QuickLaunch University Webinar Series Transcript
Legal Landscape Update: The Future of ICOs and Cryptocurrencies

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Glenn: Hello, everyone, and welcome to today's QuickLaunch University Webinar. My name is Glenn Luinenburg and I'm a partner in the firm's Corporate Practice in Palo Alto. I'm joined by my partner, Jennifer Zepralka, as well as Petal Walker, special counsel in the firm's Securities Practice.

Over the last year, we have explored many different legal issues faced by entrepreneurs and early-stage companies as they develop their businesses. If you're interested in listening to our previous QuickLaunch University Webinar sessions, including our earlier webinar on ICOs, where we discussed the basics of cryptocurrency, links to all recordings are posted on wilmerhalelaunch.com.

I'd quickly like to introduce the speakers for today's program. My co-presenters today are Jennifer Zepralka, also a corporate partner at the firm, and Petal Walker, a securities special counsel, and they're both based in our firm's Washington DC office.

The topic of our presentation today is Legal Landscape Update: The Future of ICOs and Cryptocurrencies. As I mentioned previously, we did a background presentation a number of months ago which is available on our website. Our intention today is to provide additional information and to update the legal landscape since our presentation in November.

At the outset, I'd like to quickly review exactly what an initial coin offering is. An initial coin offering, or an ICO, 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, like Bitcoin and Ethereum, or fiat currency, to purchase the coins or tokens.

Even though the ICO raises funds, the coins are not currency. Instead, the coins and tokens can be used to transfer value within the sponsor's ecosystem or their platform. In addition to this, the coin can be traded after the issuance on exchanges that trade tokens and coins. ICOs, token pre-sales, what we call SAFTs, Simple Agreements for Future Tokens, and similar sales of blockchain-based coins and tokens have quickly become a very important fundraising option for early-stage companies.

I'd like to look at the rise of ICOs and their growth. You can see on this chart the incredible growth back in the third quarter of 2017. The growth still continues through the fourth quarter of 2017. As you can see, in relation to blockchain startups, 2017 saw over five times more capital deployed in initial coin offerings versus traditional equity financing.

The fourth quarter saw an even more significant jump with over seven times more capital deployed in ICOs. In total, ICOs raised over $5 billion across approximately 800 deals in 2017 versus approximately $1 billion across 215 equity investments in the sector during the same time period.

It clearly looks like we're in a cryptocurrency bubble right now and the question is, 'is the bubble going to burst?' Individuals choose to invest in ICOs typically because they believe that the tokens themselves

will have some value either in and of themselves as a currency or because the tokens will have value on the platform that's either created or will be created.

Given the rise in the value of cryptocurrencies in the third and fourth quarters of 2017, recent purchasers of tokens really seem to be simply hoping for a jump in the trading price of the token, similar to what we've seen in terms of the increase in the value of Bitcoin and Ethereum during this time period for the two most-established cryptocurrencies. As a point of reference, if you bought $100 of Bitcoin in 2011, that $100 investment would be worth over $1 million today. It does definitely look like a bubble.

I often get the question, 'why are ICOs so popular?' In my opinion, ICOs offer democratization of access for everyone. Everyone can participate. There's certainly no geographical limit on who can participate in token offerings.

They also offer an opportunity to invest in accumulated cryptocurrency. As we've seen, the value of Bitcoin, and Ethereum and other cryptocurrencies have dramatically increased in 2017. They've dropped a little at the beginning of this year, but they've still increased fairly dramatically over the past 12 to 18 months.

And still, to date, there's limited ways to spend the accumulated cryptocurrency, except in conversion to fiat currency or cash and that could result in loss of potential value. Investing in tokens and other coins offers people who hold large amounts of cryptocurrencies a diversification opportunity.

Tokens offer the opportunity to trade immediately. Unlike traditional VC investments, new tokens can usually be traded almost immediately on an exchange, and we'll talk about that in more detail during the presentation.

Lastly, the crypto-community really does have an inborn passion for new and modern technologies and applications, and the community does support the initiatives that are disrupting existing rules and standards.

With that being said, what's new? We'll take a look at this throughout the presentation. As we've seen in the previous chart, ICO growth has continued and the growth has been nothing short of astonishing. In 2018, so far this year, we've seen ICOs raising already $1.7 billion in capital for technology startups.

Now, ICOs have grown largely outside of regulatory oversight and without the investor protection and disclosure requirements that typically apply to traditional securities or investment offerings. A wide array of potential illegalities associated with ICOs could come up and it's beyond the scope of our presentation today, but would include the unlawful offer sale and promotion of securities, operation of stock exchange, sale of an unregistered mutual fund, the failure to meet anti-money laundering laws, and the unlawful sale, advertising, and promotion of commodities, and the list goes on from there.

What has become perfectly clear in recent months, above all else, is that the federal securities laws apply to those who offer and sell securities in the United States regardless of whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless of whether those securities are purchased using U.S. dollars or virtual currencies, and regardless of whether they are distributed in certificated form or through distributed ledger technology of cryptocurrencies.

As the excitement of ICOs has spread throughout the business and financial sectors, so too have the

concerns that the lack of regulations render this new-age currency susceptible to fraud, manipulation, and to being used as a vehicle for money laundering.

SEC Chairman Clayton's voice, in particular, has been especially loud and pervasive with respect to concerns about ICOs. Speaking in early November 2017, Chairman Clayton veered off the script and bluntly reported that he had yet to see an ICO that doesn't have a sufficient number of hallmarks of a security and also that there was a distinct lack of information about many online platforms that list and trade virtual coins and tokens offered and sold in initial coin offerings.

Along these lines, the SEC has issued a slew of unprecedented official statements about ICOs that Jennifer will cover in a little more detail, including a recent investor bulletin warning investors about ICOs. The SEC even went so far as to put the spotlight on social media ICO campaigns and endorsement by celebrities that were not properly disclosing the celebrity's financial relation to the ICOs.

In a recent speech at a securities laws conference in San Diego, Chairman Clayton indicated that he believed lawyers were failing in their role as gatekeepers and made it clear that the SEC intends to hold all gatekeepers, including lawyers, accountants, and other investment professionals, accountable for their activities in connection with ICOs and cryptocurrencies.

The SEC's Enforcement Division is devoting a significant portion of its resources to the ICO marketplace at this time. Through statements, reports, and enforcement actions, the SEC has made it clear that federal securities laws apply regardless of whether the offered security is labeled a coin or a utility token rather than a stock, a bond, or an investment contract.

The SEC has also announced the recent formation of a new Cyber Unit to target violations involving distributed ledger technology and ICOs as part of a new effort to fight cybercrime. The new Cyber Unit was created to police ICOs and is already up and running and well-staffed with seasoned SEC professionals.

In addition, the SEC has created a Retail Strategy Task Force to develop proactive and targeted initiatives to identify misconduct impacting retail investors, including to pursue misconduct perpetrated using the dark web, where Bitcoin and other cryptocurrencies are being used to pay for illicit goods.

The new team was established to apply the lessons learned from past securities fraud cases and to leverage data analytics and technologies to identify large-scale misconducts affecting retail investors. Together, the new SEC's Cyber Unit and Retail Task Force have set their sights on the ICO marketplace and have started bringing ICO-related cases, some of which Jennifer is going to cover as well, and we believe that many more will follow.

Very recently, yesterday, *The Wall Street Journal* announced that the SEC had launched a cryptocurrency probe and that the regulator had issued scores of subpoenas and information requests to tech companies, and not just the tech companies, but also their advisors involved in ICOs.

ICOs have also raised a host of criminal concerns, which has prompted action at the U.S. Department of Justice. In November 2017, the DOJ made its first ICO-related arrest, charging someone in Brooklyn with securities fraud and conspiracy for his role in the illegal unregistered securities offering of an ICO. More at that level are almost the virtual certain piece the ICOs face at this point.

Lastly, I'll introduce a topic that Petal will cover in more detail later in our presentation. The CFTC, together with the SEC, has also increased its scrutiny of crypto- and blockchain-related companies. On January 18, the CTFC filed enforcement actions against two questionable businesses attempting to benefit from cryptocurrency hike. At that time, the SEC and CFTC issued a joint statement regarding digital currency issuers, once again, warning companies and exchanges that seek to avoid following the law or simply commit fraud.

More recently, SEC Chairman Clayton, together with CFTC Chairman Giancarlo, took to *The Wall Street Journal* editorial pages to proclaim their stands regarding cryptocurrencies and ICOs, the same day that CFTC announced its third fraud enforcement action.

As you can see, the number regulatory initiatives already in 2018 has been tremendous. Jennifer will now provide additional insights regarding how the SEC is treating token offerings and cryptocurrencies.

Jennifer: Thank you, Glenn. Let's drill down a little bit on the regulatory landscape from the SEC side and the framework that the regulators are applying, and then Petal will cover the CTFC activities in just a bit.

As Glenn mentioned, the ICO market sprang up pretty quickly over the last year, so it seems to be going on unchecked for a while. There were simply fraud and Ponzi scheme type arrangements that drew the SEC's notice, but generally, the organization didn't seem to focus on the question of whether these things that were being sold were securities.

But then the SEC officially weighed in for the first time in July of 2017, with the issuance of its Report of Investigation on The DAO. It maybe should have gone without saying, but the report was important, nonetheless, for stating in clear terms that the SEC was going to apply traditional securities laws analysis to new technologies and you don't get a free pass from regulation just because you've come up with a new model for capital raising. And that's something that's still kind of sinking in in the market, I think.

Let's think a little bit about why this matters. It's pretty obvious from the long list of the things that Glenn just ran through of all the potential enforcement activity that the consequences of selling something that ends up being considered a security without compliance with the securities laws can be pretty significant.

The basic framework under the federal securities laws is that any offer and sale of securities must either be registered under the Securities Act or require you to have an exemption from registration. Obviously, these things are not registered. Applying that to an ICO, the key here is whether the tokens you're selling are securities or not.

If they are securities and you didn't do what was necessary to have an exemption from registration in structuring that offering, then the view is that you will have conducted an illegal offering. In that case, you could be looking at civil or even criminal liability, and under the securities laws, purchasers of those securities could force the seller to buy back the securities, which could be a pretty devastating thing for a startup.

The consequences could also be very serious for exchanges and intermediaries in token sales if those tokens are considered securities. Securities laws don't apply only to the people who issue them or sell them, but also to those who are in the middle of the transaction and they could face serious liability as

well.

How should we look at the traditional securities law now to determine whether the federal securities laws are impacted? Let's look very quickly at The DAO, which is kind of old news at this point, and most people who are following this space have already read it, and then we'll turn to the more recent *Munchee* case.

The DAO sold tokens in an ICO in 2016. The marketing for that offering made it pretty clear that The DAO would earn profits by funding projects that would provide token holders with a return on their investment. In many ways, when you look at the fact pattern in that case, it's pretty obvious why the SEC would see a security here.

Both the '33 Act and the '34 Act, which are the two main operative laws in the federal securities regime, define a security very broadly and include the concept of an investment contract. The longstanding test to see if you have an investment contract is set out in the *Howey* case from 1946.

The DAO report was useful to those of us working in this area because the SEC very carefully laid out its application of *Howey* to show that The DAO was an investment contract. The elements to be considered under *Howey* are now familiar to almost anyone who is following this space.

You must look at whether the purchasers of the instrument invested money in a common enterprise with a reasonable expectation of profit derived from the efforts of others. It's amazing that a case that was really only familiar to securities lawyers is now so widely discussed in way cooler circles than securities bar.

The structure of The DAO pretty clearly met these tests and really looked more like some sort of investment fund than anything else. The way things landed in that report didn't really surprise people who were already familiar with the securities laws and the concept of investment contracts.

But there were still open questions about other types of ICOs where it wasn't so squarely an investment, but instead, the token had some other use other than just to provide a return to the holders, and that's where the SEC's *Munchee* case in December gave us some more color.

Munchee had created an iPhone app for reviewing restaurant meals. They conducted a sale in the fall of 2017 of tokens to raise capital to improve that app and to build out its platform. The punch line here is that they settled an SEC enforcement action in December agreeing to cease and desist from violating Section 5, which is the key registration provision of the '33 Act. That's the basis for that statement I made earlier that every offering on securities needs to either be registered or exempt.
Munchee violated Section 5 because this offering was not either registered or squarely within an exemption.

If you spend a lot of time laying out the facts and the terms of this offering, you'll see the offering materials for this ICO described the way that the tokens would increase in value, which was pretty key to the case. Also key was the fact that the offering material told the potential purchasers that the tokens would be traded on secondary markets.

Interestingly—and the SEC pointed this out in the order—Munchee claimed to have done the *Howey* analysis, but had determined that there was not a significant risk of it being a security. The SEC did not agree. At the time of the sale, Munchee had its app, but buyers were not able to buy any goods or

services on the ecosystem.

This points out some of the tension in the analysis. A lot of people out in this market have been proceeding under the impression that a token that has some utility will not be a security, but this case makes it clear that in the SEC view, that's not enough. That a token can have some utility, but if the real reason people are buying it is because they are expecting to share in the upside of the business, you need to look harder at that analysis.

Other important things to know in this case: the SEC noted that the company promoted the sales of the tokens to professional cryptocurrency investor types and not to the people who would be expected to actually use the app or the platform to do the restaurant reviewing. The record in this matter also included public statements from the founders and promotion of other people statements that shouted the opportunity for profit which didn't help their case.

Working through the *Howey* test, the SEC found that all the elements of that test had been met. There was an investment of money because the tokens were bought with Bitcoin or Ether. The SEC did not give a lot of real estate in the discussion to the common enterprise prong of the test, but they talked about it more in the context of the expectation of profits, looking at the efforts of building the ecosystem which would then create the demand for the tokens and in turn add to their value.

Some of the key facts that went into the analysis were that while the app existed, it was still subject to improvement and the ecosystem that the company intended to build and on which tokens would be used did not exist at the time. People talk a lot about utility tokens versus security tokens. Actual utility is clearly very important. The SEC did know that there was not a whole lot of utility here at all, but just having some utility is not the only key thing. As I mentioned, the SEC has made it clear that some utility doesn't take you out of the securities laws if what's really going on is that people want the tokens because they have an expectation that they can profit from them.

The SEC also focused on features of the token, which is kind of technical for an SEC order discussion on features of the token that could cause the token to appreciate in value. And they pointed out things like appeared membership plans that gave higher payouts to people who hold more tokens. The companies intend to burn tokens over time to reduce the supply and increase the scarcity.

In addition, companies may also plan to support secondary trading, and to promote liquidity in the tokens, by buying and selling from the company supply. These were all facts that went into the consideration of whether people were relying on the efforts of others in that they're getting the value of these tokens. Also, in this case, we have to look at the marketing, which was seen as promoting to potential purchasers the opportunity to profit.

I think there's a lot to take away from this case for what the SEC is focusing on as we look at these offerings going forward and as a reminder that we all have to step back and look at the offering as a whole when doing the analysis. It's probably not enough to just say, "Well, we don't have the common enterprise prong in a clear black and white sort of way, so I'm going to be okay." The SEC is clearly looking at this more holistically and seeing the intent in kind of almost the mindset of the purchasers.

As Glenn said at the outset, the SEC is focusing more on ICOs, and getting this right is feeling more and more important as the SEC pressure is continuing. The SEC Chairman has been very vocal in speeches and testimony. He has said more than once that just about every ICO he's seen has looked like a securities offering, which makes us have to look at this all very carefully as we move forward. And,

by giving warning language to us securities lawyers that it's our role to act as gatekeepers, you will find that our analysis will be rigorous to try to keep you all out of trouble.

It's important to notice the reports yesterday about the subpoenas that are being issued by the SEC to startup companies and their advisors. This would appear to be the beginning of some serious enforcement activity in this space. If you're involved in startups, you've probably never had to interact with the SEC before. Let me note just how important it is to take it seriously. If you do hear from the SEC, number one, don't destroy any documents. If you get a subpoena, you'll make things way worse for yourself. Number two, find experienced counsel pretty quickly before you start talking to the staff.

Is it all gloom and doom? Not necessarily. It doesn't mean it's impossible to have a true utility token but not a security when you look at all the facts and circumstances. There's a lot of risk, and there will be a lot of scrutiny. You should, in a perfect world, be able to create a token that's linked to the use of a particular product or service not marketed as an investment, use it as a medium of exchange and have a closed kind of system that would work. But realistically, in this climate, that's going to be a pretty high bar to be comfortable that what you have is definitely not a security.

As you're working through it, you need to look at the economic realities of the transaction and really use caution now while we're in this hot moment for enforcement. That doesn't mean that this market has to die. If you're thinking of an ICO, you want to think seriously about whether you can do it as a compliant securities offering. There will be some drawbacks to do it as a securities offering compared to the freewheeling ICOs of the good old days last year, but it may keep you out of trouble.

There are a few different exemptions that could be available. Regulation D is the one that I think most people are thinking about right away. That's available if you're willing to limit the purchasers of the tokens to accredited investors and meet the other requirements of the safe harbor, which includes taking reasonable steps to verify that the ultimate purchasers of the tokens are accredited investors.

Certain third parties are providing this service, which is very helpful, and a big issue on this is this is a private placement exemption. It comes with trading or resale restrictions under the securities laws, so these would be restricted securities, which means that they're not going to be freely tradeable for a year after they are issued, which is very different from the business model that people have been proceeding under.

Some issuers may also try to comply with Regulation S, which is the exemption for offshore offering. This is not particularly helpful to a company that wants to sell its token to a US person even if the issuer is offshore. Being offshore is not just that you can incorporate someplace else with all of your management and people sitting in the United States. It takes a little structuring if you're going to try to do a Regulation S offering.

If you need to have a token sale that is really tradable right away, there are options. There is the Regulation A exemption or a full-blown '33 Act Registration. Regulation A is exemption from registration for limited offerings but there are dollar amount restrictions and it requires going through a review process with the SEC staff. But I think it's viable because at the end of the day, you could get through that review and get the staff comfortable with your offering, you would be able to sell your tokens to any type of investors, not just accredited investors, and they would be freely tradeable right away. It does come with some ongoing reporting obligations afterwards.

'33 Act Registration would also provide those benefits of selling to any retail investor and having no

restrictions on transfers, but it does come with more burdensome requirements than Reg A. I think there may be some tentative movement into exploring the Regulation A's base. I would be kind of surprised if this moved into registration, but maybe. The good part about it is that the SEC staff has indicated repeatedly its willingness to work with ICO companies that want to comply, so if you're interested in exploring and doing a good exempt offering, I think, with good counsel and the ability to talk to the staff, that could work out.

Just briefly, there are separate questions about pre-sales of tokens even where the token to be issued is planning to be a utility token and intended not to be a security. It's hard to make an argument that the interest sold in a pre-sale are not securities. Many companies have addressed this with the use of a SAFT that's sold as a ready private placement.

There are also lots of questions about whether the token, when it's finally issued, after that SAFT is used, has any chance of not being a security because of the credit of the securities offering. I think it's possible, but it faces all the difficulties that we already addressed particularly in this climate. You'd have to really have a very convincing argument that what you're issuing is truly a utility token.

As with so much of this, the key is to get really good serious advice as you work through it. And thank you for listening to that update. I'm sure we'll have some questions on these SEC issues at the end. Now I want to hand it over to Petal to switch gears slightly, and hear about what's going on at the CFTC.

Petal: Thank you, Jennifer. First, I will go through a primer on the CFTC's current oversight over crypto. I know there are many on the line who are CFTC veterans and some who are not as familiar with the agency, so I'm going to try to both introduce the agency as well as bring everyone up to speed.

Let's start first with definitions. The first definition is commodity. It's a very broad definition. There are some specified agricultural products in that definition, but at the end, it says, "And all other goods and articles, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." Basically, any good, article, service or right or interest that is the subject of a futures contract could be defined as a commodity. It's very broad and efficiently made very clear that all cryptocurrencies are commodities.

A swap definition is also very broad. A swap is a contract that provides for any purchase, sale, payment, etc., that is dependent on the occurrence or non-occurrence of an event or contingency. If you have an instrument where the purchase or the sale is dependent on something happening that is outside of the control of the participants, then that could be a swap.

It also mentions how a swap is also a contract where you have an exchange of payments where you're really moving risk based on a future change, the potential of future change. It's possible that you may think that you've created just a regular token, but within the token, the programming is such that risk is being transferred between parties and the token itself is actually a derivative, is actually a swap. You definitely have to get good advice on the instruments themselves.

A spot contract is the underlying cash market. Spot contracts have to have an intent to deliver and have actual delivery. If the transactions are leveraged, then they must result in delivery within 28 days or be between commercial entities. The commission has proposed an interpretation on actual delivery, which I will also discuss.

If it is a true spot exchange, it does not have to be registered with the commission. If you are acting as an intermediary on a spot exchange, then you also do not have to be registered as an intermediary. But if, as I noted before, the actual cryptocurrency is really a swap, then all of that changes and you are right in the heart of CFTC land.

In terms of actual delivery, the commission recently put out a proposed interpretation about leveraged transactions and noted that actual delivery means that the recipient of the delivery can actually take the cryptocurrency out of the exchange and use it for other purposes and neither the offerer or the counterparty has interest in it. This makes sense in terms of traditional delivery in agricultural products etc., but it's different in the crypto space, and this proposal has been highly controversial and I'm sure we'll see much more about this in the years to come.

The CFTC has also commented on the SEC's analysis and noted that that is separate from the CFTC's analysis. So, it's possible that the CFTC can look at a token and find that it is a commodity or a derivative itself regardless of the SEC's analysis of that same product. The CFTC is definitely keeping all options open and so we definitely need to make sure that you're engaging in a CFTC analysis as well as the SEC one.

Now, for the contract. The first swap derivative was the Bitcoin swap at TeraExchange issued in 2014. The interesting thing is that the CFTC was not looking to be the regulator of crypto. It was kind of thrashed upon them because to do with the self-certification process, now, number one, the commodity definition is very broad, as we've discussed, but also, secondly, the actual contract approval process is such that the commission can't deny that contract unless it is inconsistent with the Commodity Exchange Act—which is a very high bar.

This first contract was brought upon the Commission, but now, today, we have two Bitcoin futures being traded on the CME and CFE. They have very light trading right now, but the hope is that over time, they'll gain more volume and help to bring some stability to the market, some more stability to the market.

The CFTC caught a lot of flak for self-certifying these futures, so early in January they issued a backgrounder where they explained the limits of the self-certification process, which I mentioned earlier, as well as their own due diligence. On January 19 of this year, the chairman noted in a speech that the CFTC is engaging in heightened review of these contracts, and toward the end of January, an advisory committee of the CFTC also reviewed the process. There's been lots of controversy about these contracts and the CFTC is currently reviewing them with a heightened review.

Let's go now to the CTFC's crypto agenda. We've discussed the definitions and the contracts, but let's discuss in terms of the overall agenda. Chairman Giancarlo, who is a Republican, has a two-pronged approach towards fintech and cryptocurrency. First, having a positive approach, one to encourage innovation, not one to get in the way of innovation. But then the second prong is to have a pretty strong approach towards enforcement against fraud and manipulation.

The other two commissioners are Commissioner Quintenz (R), who has been generally supportive of fintech and has a hands-off policy generally, and Commissioner Behnam (D), who has been more circumspect about that. But, for the most part, the CFTC is going forward with the chairman's two-pronged agenda.

The first prong is really captured in LabCFTC. LabCFTC is basically a part of the Commission that has

two purposes. One purpose is to help fintech innovators understand the CFTC regulatory landscape. The other purpose is to help to the CFTC understand what's happening in fintech, including getting reg tech help as well.

In terms of the second prong and the focus on enforcement, the CFTC has issued several guidances to this end. One is the LabCFTC Primer in October 2017. In that Primer, the CFTC made a very important point, which is that for derivative on commodity, the CFTC has broad authority, regulatory and enforcement.

But even in the underlying cash market, for those transactions, the CFTC has authority over fraud and manipulation. That was a very important point that the CFTC made clear that they saw their jurisdiction expanded in that way. They also noted several prohibited activities, including price manipulation, wash trading, and failure to register platforms and intermediaries.

There are also other advisories. There were two advisories that were focused on more of the retail customers talking about general concerns over Bitcoin and just volatility in the market, pump-and-dump schemes, etc.

Let's go on to enforcement, which has several pieces. It chases the first coinflip of 2015. Basically, the platform was found in violation for not registering. Then TeraExchange, in that same year was accused of wash tradings by the commission.

The Gelfman Blueprint scenario was alleged to be a Ponzi scheme just using cryptocurrency. Cabbage Tech was also alleged to be basically fraud, misappropriation of funds, straight theft just using cryptocurrency.

The Dillon Michael case saw 1.1 million in Bitcoin taken from over 600 people and then misappropriated through this alleged Ponzi scheme. In My Big Coin Pay, the Commission alleged that the actual platform had made fraudulent statements claiming, for instance, that the currency was backed by gold, when it was not.

Looking back at these enforcement matters, several things stand out. One is that a lot of this is just garden variety fraud just in crypto and also that the commission is going after the exchanges as well as the intermediaries.

Let's look back here. I think that the fundamental questions that you have to ask yourself if you are innovating in this space are, number one, 'is the financial product that you're using a CFTC-regulated product?' If it is a derivative on a cryptocurrency, it definitely is, but then again, the actual cryptocurrency itself may actually be a derivative based on how it's structured, based on the programming.

If yes, it is a CFTC-regulated product, then question two is 'does the way that you are interacting with this financial product subject you to registration?' Not everyone who uses a derivative has to register, but if you are a platform or an intermediary, then you may have to.

Lastly, there are also certain requirements that even if you're not required to register, you still have, including reporting and recording keeping.

Jennifer: Thank you, Petal. We're seeing some questions regarding the standard risk disclosures

recommended on marketing materials discussing cryptocurrencies.

There are lots of things you need to worry about around the marketing materials discussing cryptocurrencies. As I mentioned before, that was a big part of the *Munchee* case. You need to be careful if you're trying to not acknowledge that this thing that you're selling is a security and you certainly don't want to be marketing it as an investment.

Even that aside, whether you're doing a securities offering or you're doing a utility non-securities ICO, I think the derivative disclosures are not especially different from what you would see in a more traditional securities offering. You need to disclose the material risks to your purchasers of what could affect their transaction.

We see besides the normal business risk disclosures that these are startups, and you need to understand before you buy anything that there's risk in investing in any early-stage company. If we're talking about a securities offering that's compliant with like the private placement exemption, I'd expect to see a pretty significant disclosure about the lack of liquidity and transferability of these things.

You do see in a lot of these offerings that the companies are acknowledging the regulatory risk here that the SEC space is evolving and that even the ones who say that they have a strong *Howey* analysis and don't believe they're selling a security, usually use this risk disclosure saying, "We could be wrong."

Glenn: The next question asks: 'Many companies pre-sell tokens to accredited investors using Regulation D. How do you analyze the securities and financial regulations they will have to comply with when they want to include crypto tokens for sale on their app or platform?'

It's an interesting question and it covers a couple of points that I wanted to address. The pre-sales or Simple Agreements for Future Tokens(SAFTs) are almost always a security. The issuance of a SAFT should be treated as a security. SAFTs involve the sale of tokens for future delivery at a time when the token has not yet been created or when the tokens relate to, in fact, a platform that has not yet been significantly developed and or commercially used. In these cases, the tokens are often securities because their future value depends significantly on the efforts of the token sponsor, and that's one of the key prongs of the *Howey* test that Jennifer has outlined.

The SAFT typically also is a security because it is a contract to buy a security. It is a contract to buy these tokens. The tokens that are issued pursuant to a SAFT maybe securities, they may not be securities. Whether a token delivered pursuant to a SAFT is a security continues to depend on whether the value of the token depends significantly on the efforts of the token sponsor and potentially on another third parties as well. So the *Howey* test, again, would govern that analysis. The fact that the tokens were purchased on a delayed basis through a SAFT rather than through a direct issuance is not particularly a fact to the analysis of whether the tokens are securities.

At the time that SAFT converts to a token, to the extent that the token is solely a utility token, the token should be treated as a security. And, as Jennifer indicated, there is a possibility the utility token that has utility on a fully developed platform that's widely used is not a security. If the token-based platform is fully developed and the tokens are widely used commercially on that platform, they should be treated as securities. But the problem is that many token-based platforms are never fully developed.

The sponsors, the companies that are issuing or creating the tokens are always continuing to develop or market the platform or the continuing commercial viability of the platform may be dependent upon third

parties to develop new applications to run on that platform like Ethereum, for example. In these cases, even tokens that have some utility at the time they're issued may still, in fact, be securities because of the continuing efforts of the platform sponsor and others may have a significant impact on the value of the token.

The bottom line to this question is you need to constantly run the *Howey* test to determine whether the underlying token that's being issued pursuant to a SAFT is, in fact, a security or not.

Jennifer: Let's talk about what happens if you do one of these offerings as a compliant securities offering under one of the exemptions that I mentioned, since we've got a few questions in about Regulation A and about Regulation D.

One is 'Will a Regulation A ICO be allowed in all US states?' Now, that's a good question. It depends, is the answer. There are two tiers to Regulation A. If you did tier one, the offering would still be subject to states' securities regulation and you'd have to go through the process with the states and it would not necessarily be allowed in all US states.

If you did the offering under tier two of Regulation A, which comes with more requirements and more ongoing reporting afterwards, it's not the easiest thing in the world. But, if you did a tier two Regulation A offering, that comes with preemption of the states securities laws. So I think that that would be allowed in all US states.

Regulation A securities would be tradable. I saw a question about whether they would be allowed to be traded on a secondary market. In theory, yes, but you'd need to find a secondary market, some sort of exchange or an ATS that is willing to trade these because they would be securities.

You'd need to have a broker-dealer or a regulated entity in the middle of that transaction and it wouldn't probably just be able to go trade on the existing crypto exchanges that are out there because they're not set up to be broker-dealers and engaged in securities transactions for the most part.

On Regulation D, someone was paying attention to what I said about the transfer restrictions and not being freely tradable for a year. If you want to do a fully compliant Regulation D offering, one of the terms of that rule is that the issuer has to take steps to make sure that the purchasers know that their securities are restricted and can't be resold without compliance with the securities laws.

Another question I saw is whether or not there are requirements for a 12-month lock-up. It's not a requirement in the rule that you actually put on a 12-month lock-up, but you definitely have to take reasonable steps to not allow those securities to just go be traded willy-nilly. The consequences of not paying attention to that part of the rule means that the exemption would not be available to you and so that would not be especially compliant. Those are some kind of securities laws questions that came in.

Glenn: We did receive some questions about how the regulatory environment in the US has become inhospitable for token offerings. Can we just simply take offshore and create a new entity abroad or do the offering in a more favorable jurisdiction?

It's a good question. Using an offshore entity to issue tokens certainly does not change the applicability of securities laws to tokens if they are offered and sold in the United States. Tokens that are securities generally may only be sold in the US by the issuer if the tokens are registered with the SEC or they're sold in an exempt transaction as Jennifer has explained. This is true regardless of where the issuer of the

token is located. If you're actually distributing the tokens in the US, you need to comply with securities laws in the US.

While certain foreign countries are widely viewed as providing a less restrictive regulatory environment for tokens than the current regulatory environment in the US, in my view, in many instances, it's really too early to tell whether this position is fully justified. Several countries have indicated that they may treat some tokens as securities. Other countries have barred token offerings entirely or otherwise encouraged issuers to proceed with caution. The bottom line is you should consider local law when you're offering a token in jurisdictions outside of the US.

There was also a question about how the proceeds of the coin offerings are treated. Such as whether it's treated as a purchase of prepaid services alone, whether it's treated as equity on your balance sheet, or something else. Again, a very good question. The bottom line is, in the United States, for federal income tax purposes, most direct sales of tokens generate taxable income to the token issuer on the basis that you're prepaying for services or goods. They're not treated as traditional equity.

We believe that an issuer may defer a portion of the income from the sale of a pre-sale or a SAFT for one year under certain circumstances, but yes. So, to the extent that you're issuing a utility token that will have utility on a platform, it's not going to be treated on your balance sheet as traditional equity. You need to think about the manner in which the IRS will be treating this and all indications are that these sales will be treated as taxable income.

Petal: That concludes our presentation today. Thank you all very much for joining us. We hope you will join us for our next session on April 10, where colleagues will talk about term sheet basics and best practices for negotiation. You'll receive information about that topic in the coming weeks.

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