

# *ICOS AS A FUNDING MECHANISM FOR BLOCKCHAIN STARTUPS: THE CURRENT STATE OF PLAY*

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Idaho State Bar, Business and Corporate Law Section CLE

**PARSONS  
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LATIMER**

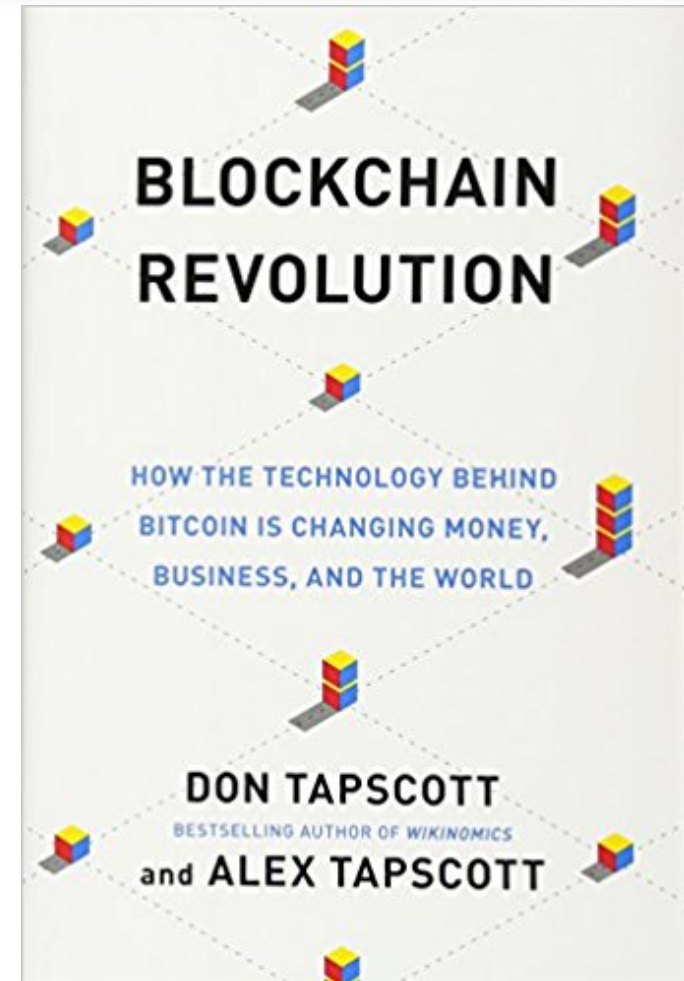
# Presentation Outline

- What is Blockchain?
- What is an ICO?
- Types of Tokens Offered in ICOs
- Uncertainties Surrounding ICOs
- The DAO Investigation Report
- Towards Compliant ICOs?
- SEC Enforcement Actions
- Conclusion

# WHAT IS BLOCKCHAIN?

“The blockchain is an incorruptible ledger of economic transactions that can be programmed to record not just financial transactions but virtually anything of value.”

- Don & Alex Tapscott, Blockchain Revolution (2016).



# WHAT IS BLOCKCHAIN?

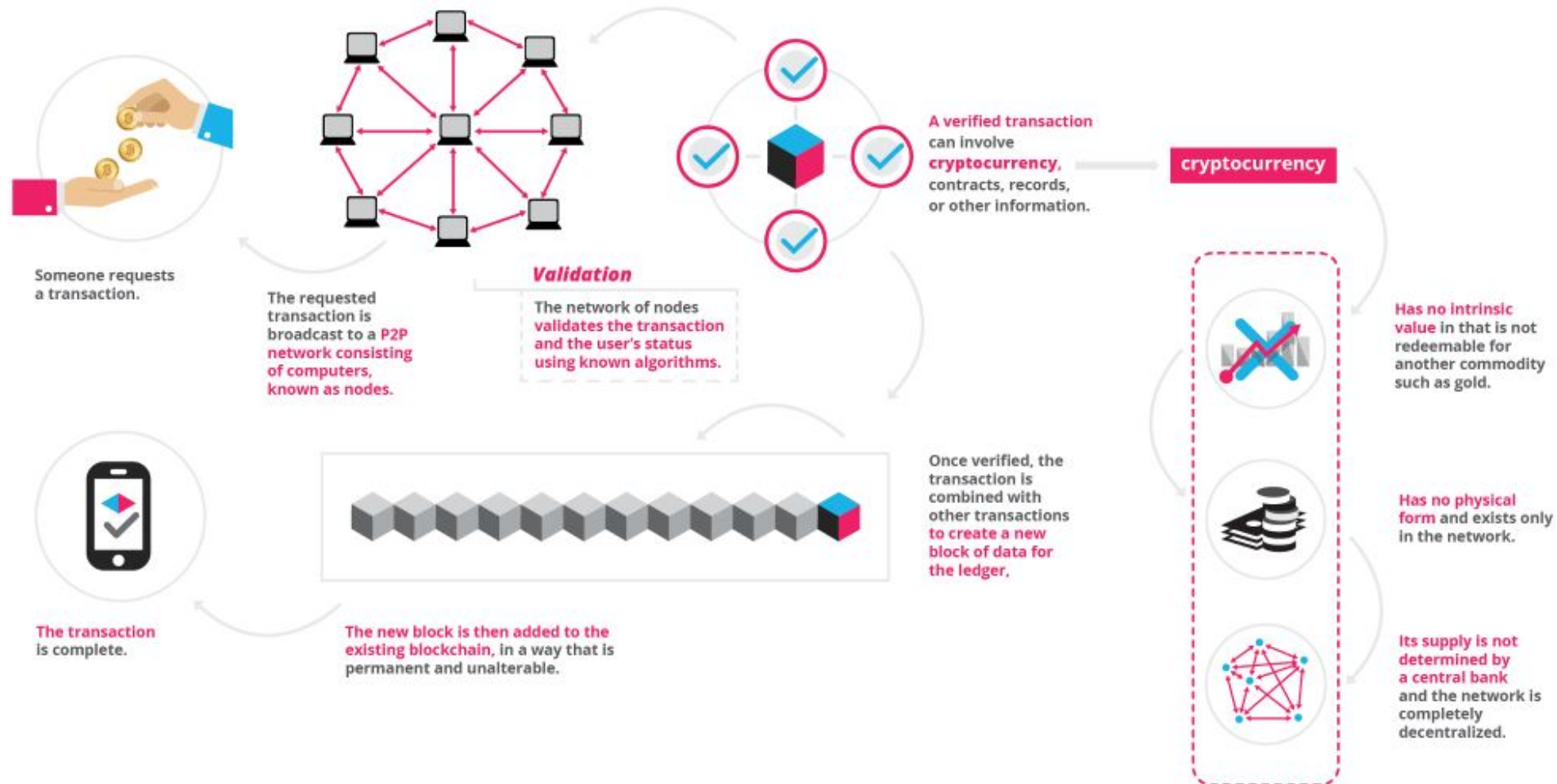
## Blockchain is Not Just Bitcoin

- Bitcoin is the first decentralized digital currency that does not rely on a central government authority for its backing.
- Bitcoin is a “scarce asset”
  - Created through digital mining process
  - Finite number – up to 21 million
- While Bitcoin was Blockchain’s first use-case, the technology has much larger potential beyond virtual currencies



# WHAT IS BLOCKCHAIN?

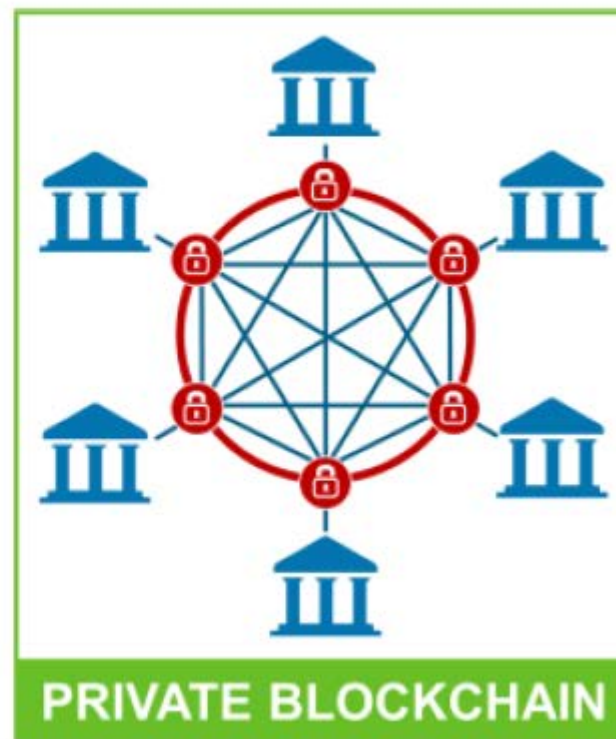
## Blockchain is Not Just Bitcoin



# WHAT IS BLOCKCHAIN?

## Blockchain is Not Just Bitcoin

Public | VS private Blockchain

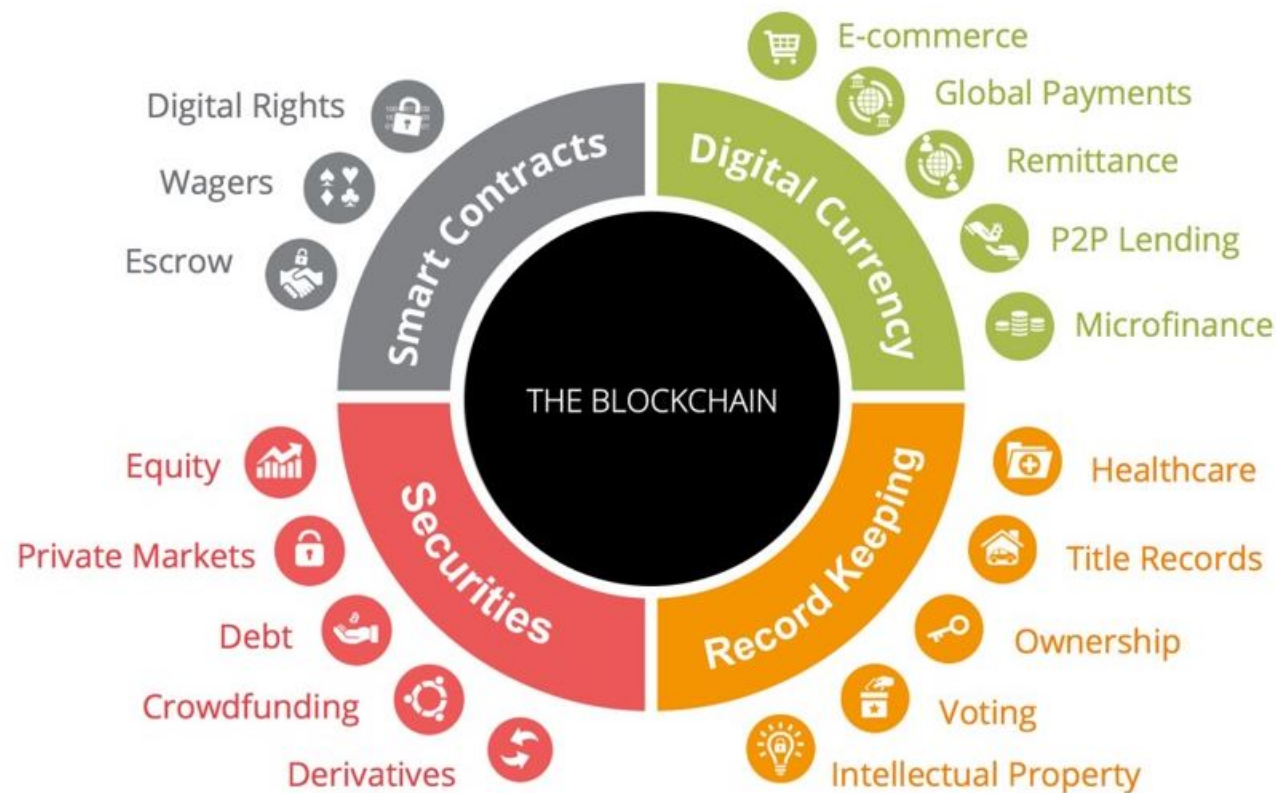


Source: [https://www.sc.com/fightingfinancialcrime/av/SCB\\_Fighting\\_Financial\\_Crime\\_Deep\\_dive\\_Blockchain\\_August\\_2017.pdf](https://www.sc.com/fightingfinancialcrime/av/SCB_Fighting_Financial_Crime_Deep_dive_Blockchain_August_2017.pdf)



# WHAT IS BLOCKCHAIN?

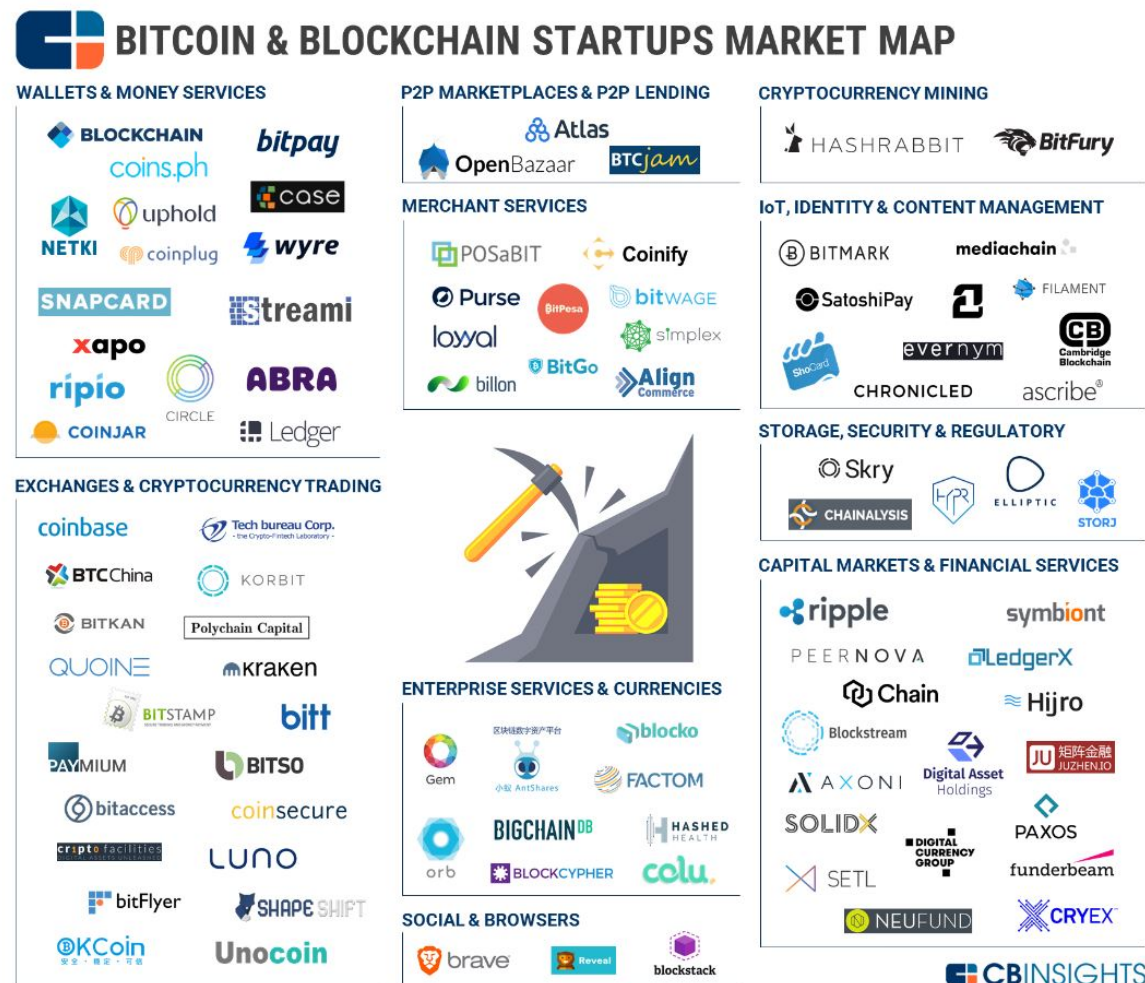
## Blockchain is Not Just Bitcoin



Source: [BTCS.com](https://btcs.com)

# WHAT IS BLOCKCHAIN?

## Snapshot of Blockchain Ecosystem





# WHAT IS BLOCKCHAIN?

## Why Blockchain is Gaining Traction

- Cost and Efficiency
  - Removal of Intermediaries
  - Reduced Transaction Costs
- Real Time Processing
  - Availability of Transparent and Real Time Data
  - Near Real Time Processing
- Data Integrity
  - Immutable Transparent Records
  - Audit Trail of All Transactions Processed
- Robust
  - Not Controlled by a Single Entity
  - No Single Point of Failure

# WHAT IS BLOCKCHAIN?

## Main Blockchain Industry Consortia



**HYPERLEDGER**



ENTERPRISE  
ETHEREUM  
ALLIANCE



**Digital Asset** Holdings

# WHAT IS AN ICO?

- Relatively new fundraising method through which virtual tokens or coins are created and distributed using blockchain technology.
- Tokens may be denominated in fiat currency or virtual currency
- After issuance, tokens may be resold in secondary markets
- Tokens have their own value independent of the cryptocurrency used on the platform

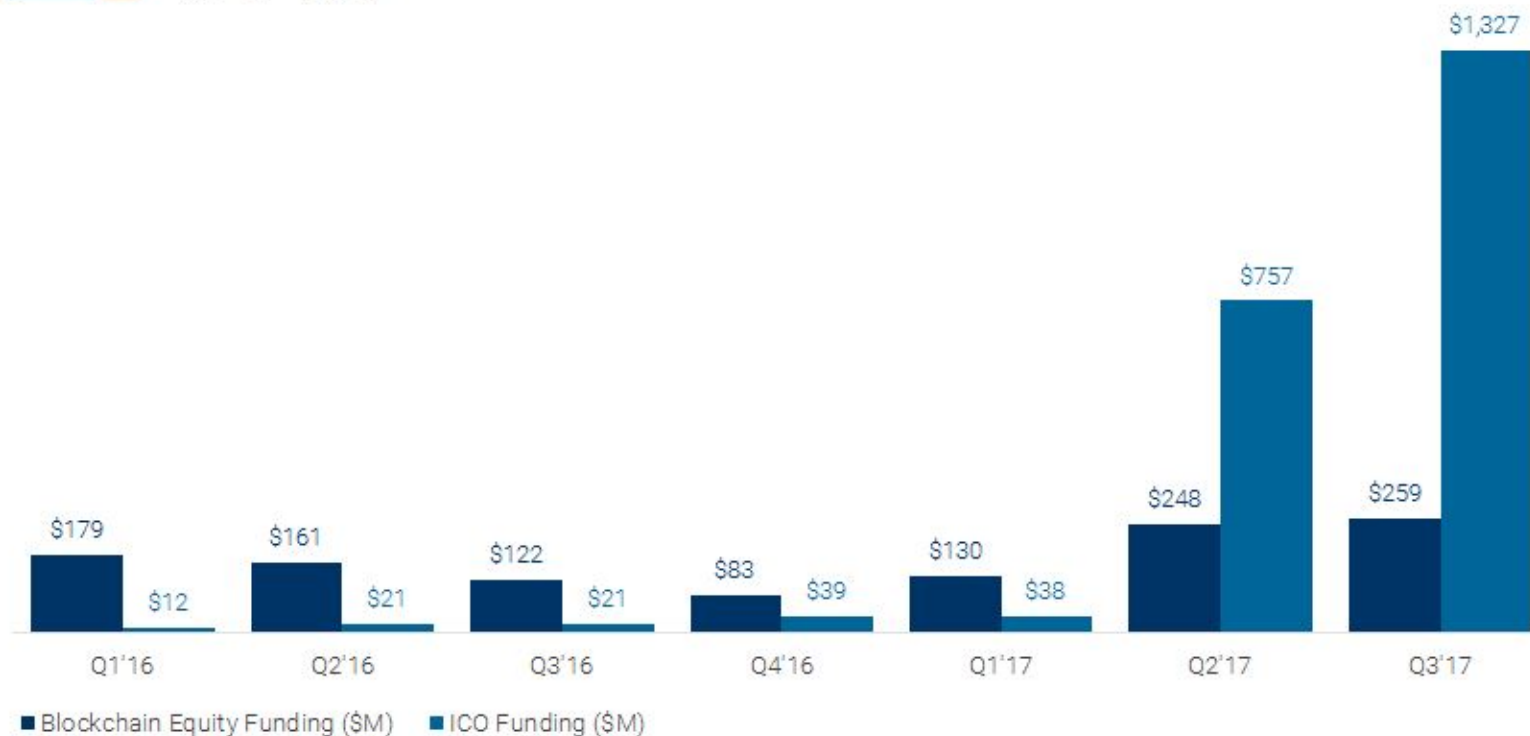
# WHAT IS AN ICO?

## Recent Uptick in ICO Deals



### Blockchain equity funding vs. ICO funding

Q1'16 - Q3'17



Sources: CB Insights, TokenData, CoinSchedule.

CBINSIGHTS

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# WHAT IS AN ICO?



## 134 blockchain startups with ICOs

Closed initial coin offerings greater than or equal to \$500K. 2014 – 2017 (09/08/2017)

### ASSET MANAGEMENT



### MEDIA & ADVERTISING



### GAMBLING & GAMING



### INFRASTRUCTURE & DEVELOPMENT



### EXCHANGES & WALLETS



### TRADING



### DAO & TOKEN LAUNCH



### COMPUTING & STORAGE



### OTHER



### BROWSERS & SOCIAL



### CROWDFUNDING & LENDING



### PREDICTION MARKETS



### HEALTHCARE & INSURANCE



### IDENTITY & INTERNET OF THINGS



### PAYMENTS & BANKING



### FINANCIAL SERVICES



Sources: CB Insights, TokenData, CoinSchedule. Map is illustrative; not exhaustive. We make no claims to the value of any of these projects.





# TYPES OF TOKENS

## Securities Tokens

- When capital raised from ICO is used to fund development of the network.
- Network may be pre-functional.
- Provides token buyer an interest in the project analogous to an membership interest in an LLC, partnership, etc.

## Utility Tokens

- When a token acquired as part of an ICO is intended to be used to access or use the network.
- Network is fully functional.
- Derives value primarily from consumptive use and may be analogized to a token at an arcade, a gift card, or software license.

# TYPES OF TOKENS

- Whether a token is a utility or security has practical implications
- If a token is a security, then it subject to regulation by the SEC unless an exemption is available
- Most commonly used exemption is “private placement” to accredited investors
- Regardless of the type of token, the issuer may not make any material misstatements or omit material facts in the course of the offering.

# UNCERTANTIES SURROUNDING ICOs

- Developing Securities Regulation Framework around ICOs in the U.S.
- Informational Asymmetries between Issuers and Investors
- Risk of Promoters Failing to Deliver due to Relative Infancy of Technology
- Potential for Fraudulent ICOs by Unscrupulous Promoters
- Risk of Overcapitalization in Successful ICOs
- Other Non-Securities Regulatory Challenges
  - Federal Money Services Laws
  - Federal (and State) Tax Laws
  - Federal Commodities Regulations
  - State Blue Sky Laws

# THE DAO INVESTIGATION REPORT

- The SEC has yet to issue formal guidance concerning
  - The regulatory treatment of utility tokens
  - Whether it sees a distinction between securities tokens and utility tokens
  - Circumstances in which utility tokens may be deemed to constitute securities
- It has offered useful insight on its regulatory stance in a July 2017 investigation report

# THE DAO INVESTIGATION REPORT

## Nature of Token at Issue

- The Decentralized Autonomous Organization (the “DAO”) is a platform created by Slock.It, a German entity.
- The DAO was a crowdsource venture capital platform
- The DAO operated using a “smart contract” on the Ethereum blockchain.
- The DAO operated like a venture fund where tokens were sold in exchange for ether which was then pooled.
- Token holders were permitted to vote on a menu of investments to which the DAO would apply portions of the pooled funds.
- Token holders were also to share in the profits from the investments.
- The DAO ICO was unregistered and no exemption was sought.



# THE DAO INVESTIGATION REPORT

## SEC Analysis and Conclusion

- According to SEC, definition of “security” is flexible and adaptable
- The SEC focuses on substance (and not the form) of the overriding economic realities
- In analyzing the DAO tokens, the SEC invoked the four-pronged “Howey test” under which an instrument is a security if it relates to:
  - (i) an investment of money
  - (ii) in a common enterprise
  - (iii) with a reasonable expectation of profits
  - (iv) to be derived from the entrepreneurial and managerial efforts of others
- The SEC concluded that the DAO Tokens were securities subject to its regulation.

# TOWARD COMPLIANT ICOs?

## The SAFT Framework

- The persistent regulatory uncertainty has spawned efforts aimed at creating regulatorily compliant ICOs and tokens.
- One such effort has yielded the Simple Agreement for Future Tokens (SAFT)
- In the SAFT model, a clear distinction is made between pre-functional utility tokens and fully functional utility tokens.

Pre-Functional Tokens	Fully Functional Tokens
Tokens issued before a network is operational Key motivation – Ability to profit once the token is re-sold after the network is functional	Tokens issued after a network is fully operational Key motivation – Ability to access and use the fully functional network

# TOWARD COMPLIANT ICOs?

## The SAFT Framework (Cont.)

- The model presumes that **pre-functional utility tokens** are likely to satisfy all four prongs of the Howey test and are thus securities.
- The model presumes that **fully functional utility tokens** are unlikely to satisfy all four prongs of the Howey test, making them less likely to be deemed to be securities.

# TOWARD COMPLIANT ICOs?

## The SAFT Framework (Cont.)

- The SAFT itself is a security offered to U.S. accredited investors for pre-functional utility tokens.
- Once the platform successfully launches, and while the SAFT is in effect, the company is obligated to issue the now fully functional utility tokens to the SAFT holder.
- Proponents of the SAFT model believe that there is a strong argument that the now fully functional utility tokens are not securities and thus not subject to SEC regulation.
- They further argue that the SAFT model addresses many securities, money transmitter, tax, and policy concerns based on the current legal landscape.
- However, the SAFT has yet to be scrutinized by a U.S. court or regulatory agency.

# TOWARD COMPLIANT ICOs?

## The SAFT Framework (Cont.)

- Criticisms of the SAFT Model.
  - Practical: Some view its blanket treatment of pre-functional utility tokens as securities to be an oversimplification given that the SEC's affirmation in the DAO investigative report that the nature of a token is to be evaluated on a case-by-case basis.
  - Philosophical: Some have criticized it as failing to fully live up to the "ideal" that ICOs are intended to "democratize" and ultimately disrupt venture capital funding, specifically by opening up deals to retail investors across the globe.



# TOWARD COMPLIANT ICOs?

## The SAFT Framework (Cont.)

- CoinList became the first company to use the SAFT in its FileCoin token issuance in August 2017.
- Since then, an increasing number of blockchain ventures have followed suit or are planning on following suit.
- Closer to home, tZero and ULedger are planning ICOs using the SAFT framework.

# SEC ENFORCEMENT ACTIONS

## REcoin Group Foundation and DRC World

- In an August 2017 filing, the SEC alleged that, in mid-2017, Zaslavskiy and his companies committed fraud by selling unregistered securities in ICOs for digital coins that did not actually exist.
- REcoin was advertised as “The First Ever Cryptocurrency Backed by Real Estate” and claimed to have a team of professionals prepared to invest the raised funds in real estate (and that investors could expect sizeable returns).
- The SEC alleged that no such team of professionals existed nor had any team been consulted and that REcoin misrepresented that it had raised between \$2 million and \$4 million instead of approximately \$300,000.
- The SEC alleged that, while DRC World claimed to invest in diamonds, no such investments were made nor had DRC World engaged in any operations.

# SEC ENFORCEMENT ACTIONS

## PlexCorps

- This December 2017 action, marks the first enforcement action by the SEC's new cyber unit.
- SEC froze assets of PlexCorps, which it accused of fraudulently selling up to \$15 million in tokens.
- SEC alleged that PlexCorps promised massive returns (1,354% in one month) it was unlikely to deliver while advertising a non-existent team of experts and obscuring its founder past financial crimes.
- The complaint seeks permanent injunctions, disgorgement plus interest and penalties.

# CONCLUSION

- In unscripted remarks at a November 2017 conference, SEC chairman, Jay Clayton, discussed several issues relating to ICOs, including his view that there is a lack of information about many online platforms that trade tokens.
- He added: “I have yet to see an ICO that doesn’t have a sufficient number of hallmarks of a security.”
- He did not indicate whether he was referring to (a) securities tokens as opposed to utility tokens, (b) pre-functional utility tokens as opposed to fully functional utility tokens, and/or (c) whether he considers such distinctions to be material.



# CONCLUSION

- At a prior event in September 2017, Mr. Clayton identified ICOs as one of two new priorities for the SEC. The other being . . . . Cybersecurity
- The Cyber Unit announced by the SEC in September 2017 lists “violations involving distributed ledger technology and initial coin offerings” as among its enforcement priorities.”
- Companies considering ICOs that allow U.S. purchasers to participate must be mindful of securities regulations unless the issuer can establish that the token is not a security.
- As things stand, the SEC may treat issued tokens as securities unless the issuer can establish otherwise.
- If in doubt, proceed under the assumption that the token is a security.



# QUESTIONS?

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