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INSIGHT: Regulation A: A Pathway for the ICO?

BY BONNIE J. ROE

How should an initial coin offering, or ICO, be conducted? Despite a burgeoning ICO market, there is little consensus.

ICOs are offerings of digital assets, or tokens, generally associated with a platform or project to be developed by the issuer or sponsor of the token, usually a start-up company. The token represents a set of rights on a distributed ledger or blockchain and is typically designed to have some use or functionality on the platform to be developed. Tokens may, but generally do not, represent a share of the issuer's stock. Tokens are generally designed to be freely tradable, at least theoretically, without the use of an intermediary.

Regulation A may be the best alternative for conducting an ICO. An alternative to registration under the Securities Act of 1933, as amended (the ''Securities Act''), Regulation A makes it possible for early-stage companies to offer securities to retail investors. Unlike privately issued securities, tokens issued under Regulation A would be potentially tradable without federal securities law restrictions and could be sold initially to retail investors.

To use Regulation A, however, ICO sponsors may need to make some fundamental compromises when structuring both the token and the token issuer. These compromises might provide greater protection for token investors and force token issuers to take on greater long-term responsibilities to their token investors. Whether ICO sponsors will see these compromises as being worth the effort remains to be seen.

Some Background on the ICO Market The use of Regulation A for ICOs began to be discussed in the fall of 2017, and the first Regulation A offering statement for an ICO issuer was filed in November 2017. Previously, most ICOs were conducted as if there were no applicable regulations governing them. Entrepreneurs took the position that the tokens were not securities, and therefore the sale of the tokens was not a securities offering. Tokens were designed to have some use, defined in a ''white paper'' posted on the issuer's website. The tokens typically did not purport to represent either debt or equity on their creator's balance sheet. Tokenholders did not have voting rights, except possibly with respect to projects on which their tokens could be expended or other matters affecting the future ''ecosystem'' in which the tokens were designed to be used or traded. In the meantime, tokens minted in many ICOs were freely traded on newly established, unregulated (and potentially illegal) token exchanges.

Of course, securities lawyers worried that the tokens might in fact be securities, because they were issued to raise capital for enterprises which would use the funds to engage in activities that were designed to make the tokens more valuable. Investors purchased tokens with the expectation that the tokens would increase in value through those efforts and that they would be able to resell the tokens for a higher value. Various lawyers and others in the industry developed scoring systems to distinguish between ''utility tokens,'' which were thought not to be securities, and ''security tokens,'' which were. In many cases, however, the projected utility was often far in the future and depended on the development of an ecosystem or market only vaguely outlined in the white paper.

Into this Wild West environment strode the Securities and Exchange Commission (the ''SEC'') on July 25, 2017, brandishing the so-called DAO Report, an investigative report of an ICO pursuant to Section 21(a) of the Securities Exchange Act of 1934, as amended (the ''Exchange Act''). In the DAO Report, the SEC stated that, while not all tokens were necessarily securities, each had to be analyzed separately under the existing case law governing whether an instrument or other asset should be considered a ''security'' for the purposes of applying the federal securities laws. The SEC then applied the test first used by the U.S. Supreme Court in 1946 in *SEC v. W.J. Howey Co.* to the DAO token and found that it met all four elements of the *Howey* test: (i) an investment, (ii) in a common enterprise, (iii) with the expectation of profits, (iv) through the efforts of others.

Since the DAO Report, the SEC has continued to study the ICO market. While the principles that were announced in the DAO Report have not changed, it is possible to discern some evolution in the SEC's thinking over time. In off-the-cuff remarks made in a speech given in November 2017, SEC Chair Jay Clayton noted that he had ''yet to see an ICO that did not have a sufficient number of hallmarks of a security,'' which effectively put an end to many an argument that any particular token was not really a security because of some element of utility that it purported to have. In ruling on the Munchee token in December 2017, the SEC affirmed that having a current utility does not make a token not a security.

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More recently, in a speech on June 14, 2018, William Hinman, the Director of the SEC's Division of Corporation Finance, suggested that it might be possible for a token to evolve from a security into a currency, as many believe that the digital currency Ether has done. In Hinman's view, a digital asset will most likely be found to be offered as an investment contract and thus a security if ''a third party—be it a person, entity or coordinated group of actors—drives the expectations of a return.'' That in turn will depend on any number of facts and circumstances, including, among other things, whether a person or group has a stake or interest that would provide a motivation to seek to increase the value of the tokens and whether purchasers of the tokens were seeking a return. In the case of Ether, Hinman believed that the network now is sufficiently decentralized, with no party particularly interested in driving a return. Nonetheless, Hinman stressed that under his analysis most ICOs are securities offerings.

Possible Exemptions from Registration and the SAFT Alternative If tokens are securities, then under Section 5 of the Securities Act their offer or sale must be either registered under the Securities Act or exempt from registration. Going through the most likely options and some of their more obvious drawbacks quickly, tokens might be issued in compliance with:

- Rule 506(c) of Regulation D, which, among other things, would limit the offering to verified accredited investors and result in the issuance of ''restricted securities'' with a one-year holding period;
- Regulation S, solely to non-U.S. persons outside the U.S., with limitations on the ability to re-sell to U.S. investors;
- Regulation Crowdfunding, under which no more than $1,070,000 can be raised in any 12-month period;
- Full registration on Form S-1 under the Securities Act, a prospect too daunting for most ICO issuers; or
- Regulation A, as further described below.

Most issuers currently choose a path that evolved in the months following the DAO Report. While acknowledging that a token with no current utility might be a security, common thought was that when the platform, for which the token was developed, becomes fully functional, the token would no longer constitute a security. On this theory, it was proposed that investors might instead purchase rights under a ''simple agreement for future tokens,'' or SAFT, which could be exchanged for tokens, at a discount, when the platform or business for which they would have a use had been established. While the SAFTs are acknowledged to be securities and are sold in compliance with Rule 506(c), the hope is that the tokens, when issued, will not be securities and can thus trade freely without restriction, at least as far as the securities laws are concerned.

One problem with the SAFT is its basic assumption that when the platform is developed, the tokens won't be securities, a conclusion that seems doubtful in light of the SEC's interpretations and the typical structure of an ICO or SAFT issuance. Essentially the SAFT depends on the idea that having a utility precludes an asset from being a security, a position that the SEC has rejected. Yet even if the tokens are no longer securities when they are ultimately issued, they might be considered securities in the hands of the SAFT investors, who purchased the SAFTs to invest in the tokens while relying on the efforts of the ICO sponsors to make the tokens valuable.

Purchasers of a SAFT would be able to sell either the SAFT or the resulting token, but only in private transactions and subject to the various federal and state restrictions that apply to sales of other privately issued non-reporting company securities. For some measure of free transferability, either Regulation A or full registration under the Securities Act would be required.

Regulation A Requirements While Regulation A is meant for smaller companies, it imposes a significant compliance burden, including the preparation of a detailed disclosure document, or offering circular, that is filed with the SEC via EDGAR. The offering circular is part of an offering statement on Form 1-A, which is similar to a registration statement on Form S-1, only shorter and less comprehensive. The Form 1-A is subject to SEC review and comment before the SEC declares it to be ''qualified,'' much in the way that a registration statement undergoes SEC review and comment before being declared effective. The initial filings of a first-time Regulation A issuer may be made confidentially, so long as the Form 1-A is filed publicly at least 21 days before becoming qualified.

For Tier 1 of Regulation A, which permits offerings of any amount up to $20 million, the issuer has minimal post-qualification disclosure requirements. Tier 2, however, which permits offerings in any amount up to $50 million, requires the issuer to file periodic reports modeled on those that might be filed by a reporting company, but in less detail. While Tier 2 requires audited financial statements, Tier 1 requires only financial statements that are prepared in accordance with generally accepted accounting principles, unless audited financial statements have otherwise been prepared.

Tier 1 offerings are not exempt from Blue Sky qualification, although a coordinated filing and review system makes this less onerous than it might seem. Tier 2 offerings are exempt from Blue Sky qualification, but states may impose filing requirements, with relatively high filing fees and possibly other requirements relating to the use of broker-dealers.

Given these complex requirements, what is the attraction of Regulation A? First, that the securities issued under Regulation A are not ''restricted securities'' under Securities Act Rule 144, and therefore, from a federal securities law standpoint, can be freely transferred, without registration or an exemption from registration, by a person who is not an affiliate of the issuer. The extent of this benefit, however, can easily be overestimated. Unless listed on a national stock exchange, which requires full registration under the Exchange Act, securities issued under Regulation A are not ''covered securities'' under Section 18(b) of the Securities Act. This means that they are not exempt from any applicable Blue Sky qualification requirements when they are transferred from one shareholder to another. In addition, in the absence of current reporting, provided by compliance with Tier 2 but not Tier 1, prices for securities cannot be quoted publicly by brokers under Exchange Act Rule 15c2-11. A hypothetical token that was issued under Tier 2 by an issuer that was current in its Tier 2 reporting could be traded by a registered broker-dealer on an over-the-counter market or online platform if an exemption from Blue Sky qualification could be obtained. Many states have a ''manual exemption'' that enables securities of an issuer listed in a manual to be traded by brokers without Blue Sky qualification in

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their state, and it might be possible for the hypothetical token issuer to obtain such an exemption. Without current reporting and without a Blue Sky exemption, however, the seamless trading envisaged by ICO enthusiasts would be impossible.

Another attraction of Regulation A is the ability to make initial sales to investors without first determining that the investors are accredited, as would be necessary for either Rule 506(b) or (with possibly more verification efforts) Rule 506(c). Sales of Tier 1 securities can be issued to non-accredited investors without any restriction, while Tier 2 securities are subject to a minimal restriction: issuers must note in their offering materials that non-accredited investors may not purchase the securities in amounts greater than 10% of their annual income or net worth.

Special Problems of Preparing a Regulation A ICO As the fundamental message that tokens would be treated as securities was absorbed towards the end of 2017, a number of potential ICO issuers began to prepare Regulation A filings. Yet by the end of the first half of 2018, only four such issuers had filed a publicly available Form 1-A, and none of these filings had yet to become qualified. Of course, it frequently takes a long time for smaller companies to prepare filings and to complete the SEC review process, generally because such companies have fewer resources at hand. There is no reason to assume that the ICO issuers would not experience difficulties of this kind. Nonetheless, there are a number of other problems that are unique to ICO issuers.

Eligible Securities

Regulation A is only available for the sale of ''eligible securities,'' defined in Rule 261(c) as: equity securities, debt securities, and securities convertible or exchangeable to equity interests, including any guarantees of such securities, but not including asset-backed securities.

In themselves, tokens are not clearly any of the above types of securities. Although it is possible for tokens to represent a class of equity securities, this is not what most ICO issuers envisage. To use Regulation A, an ICO issuer must organize as an entity and establish the relationship of the token to the entity, as debt or (more likely) a class of equity securities of the issuer, or a right to convert into a class of equity securities, either at the option of the token holder or upon the occurrence of certain events.

Of the four Form 1-A offering statements filed for an ICO in the first half of 2018, two relate to tokens representing either common or preferred stock and one is for a token convertible into common stock on certain events (an underwritten offering of common stock meeting certain criteria; the board's decision to declare a conversion event; or bankruptcy). The fourth, in its May 2017 filing, covers warrants that convert into tokens; if no token issuance occurs, management may in its discretion cause the warrants to be converted into common stock.

Identifying the Issuer

As the classic ICO token represents rights on a decentralized ledger, not an interest in the particular company that caused it to be created, it could be argued that there is no ''issuer'' in an ICO. Moreover, for some ICO transactions, it may literally be difficult to identify the issuer, as key elements of the network to be built may be held in different entities, and individuals listed as key backers of the ICO may have little or no formal connection to the entities.

Recording Transactions on the Issuer's Financial Statements

If the token is neither equity nor debt, even if it is convertible into equity under certain circumstances, its place on the balance sheet of an entity may be unclear and for similar reasons it may be difficult to determine how to account for the transaction in which the tokens are issued. This may make it challenging to prepare financial statements for the initial Regulation A filing.

Periodic Reporting Obligations

Because ICO issuers presumably want to use Regulation A to facilitate aftermarket trading, they are most likely to select Tier 2 of Regulation A. Given the uncertainty about how to account for the ICO issuance and perhaps how to report on the development of the network on a going forward basis, preparing the subsequent reports required of Tier 2 filers could be difficult. Moreover, like other early stage companies, ICO issuers may be hesitant to commit to long term reporting requirements.

Establishing the Rights of Securityholders

If tokens are sold with the expectation that the proceeds will be used to create a network or project in which the tokens will have a particular function as described in the offering materials, then presumably token holders will have a right of action against persons identified in the offering materials if the proceeds are used for some other purpose. In this sense, purchasers of tokens or instruments convertible into tokens may have rights against the ICO organizers, without there being any constituent documents. If the tokens are not either debt or equity, however, token holders will not automatically have any of the traditional rights that holders of equity or debt have under constituent documents such as a certificate of incorporation, bylaws, indenture or note purchase agreement or any rights under state corporation law. For example, there would be no voting rights or rights on liquidation. One way to address that particular absence might be through agreements with the purchasers that might apply also to their successors and assigns. Defining and describing the rights embodied in these agreements in response to Form 1-A's requirement that the issuer describe the rights of securityholders might give comfort to the SEC reviewer that investors could become adequately informed about the nature of their rights.

Ability to Track and Record Transfers

Theoretically, blockchain transactions provide their own transparent and immutable record of transfers and, theoretically, this might obviate the need for intermediaries such as transfer agents. But secondary sales on the blockchain, if they are allowed to occur without intervention, are both anonymous and outside the control of the issuer or anyone acting on the issuer's behalf. This may make it impossible to know who is buying or selling, which opens up a Pandora's box of questions. Is an insider buying or selling with inside information? Is the seller a major holder or other affiliate who might be deemed to be an underwriter and whose sales might result in the purchasers acquiring restricted securities? Is an unlawful distribution or pump-and-dump scheme taking place?

Possible Need for Exchange Act Registration

While the SEC generally expects issuers to maintain accurate stock ownership and transfer records, it does

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not require Regulation A issuers to retain a registered stock transfer agent. Retaining such an agent, however, is the condition of one benefit accorded to Tier 2 issuers: if they do so, record holders of the securities they issue pursuant to Regulation A will not be counted for purposes of determining whether the issuer needs to register its securities under Section 12(g) of the Exchange Act. Section 12(g) requires registration for issuers of equity securities that have over 2,000 record holders or over 500 record holders that are non-accredited investors.

If secondary sales can occur without a transfer agent and without the issuer's knowledge, the issuer may have to register the tokens under Section 12(g) of the Exchange Act. The issuer will have no other way of knowing if either the 2,000 record holder or the 500 non-accredited record holder threshold is reached.

Currently, there are apparently no transfer agents providing services to issuers of tokens. However, the token issuer could impose restrictions on the transfer of tokens so that each transfer could be scrutinized before it occurs, and the parties could identify themselves in some way to the issuer and any broker that might be involved.

Ability to Purchase Securities Using Cryptocurrency

ICOs generally permit investors to purchase interests using either ''fiat currency'' (such as U.S. dollars) or cryptocurrency. Because of fluctuations in the value of cryptocurrencies, the issuer should establish and disclose a protocol for how investments made at different times will be valued. For example, the issuer may escrow amounts received from prospective investors until a minimum investment amount is received.

The use of cryptocurrency also raises anti-money laundering (''AML'') and know your customer (''KYC'') concerns. Issuers of securities do not normally need to worry about AML and KYC issues. They receive their funds through banks and brokerage accounts and can rely on these financial institutions to maintain appropriate controls. For the ICO issuer, however, funds may come directly to the issuer's account on a cryptocurrency exchange. In this case, the issuer may need prospective investors to execute subscription agreements or similar documents that identify them for AML and KYC purposes.

A Tier 2 Offering of Tokenized Equity Securities: A Possible Solution A potential ICO issuer contemplating a Regulation A offering could make life relatively easy for itself by choosing to issue tokens that represent shares of a class of equity securities, with rights set forth in the issuer's certificate of incorporation and bylaws. Governance and other rights of token holders could thereby be established and described. Financial statements could be prepared and audited in the ordinary course. The token might be designed in such a manner as to permit the issuer to control transfers, possibly resulting in the ability to use a transfer agent. The issuer could then obtain an exemption from the Section 12(g) limitations on record holders for securities issued under Tier 2 of Regulation A. As long as the issuer remained current in its Regulation A reporting, the tokens could be traded over-the-counter or potentially on an online trading platform qualifying as an alternative trading system, or ATS, subject to any restrictions that might be imposed by state Blue Sky laws. In the alternative, the issuer might opt for full Exchange Act registration, plus a listing on a national securities exchange, if in the future any exchange were to permit token trading. This in turn might allow the tokens to be traded freely, exempt from Blue Sky regulation.

Such a model may not appeal to most ICO issuers and, among other things, it would be relatively expensive to implement. It is possible to imagine some legislative or regulatory fixes that would make some of this easier for the issuer or that would facilitate trading. For example, it might be possible to structure a Blue Sky exemption for all Tier 2 Regulation A issuers that were current in their SEC reporting. It is also possible to imagine being permitted to issue and sell under Regulation A tokens that bore little or possibly no relationship to the issuer's equity securities, so long as a defined set of rights of token holders existed. It is harder to imagine the SEC allowing trading of tokens issued in ICOs to occur without SEC reporting, including financial reporting and some disclosure of the governance or contractual rights of the token holders.

Free transferability comes with the price of SEC reporting and disclosure for the initial issuance and for subsequent trading. Given this basic regulatory bottom line, Tier 2 of Regulation A could be the best possible alternative for an ICO issuer looking to provide some measure of free transferability for its tokens.

Bonnie J. Roe is a corporate partner at Cohen & Gresser LLP with over 30 years of experience advising publicly and privately held companies and funds. Her practice focuses on securities law and capital markets, financial regulation, and fintech. Bonnie represents U.S and internationally based companies, financial intermediaries, and investors in public and private offerings, including cross-border offerings and initial coin offerings. She also regularly advises public companies and their boards of directors on public disclosure, SEC compliance matters, corporate governance, and executive compensation.

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