case-by-case approach similar to the U.S. of considering whether coin offerings constitute securities sales, while China and South Korea have banned ICOs outright on fraud concerns.

While the global regulatory scheme plays out, jurisdictional questions will need to be sorted out domestically as well.

The U.S. Commodity Futures Trading Commission said in October that digital tokens issued in ICOs can be considered commodities and come under the agency's oversight, putting the futures watchdog on par with the SEC's approach. The CFTC, which in 2015 determined that bitcoin and other virtual currencies are properly defined as commodities, said it will also take a case-by-case approach in determining where oversight of ICOs is warranted.

"Both [agencies] are trying to work out their jurisdiction," said Benjamin Sauter, a defense litigator with Kobre & Kim LLP, adding that participants of ICOs and cryptocurrency transactions should not be lax.

The enforcement actions and guidance announcements put out by the SEC and CFTC are "telling the world and putting people on notice that they view these things as within their purview," Sauter said.

In addition, regulators are expected to step up scrutiny of intermediaries, such as exchanges and brokers who facilitate cryptocurrency-based transactions on the secondary market. In his Dec. 11 statement, Clayton stated the SEC has not to date approved for listing and trading any exchange-traded products holding cryptocurrencies or other assets related to cryptocurrencies.

"Similarly, I also caution those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act of 1934," Clayton said.

State authorities are also expected to get more involved in regulating ICOs. Massachusetts Commonwealth Secretary William Galvin on Dec. 15 said the state's Securities Division would conduct an exam sweep of Massachusetts entities engaged in ICOs, three days after he issued a statement warning the public about "bitcoin mania."

That has digital currency lawyers like Marco Santori of Cooley LLP concerned that aggressive state regulators will overstep their bounds. He argued that investor protection concerns are attenuated with ICOs because token purchasers, at least for now, are "overwhelmingly enthusiasts who understand what they are getting into."

"The risks of stifling real innovation in this space far outweigh the investor protection concerns right now," Santori said.

Apart from regulatory action, Santori said he will be watching plaintiffs activity to glean direction on the climate for token sales. David McGill, a defense litigator with Kobre & Kim, said he expects authorities to begin issuing subpoenas to rein in ICOs suspected of fraud as well as more guidance from the SEC in the form of no-action letters.

"It will be a very interesting year," McGill said. "The battle lines have been drawn."

--Editing by Katherine Rautenberg and Catherine Sum.