

The logo for K&L GATES is displayed in white, uppercase letters within a red rectangular box. The background of the slide features a stylized financial chart with teal bars and a red line graph, overlaid on a dark blue background with horizontal lines and binary code (0s and 1s) in a lighter blue color.

13 December 2017

ICOs - The Hottest Thing in FinTech *and* a Trap for the Unwary

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AGENDA

- Introduction
 - What are ICOs? The ICO Boom
 - Legal and Regulatory Concerns
 - Potential Liability and Options
- When ICOs are likely to be an offering of a security
 - Limiting scope; private placement offering
 - Simple Agreement for Tokens, or “SAFTs”
- Why ICOs? Two business perspectives
 - David Harris, London Stock Exchange
 - Jos Evans, AI Exchange
- Q&As





WHY ARE WE HERE?

- ICO “boom” heard ‘round the world – perceived as a fast way to raise big money
- Gap between what happened from 2016-2017 and the current legal landscape <https://www.tokendata.io/>

HEADLINES -

- Boom in Bitcoin and Ethereum brings surge in initial coin offerings
- 2017 ICOs Boom, and There’s More To Come
- Crypto boom spawns blockchain accelerators to help startups raise funds with ICOs

BUT ALSO

- “ICOs Are Absolutely Securities” Says Former SEC Boss Amid Crypto Boom
- Cryptocurrency boom stalls as regulators focus on ICOs





INTRODUCTION: WHAT ARE ICOS?



WHAT ARE INITIAL COIN OFFERINGS?

- A means of raising funds for new businesses, by issuing and selling “tokens” that are issued on the blockchain and may be able to be sold on various token/currency exchanges.
- Digital tokens should be distinguished from primary cryptocurrencies.
 - Often issued pursuant to creation of a smart contract formed on Ethereum distributed ledger.
 - Many different purposes for tokens and can implicate various regulatory frameworks.
- Two levels – “icing” and the “cake”. Underlying business is key.
- Digital tokens can have the following features:
 - Equity like features (e.g., voting rights and rights to distributions).
 - Debt like features (e.g., right to receive fixed additional tokens or revenue from mining or other activities).
 - Consumptive use tokens (e.g., prepayment of right to use services on the platform).





INITIAL COIN OFFERINGS

- Why do an ICO? Perceptions of:
 - Rapid fund raising
 - No dilution of ownership
 - No liquidation preferences
 - Potential for Transferability
- Primary role of secondary market
- Crowdfunding / General Solicitation
- Documents
 - Terms and Token Sale Conditions
 - White Paper
 - PPM/Risk factors





CRYPTOMANIA!

These tiny "penny cryptos" could be like buying bitcoin in 2011 research.palmbeachgroup.com

Bitcoin (USD) Price

Closing Price OHLC

1h 12h 1d 1w 1m 3m 1y All

Dec 6, 2017 to Dec 7, 2017 [Export](#)



\$15,547.30 ▲ **13.41%**

Today's Open	\$13,708.99	Change	▲ \$1,838.31
Today's High	\$16,615.94	Market Cap	\$0.26T
Today's Low	\$13,336.40	Supply	16,726,425





CRYPTOMANIA!

Ethereum (ETH) Price

Closing Price OHLC

1h 12h 1d 1w 1m 3m 1y All

Dec 6, 2017 to Dec 7, 2017 [Export](#)



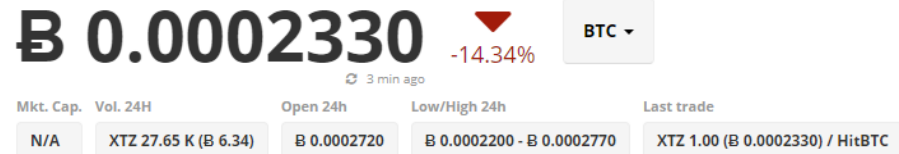
\$435.42 ▲ 1.70%

Today's Open	\$428.13	Change	▲ \$7.30
Today's High	\$441.40	Market Cap	\$39.79B
Today's Low	\$414.41	Supply	96,195,931

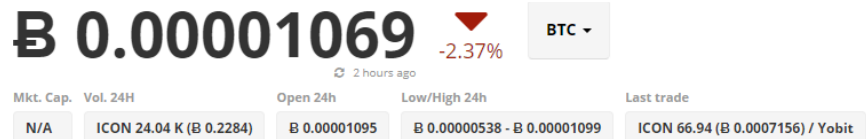


A CLOSER LOOK AT ICO TOKENS

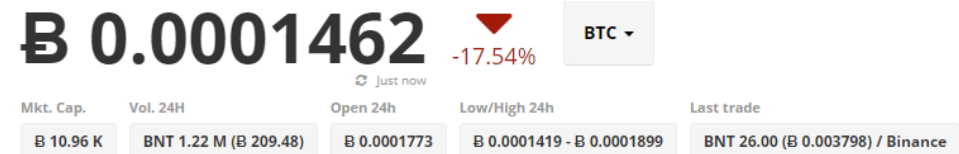
Tezos: Completed July 2017
(July 1-13)
Raised **\$230,498,884**



Icon: Completed September 2017
(Sept 20-20)
Raised **\$42,561,000**
Sale price **\$ 0.213**
Current price **\$1.861** **8.75x**



Bancor Protocol: Completed June 2017
(June 12 - 12)
Raised: **\$153,000,000**
Sale price **\$3.857**
Current price **\$ 2.528** **(0.66x)**





GROWING REGULATORY CONSIDERATIONS FOR ICOS



REGULATORY CONSIDERATIONS

- Securities law implications of certain digital-token offerings are garnering particular attention from regulators.
- In addition, regulators globally have expressed concern about the potential for fraud, money laundering, tax evasion and cybersecurity risks.
- Regulators from the following countries have signaled concerns with ICOs:
 - Singapore
 - Canada
 - Peoples Republic of China
 - Republic of Korea
 - Russian Federation
 - Hong Kong
 - United Kingdom
 - Malaysia
 - Thailand
 - Dubai





SECURITIES CONSIDERATIONS

- Whether a digital token is a security depends on the facts and circumstances of the particular case
- If a token is a security it can be offered and sold only in compliance with United States securities law
 - Under the Securities Act, is the offering properly registered or exempt from registration? If exempt, are the investors accredited investors and did they receive adequate disclosure?
 - Under the Exchange Act, is the offering conducted through a platform compliant with Regulation Crowdfunding? Are any intermediaries, such as token exchanges or brokers, registered as broker-dealers?
 - Depending on the structure of a token offering, investment advisory considerations may be applicable, including the SEC custody rule. Similarly, Investment Company Act issues may come into play.



ARE TOKENS SECURITIES?

- Recently, the U.S. Securities and Exchange Commission (“SEC”) issued its report concluding that the tokens issued by the DAO constituted securities.
- The DAO - acronym for “decentralized autonomous organization,” i.e., a virtual organization embodied in computer code and executed on a distributed ledger or blockchain.
- Investors contributed Ether in exchange for DAO Tokens.
- DAO Tokens had limited voting and ownership rights.
- The DAO intended to earn profits by funding projects that would provide DAO Token holders a return on investment.
- No limit on number of DAO Tokens offered or on the number or accreditation status of purchasers
- Capital raise equivalent to US\$150 million.



ARE TOKENS SECURITIES?

- SEC applied the US Supreme Court's Howey test to determine whether DAO Tokens constituted an “investment contract” (and thus a security) under Section 2(a)(1) of the U.S. Securities Act of 1933 and Section 3(a)(1) of the U.S. Securities Exchange Act of 1934.
- Pursuant to the Howey test a transaction is an “investment contract” if all of these features exist:
 - (1) an investment of money
 - (2) in a common enterprise
 - (3) with a reasonable expectation of profits
 - (4) to be derived from the entrepreneurial or managerial efforts of others.

SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)





ARE TOKENS SECURITIES?

- Utility tokens – i.e., those with a consumptive use -- might not be securities because of their consumptive or redemptive qualities.

“[W]hen a purchaser is motivated by a desire to use or consume the item purchased – ‘to occupy the land or to develop it themselves,’ as the *Howey* Court put it, - the securities laws do not apply. . . .” *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).
- Securities regulatory characterization may depend on the nature of the smart contract, features of the token, accounting treatment, the use of proceeds and the extent and nature of presale or build-out activities.
- The SEC will look closely at facts and circumstances and whether a token represents consumptive value or an investment contract. An important consideration may be whether the consumptive use is immediately available





ARE TOKENS SECURITIES?

- ICO sponsors and intermediaries need to keep in mind that Howey might not be the only test that could be applied.
- The application of a particular test may depend in part on whether the token has debt or equity features as discussed in a prior section
 - Risk Capital Test. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811 (1961).
 - Family Resemblance Test. *Reves v. Ernst & Young*, 494 U.S. 56, 66-67 (1990).
 - (1) “the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]”;
 - (2) “the ‘plan of distribution’ of the instrument,” including an assessment of whether “there is common trading” of the instrument “for speculation or investment”;
 - (3) “the reasonable expectations of the investing public”;
 - and (4) “whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the investment, thereby rendering application of the Securities Acts unnecessary.”
- Also remember – in addition to securities law considerations digital tokens may raise commodity law issues depending on the facts.





IF TOKENS *ARE* SECURITIES...

If tokens are securities they may be offered in the United States or to US investors only in compliance with the registration requirements of the Securities Act or pursuant to an exclusion or exemption from those requirements





OFFSHORE SALES ONLY

- **SAMPLE: Representation and Warranties of Contributor**
- By making a contribution (i.e. transferring ETH to the Smart Contract System) for the purchase of Tokens, you hereby represent and warrant that:
 - ***
 - you are not a citizen of or resident or domiciled in the United States of America or making a contribution for the purchase of Tokens from a location in the United States of America, nor are you an entity (including but not limited to any company or partnership) incorporated, established or registered in or under the laws of the United States of America, nor are you making a contribution for the purchase of Tokens for or on behalf of any such person or entity;
 - Query: How effective are these restrictions?



PRIVATE PLACEMENT/REG D

- Private placement (or non-public offering) is a funding round of securities which are sold not through a public offering, but rather through a private offering, mostly to a small number of chosen investors. PIPE (Private Investment in Public Equity) deals are one type of private placement.
- Rule 506 of Regulation D is considered a "safe harbor" for the private offering exemption of Section 4(a)(2) of the Securities Act. Companies relying on the Rule 506 exemption can raise an unlimited amount of money from accredited investors.
- A Private Placement Memorandum ("PPM"), also known as a private offering document and confidential offering memorandum, is a securities disclosure document used in a private offering of securities by a company or investment fund.



REGULATION A OFFERING

- Regulation A unregistered offerings to retail investors subject to conditions that may make it unsuitable for large offerings but may be useful for small ones
- Amended in 2015 pursuant to the JOBS Act to be more practically useful
- Annual volume limitation (\$50 million or \$20 million with sublimits for sales by selling security-holders) depending on whether the issuer is a tier 1 issuer or a tier 2 issuer as defined in Regulation A.
- As with a registered offering, Regulation A requires that the issuer provide specified disclosures to investors and file an offering statement with the SEC, and it provides the SEC with power to issue stop orders.
- Tier 2 issuers are also subject to additional disclosure and ongoing reporting requirements, including enhanced blue sky requirements



FRAUD RISKS

The SEC Filed Fraud Charges Against 2 'Initial Coin Offerings'

<http://fortune.com/2017/10/01/sec-ico-fraud-charges/>

October 1, 2017

In a move that should be welcomed by anyone serious about innovation in financial technology, the Securities and Exchange Commission announced Friday that it would prosecute the creator of two stock-like “ICOs,” or Initial Coin Offerings, which it alleges were sold on the basis of fraudulent claims.

The two ICOs in question were marketed as “REcoin” and “DRC,” and both were run by Maksim Zaslavskiy. REcoin was advertised as “The First Ever Cryptocurrency Backed by Real Estate,” while DRC, or Diamond Reserve Club, claimed to be backed by investments in diamonds. They were touted as full-fledged companies with staff, lawyers, and relationships with retailers. But according to the SEC, neither scheme had “any real operations.” They made no investments on behalf of token buyers, and misrepresented their total level of investment.

Nearly as bad, the SEC says the digital tokens they claimed to be selling “don’t really exist,” meaning REcoin and DRC – much like the notorious global scam OneCoin – weren’t running on blockchains at all, and therefore weren’t even really ICOs.



BUSINESS CONSIDERATIONS IN LAUNCHING AN ICO

- Looking at the big picture
- Understanding the business model and having a plan—easier said than done





QUESTIONS TO ASK

- What can the token be used for?
 - Ownership of shares? Voting rights? These are indicia of a security.
 - Usable to purchase something? Consumable? These are indicia that the token would not be a security.
 - When will the product be available for use or shipment?
- Who is the issuer and in which jurisdiction(s) will it operate?
- Who are the service providers for the ICO, what are the services being provided, and where will they perform their service operations?





THE SAFT SOLUTION





SAFT – MITIGATING RISK?

- Simple Agreement for Tokens (“SAFT”) – Balances (i) need for fundraising to build a platform, and (ii) attempting to ensure a token issued after the buildout is not a security and thus can trade on a secondary basis.
- The token is issued sometimes months after the SAFT fundraising.
- SAFT issued typically in a Rule 506(c) offering and deemed a security. Simple document verifying investor identity and accredited investor status. Issuance benefits from NSMIA pre-emption.
- Token issued subsequent to SAFT deemed not a security based on consumptive use.
- Still in the beginning stages



SAFT – MITIGATING RISK?

- SAFT is not a cure-all for utility tokens. Potential limitations:
 - Is the token sold primarily to persons who could never use it for its intended purpose and whose primary interest is secondary market trading?
 - How much utility is required for the token not to be a security? Will managers of smart contract continue to be adding value over time?
 - Will managers of smart contract be able to manipulate redemption value of a token?
 - Will managers of smart contract be able to control the supply/demand of tokens in the secondary marketplace?
- SAFT may enjoy NSMIA pre-emption, but the tokens, which are purportedly not securities, have no such pre-emption. How might one of the state regulators view a token issued subsequent to a SAFT?



POTENTIAL RISKS – U.S. LAW





THANK YOU

