

# QuickLaunch University Webinar Series

## Initial Coin Offerings: Recent Developments and Legal Considerations for Startups

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## What is an ICO?

- An **ICO**, or initial coin offering, is the sale of virtual coins or tokens, often as a means of capital raising by startup companies that are involved in blockchain technology. Depending on the terms of the offering, purchasers may use virtual currencies (such as Bitcoin or Ether) or fiat currency to purchase the coins or tokens.
- ICOs, token pre-sales, and similar sales of blockchain-based coins and tokens are quickly becoming an important fundraising option for many early-stage companies.



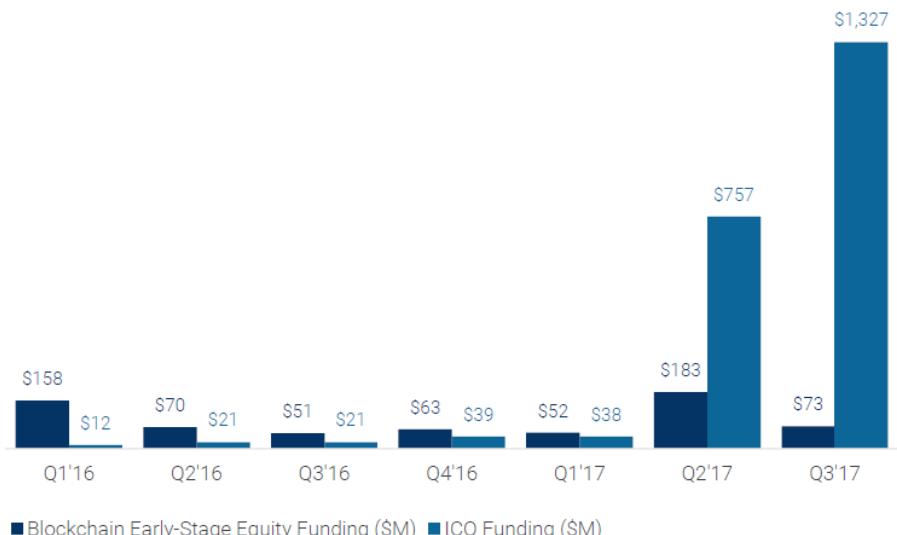


# The Rise of ICOs

- Since 2016, there have been 250+ blockchain startups that have closed ICOs for over \$2B in funding.
- Early-stage "traditional" equity investment (i.e. non-ICO) in blockchain companies by VCs and other corporate investors was \$73 million in Q3 2017, representing only 7 financing rounds (lowest point since Q4 2013).



Blockchain early-stage equity funding vs. ICO  
Q1'16 – Q3'17



Note: "Blockchain Early-Stage" includes Angel, Seed, and Series A.  
Sources: CB Insights, TokenData, CoinSchedule.





## The Rise of ICOs

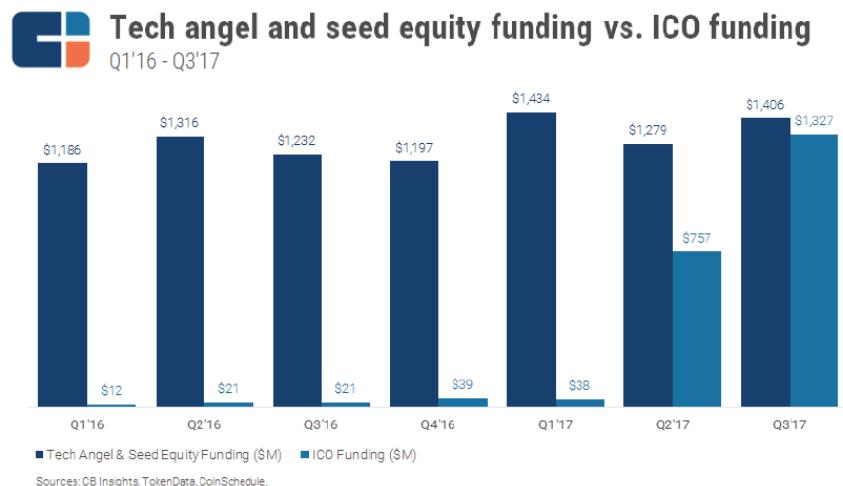
- By contrast, 150 companies raised an estimated **\$1.3 billion** via ICOs in Q3 2017. Year-to-date, ICOs have raised **more than \$2 billion**, with core development and blockchain governance platform Tezos claiming the largest ICO round at around \$230 million.
- Filecoin, a distributed file storage platform, closed the second-largest ICO YTD with its \$210M token sale in Q3 2017.
- Doubling on a monthly basis.





# The Rise of ICOs

- In Q3 2017, all tech angel and seed deals totaled \$1.4 billion, with more than 1,600 deals in that quarter.





# How Does It Work?

## **It starts with understanding cryptocurrencies**

- Cryptocurrencies like Bitcoin and Ethereum are digital currencies created and regulated—in terms of currency creation—by encryption techniques.
- In a sense, it's simple: Solve the code to unlock the cash, which can then be used to buy and sell goods and services, or be exchanged for U.S. dollars or any other fiat currency.
- Where initial coin offerings enter the picture is when a startup creates a new cryptocurrency that people buy with the more common and established Bitcoin and Ethereum.





# How Does It Work? continued

## But ICOs aren't standard money

- Even though an ICO raises funds, the "coins" are not currency. Instead, the coins or tokens purchased in an initial coin offering can be used to transfer value within the new coin's ecosystem, or to other cryptocurrencies' ecosystems.
- Not unlike a Kickstarter campaign, an ICO usually sets a minimum goal for a fundraise and a period of time to reach that goal.
- If the requirements are met, then the tokens are distributed and can be used for the purchase and use of certain products developed by the start-up.





## How Does It Work? continued

- Most "investors," however, seem to be simply hoping for a jump in the price of the new currency, much as we've seen from Bitcoin and Ethereum, the two established players. If you bought \$100 of Bitcoin on January 1, 2011, it would be worth over \$1.7M today.
- Individuals choose to invest in ICOs typically because they believe that the tokens will have value either in and of themselves as currency (e.g., Bitcoin) or because the tokens will have value on the platform to be created (e.g., Ethereum)





# How Does It Work? continued

## Launching your own currency: How it works

- Starting an ICO is not unlike starting a crowdfunding venture.
- Entrepreneurs and startups that want to launch an ICO typically create a company, build their startup to an early stage, announce their plan to launch a token sale, and publish a white paper about what they intend to create, how they intend to do it, and how much money they need to make it happen.
- Then they launch their new cryptocurrency via a service like [CoinList](#) or [Waves](#), which promises "your blockchain token in one minute."
- Like an IPO, the tokens are typically sold at a fixed price by the startup, and then they are traded on exchanges after the issuance. Laws of supply and demand determine the price on the exchanges after the initial issuance.





## How Does It Work? continued

- It all seems like ridiculously easy money, and even perhaps a bit scammy. And there have been several ICO scams to date—and they tarnish the image of all ICOs.
- Clearly, the better ICOs are well backed by strong teams.
- Scams have raised the attention of the SEC.





# SEC Confirms Some ICOs Are Securities Offerings

- On July 25, the SEC issued its Report of Investigation of an offering of digital tokens by “The DAO.”
- The Report makes clear the SEC’s view that the traditional securities law analysis applies to new technologies, noting that *“the federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using US dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology.”*

## SECURITIES AND EXCHANGE COMMISSION

### SECURITIES EXCHANGE ACT OF 1934

Release No. 81207 / July 25, 2017

Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934:  
The DAO

#### I. Introduction and Summary

The United States Securities and Exchange Commission’s (“Commission”) Division of Enforcement (“Division”) has investigated whether The DAO, an unincorporated organization; Slock.it UG (“Slock.it”), a German corporation; Slock.it’s co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.

As described more fully below, The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a “virtual” organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO was created by Slock.it and Slock.it’s co-founders, with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund “projects.” The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms (“Platforms”) that supported secondary trading in the DAO Tokens.

After DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO’s code to steal approximately one-third of The DAO’s assets. Slock.it’s co-founders and others responded by creating a work-around whereby DAO Token holders could opt to have their investment returned to them, as described in more detail below.

The investigation raised questions regarding the application of the U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”).<sup>1</sup> The Commission deems it appropriate and in the public interest to issue this report of investigation (“Report”) pursuant to

<sup>1</sup> This Report does not analyze the question whether The DAO was an “investment company,” as defined under Section 3(a) of the Investment Company Act of 1940 (“Investment Company Act”), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.





# Why It Matters if an ICO Is a Securities Offering

- Under the federal securities laws, any offer and sale of securities must be registered under the Securities Act or conducted under an applicable exemption from registration.

## A. Section 5 of the Securities Act

The registration provisions of the Securities Act contemplate that the offer or sale of securities to the public must be accompanied by the “full and fair disclosure” afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Registration entails disclosure of detailed “information about the issuer’s financial condition, the identity and background of management, and the price and amount of securities to be offered ... .” *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), *aff’d*, 155 F.3d 129 (2d Cir. 1998). “The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act’s comprehensive scheme for protecting public investors.” *SEC v. Aaron*, 605 F.2d 612, 618 (2d Cir. 1979) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953)), *vacated on other grounds*, 446 U.S. 680 (1980). Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been filed. Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce. 15 U.S.C. § 77e(a) and (c). Violations of Section 5 do not require scienter. *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976).





## Why It Matters if an ICO Is a Securities Offering

- An ICO that does not meet the requirements of an exemption from registration would likely be an illegal offering and the issuer or individual responsible for promoting it could face civil or criminal liability.
- The purchasers of the securities also have the right under the Securities Act to force the seller to rescind the transaction and repurchase the securities at their original purchase price, plus interest.
- If securities are offered, the activities of exchanges and other intermediaries would also come under scrutiny.





## The DAO – Background

- Over a one-month period in 2016, The DAO offered and sold approximately 1.15 billion DAO tokens in exchange for a total of approximately 12 million Ether (ETH), a virtual currency used on the Ethereum Blockchain.
- At the time the offering closed, the total ETH raised by The DAO was valued at approximately \$150 million US dollars.
- Investors could hold the tokens as an investment with certain voting and ownership rights or could sell them on web-based secondary market platforms.





## The DAO – Background continued

- The tokens were promoted and sold through a website that described The DAO's purpose as being “[t]o blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code.”
- According to promotional materials, The DAO would earn profits by funding projects that would provide DAO token holders a return on their investment. Token holders would receive “rewards” and then vote to either use the rewards to fund new projects or to distribute the ETH to token holders.





## The DAO – Background continued

- There were no limitations placed on the number of DAO tokens offered for sale, the number of purchasers of tokens, the level of sophistication of purchasers or their ability to resell the tokens.
- The DAO represented that the tokens would be available for secondary market trading after the offering period, and a number of platforms posted notices on their own websites and through social media to say that they would support secondary market trading of the tokens.
- In addition to secondary market trading on the platforms, the tokens were to be freely transferable on the Ethereum Blockchain and token holders would be able to redeem their tokens for ETH through a process referred to as a DAO entity “split,” which the SEC described in its Report as a “complicated, multi-week (approximately 46-day)” process.





## The DAO – Background continued

- Following the offering, between May and September 2016, the tokens were sold on a number of different platforms, which used electronic systems that allowed their customers to post orders for the tokens anonymously.
- In June 2016, an unknown individual or group was able to exploit a flaw in The DAO's code to steal approximately one-third of The DAO's assets.
- The DAO took steps to revise the Ethereum protocol going forward so that token holders could exchange their tokens for ETH and avoid loss of their investments.





# The DAO – Securities Law Analysis

- Both the Securities Act of 1933 and the Securities Exchange Act of 1934 include a broad definition of the term “security” that encompasses a variety of instruments, including an “investment contract.”
- The facts and circumstances test set forth by the US Supreme Court in *SEC v. W.J. Howey Co.* has long been applied to determine whether a particular instrument should be considered an “investment contract” and therefore a “security” for purposes of the Securities Act.





# The DAO – Securities Law Analysis

- The elements to be considered in the application of the *Howey* test are whether the purchasers of the instrument: (i) invested money or valuable goods or services; (ii) were investing in a common enterprise; (iii) with a reasonable expectation of earning profits; (iv) that were to be derived from the efforts of others.
- The SEC Report provides a detailed analysis of the facts and circumstances of the DAO offering and applies the Howey test to determine that the DAO tokens were “investment contracts” and therefore subject to the federal securities laws.





## The DAO – Securities Law Analysis

- The SEC easily found that three of the elements were met—that the payments by purchasers in Ether would be considered an investment of money, and that the investors in The DAO were investing in a common enterprise and had a reasonable expectation of profit in light of the stated objective of The DAO, which was to fund projects in exchange for a return on investment, and token holders would share in potential profits.





# The DAO – Securities Law Analysis

- The SEC discussed in detail the application of the fourth element of the test—the requirement that the investors have an expectation that the profits would be derived from the efforts of others. Key to this part of the analysis was the significant reliance The DAO investors placed on the managerial and entrepreneurial efforts of the founders and curators. The SEC also noted in this respect that DAO token holders had only limited voting rights and access to information.
- Seen through the lens of the *Howey* test, it is not surprising that the SEC found a security to exist in the DAO offering.





## What Does The DAO Report Mean for ICOs Going Forward?

- The most notable element of the report was the fact that the SEC did not issue a blanket characterization for blockchain tokens as securities—rather, it said that those determinations would be made on a case-by-case basis, with some falling in that definition and others outside it.
- While not free from doubt, the new clarity on the SEC's view of the appropriate analysis to be applied may make it easier for token issuers to structure their offerings to avoid characterization as a security.





## What does The DAO Report Mean for ICOs Going Forward?

- The SEC has now made it clear that it is willing to assert jurisdiction if a security is present based on the *Howey* analysis.
- In this situation, issuers of such tokens may wish to consider structuring the offering to comply with the US federal securities laws.
  - However, an acknowledgment that a particular token is a security may have other significant regulatory consequences.





# Issues for Exchanges and Intermediaries

- The Report also stressed the need for compliance with the requirements under the Exchange Act for registration of exchanges that effect transactions in securities.
- Section 5 of the Exchange Act makes it unlawful for any exchange to effect a transaction in a security unless the exchange is registered with the SEC or exempt from registration.

D. A System that Meets the Definition of an Exchange Must Register as a National Securities Exchange or Operate Pursuant to an Exemption from Such Registration

Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. *See 15 U.S.C. § 78e.* Section 3(a)(1) of the Exchange Act defines an “exchange” as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood . . .” 15 U.S.C. § 78c(a)(1).





## Issues for Exchanges and Intermediaries

- In the Report, the SEC concludes that various platforms that traded DAO tokens met the definition of an “exchange” under the Exchange Act and did not appear to have a valid exemption from registration.
- As a result, had the Division of Enforcement determined that it would recommend that the SEC pursue an enforcement action against the platforms, the SEC would have alleged violations of Section 5 of the Exchange Act, and could have pursued a cease and desist order, disgorgement and/or penalties.





## Other Regulatory Questions

- Will the tokens be subject to regulation by the CFTC under laws applicable to trading of commodities?
- Will state money transmitter laws (or the federal regime for money services businesses) apply to the tokens?
- Does the New York State bitlicense apply to the issuer of the tokens?
- Regulatory issues outside of the United States
  - China recently banned ICOs; other countries have issued guidance and warnings.





## Conclusion

- Market participants should continue to proceed with caution in structuring offers and sales of tokens, and should consider carefully the factors considered in the SEC's Report and the SEC's analysis and conclusions based on those factors.
- In particular, it will be important for market participants to consult with experienced counsel in considering transactions involving tokens and other virtual currency.





# Questions

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