

ICOs As Exempt Securities Offerings: An Economic Analysis

By **Simona Mola, An Wang and Michael Liftik** (June 28, 2018, 2:36 PM EDT)

The number of initial coin offerings has exponentially increased since early 2017.[1] After a large setback in August 2017, possibly due to their being banned in China and South Korea,[2] ICOs have bounced back in 2018, reaching a total of 334 offerings and cumulative ICO proceeds of \$13.9 billion as of the end of May,[3] exceeding venture capital investment in blockchain projects.[4] According to the [New York Times](#), technology startups using ICOs can raise much more money, much faster, than venture capitalists.[5] For example, [Coinbase](#) — a virtual currency company funded with venture capital — raised \$225 million in five years and eight rounds of funding, while Filecoin raised over \$250 million in one month via an ICO.[6]

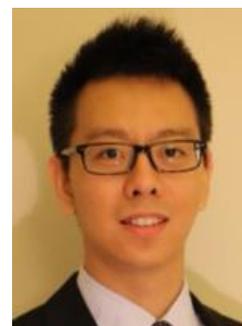
ICOs certainly have appeal as a new fundraising vehicle for startups and projects. However, given the legal uncertainty and the increasing scrutiny by regulators, they may not necessarily be a simple one. In July 2017, the [U.S. Securities and Exchange Commission](#) published its investigation on the crypto venture The DAO, concluding that tokens sold by The DAO are securities.[7] The report advises “those who would use a ... DAO, or other distributed ledger or Blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the US federal securities laws.”[8]

As the SEC pointed out, “[W]hether or not a particular transaction involves the offer and sale of a security ... will depend on the facts and circumstances, including the economic realities of the transaction.”[9] In particular, that determination depends on the bundle of rights to which investors are entitled when they purchase the tokens offered in an ICO. This bundle may include the right to share revenues from the project being developed or the company issuing the tokens, the right to vote on aspects of the project or on the management of the company, the right to participate in the development of the product or service being developed, or the right to use the product or service once it is developed.

The Howey test is often used to determine whether an ICO meets the definition of an investment contract, which is one form of a security. In [SEC v. W.J. Howey Co.](#), the [U.S. Supreme Court](#) held that an investment contract is a security if “a person invests his money in a common enterprise and is led to expect profits solely from



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the efforts of the promoter or a third party.”

In this article, we do not weigh in on the scope of the legal inquiry that determines whether a particular ICO is a securities offering. Instead, under the hypothesis that an ICO is deemed a securities offering, we examine the currently available mechanisms to raise capital for an ICO that would comply with securities laws. Based on the economic characteristics of recent ICOs, we analyze whether such mechanisms are suitable to facilitate capital formation for ICO issuers.

What Do Recent ICOs Look Like?

As **described in our previous article** on cryptocurrencies,[10] digital tokens issued through ICOs are secondary tokens that investors can purchase using a primary virtual currency, e.g., bitcoin or ether, usually at a fixed exchange rate. Some ICOs are structured into two phases — a pre-ICO phase with a discount to attract initial investors and a formal ICO phase — over a period of weeks or months.[11] Other ICOs are finalized within a very compressed period of hours or days.[12]

The proceeds are intended to finance projects typically described to investors in a white paper, while the terms of the offering are outlined in a smart contract code. At the time of the ICO, most projects are in prototype stage, with their launches expected within one to two years after the offering.[13] Approximately 77 percent of ICO projects are performed on the ethereum platform.[14] Rather than building a new private ledger, which would require considerable financial commitment, most ICO projects use an existing public blockchain, which may conversely have the effect of overloading the network and increasing the cost of running an ICO.

In terms of geography, most recent ICO projects are located in the United States, Russia and Singapore.[15] Sectorwise, most recent ICO projects fall in blockchain infrastructure, finance, social network and data storage.[16] Examples of large ICOs include Dragon Coins (\$320 million), a decentralized payment system for casinos and players; Filecoin (\$257 million), a blockchain-based storage network and cryptocurrency; Tezo (\$232 million), a blockchain network functioning as a digital commonwealth; EOS (\$185 million), a blockchain architecture allowing vertical and horizontal scaling of the capacities of decentralized applications; and Bancor (\$153 million), a digital decentralized clearing house for cryptocurrencies.

According to Coindesk, in the first months of 2018, the average ICO raised \$24 million. However, the fact that the median ICO raised only \$14 million indicates a significant dispersion in offering size, ranging from less than \$1 million to \$850 million.[17] ICO size, both on average and in median, is increasing over time. It should be noted, though, that these data reflect only successful ICOs. Only an estimated 48 percent of token sales are successful at completing the offering.[18]

A unique feature of an ICO is that both capital formation and exchange of the coins occur on internet blockchain infrastructures. Once issued via ICOs, secondary tokens exist separately from the virtual currency used to purchase them, with their values floating like exchange rates with regard to other virtual currencies, other ICO tokens, and rarely, fiat currencies. ICO tokens are often not restricted from being traded in the secondary market, so token holders can monetize their investments if the tokens increase in market value.

Development teams and advisers of cryptoprojects are usually subject to some level of vesting. An example of a vesting schedule for the development team is “three years with a three-month cliff,” meaning that a team member needs to be on the project for at least three months to receive any

tokens, and it will take at least three years, based on a preset maximum annual percentage, to sell off the entire holding of tokens. However, there is no uniformity in the vesting schedules: On average, it takes only 21 days from the completion of an ICO to the vesting of the tokens for secondary trading.[19]

Not all tokens issued via ICOs are equally liquid in the secondary market. Publicly offered tokens are more attractive to investors if there is a higher probability of their being listed on a cryptocurrency exchange. In the first quarter of 2018, less than 23 percent of the offered coins could be traded on exchanges, with the biggest hurdle being the listing cost. Based on conversations among market participants, listing cost can range from \$1 million to \$3 million, which may give issuers an incentive to overfund the project.[20]

What Mechanisms Are Available to Raise Capital for a Compliant ICO?

Assuming, as we are for present purposes, that the ICO is a security offering, the issuers must register them with the SEC unless they rely on an exemption from registration. Registering tokens via an initial public offering, which involves filing a lengthy disclosure document called a Form S-1, is not a suitable avenue in the crypto world. Among other issues, the exacting financial and governance disclosure requirements of an S-1 may pose significant challenges to most ventures looking to raise capital through an ICO. Another factor is cost. While a startup should expect to pay about \$500,000 in direct costs, mostly legal fees, to raise money through an ICO,[21] this is considerably less expensive than the direct costs of an IPO (typically equal to 7 percent of the proceeds).

Among the available exemptions from registration, three look well-suited for ICOs: Regulation Crowdfunding (Reg CF), Rule 506(c) of Regulation D, and Regulation A.[22] From an economic standpoint, these exemptions combine features that balance capital formation and investor protection. On the one hand, such exemptions would permit ICO issuers to raise different levels of capital, reach out to different types of investors, and promote different degrees of liquidity in secondary markets. On the other hand, these exemptions also emphasize the need for some investor protections, which is an important hallmark of the securities registration regime. In fact, an analysis of 1,450 digital coin offerings has found red flags in 271 offerings, including plagiarized investor documents, promises of guaranteed returns, and missing or fake executive teams.[23]

The table below illustrates the main features of these exemptions and highlights the trade-off between capital formation and investor protection. The greater the maximum offering size allowed under the exemption, the lower the ability to reach out to nonaccredited investors and to freely resell tokens in secondary markets.[24]

	Reg CF	Reg A	Rule 506(c) Reg D
Max offering size	\$1.07 million	Tier 1: \$20 million Tier 2: \$50 million	Unlimited
General solicitation	Yes, through funding portal or registered broker-dealer	Yes (testing the waters)	Yes
Investor	Individual investors subject to investment limits	Unlimited accredited investors + non-accredited investors subject to investment limits	Unlimited accredited investors; no non-accredited investors
Restriction on resale	Yes, for 1 year	No	Yes
Filings	Form C; Form C-U; Form C/A	Form 1-A subject to qualification by SEC staff	Form D
Subsequent filings	Annual report + exit report	Annual, semiannual, and current reports + exit report	Form D amendment
12(g) exemption	Yes, conditional exemption	Yes, conditional exemption	No

In general, a median or average-size ICO of approximately \$14 million-\$24 million would have two options: either Reg A or Rule 506(c) of Reg D. Which tier of Reg A to choose may pose a challenging balancing act for the ICO issuer, unless it clearly expects to raise close to the \$50 million ceiling for these offers. For example, Tier 1 of Reg A does not require audited financial statements or ongoing periodic reporting requirement, while Tier 2 does. But, Tier 2 offerings preempt state law registration requirements, meaning the issuer does not need to file in each state in which the offering is made, while Tier 1 does require compliance with state securities regimes. Both tiers allow issuers to reach out to nonaccredited investors, and the token would be sold without any restriction on resale. However, Tier 2 nonaccredited investors are subject to investment limits. Rule 506(c) offerings under Reg D allows issuers to raise an unlimited amount of capital but only from accredited investors, who would receive tokens for which resale would be restricted. Reg CF may provide a very simple and streamlined option for the ICO issuer looking to raise only small amounts of capital.

What Currently Available Mechanisms Are Suitable for ICOs?

The answer to this question naturally depends on facts and circumstances. In general, relative to a traditional unregistered offering, an ICO faces additional hurdles in these frameworks. First, given the anonymity of blockchain transactions, it can be technically challenging to verify accredited investor status, as well as determine compliance with investment limits for nonaccredited investors. While in a traditional unregistered offering the accreditation information comes from an investor whose name is on the bank account where the funds originate, there is no link in a blockchain wallet between the person making the accreditation representations and the source of funds. Similarly, counting the number of “holders of record” that trigger Section 12(g) registration requirements may be challenging because one holder may have more than one wallet address, among other technical issues.

Second, ICO issuers of legally compliant Reg A offerings must qualify their offering before they can sell their tokens. Statistics on traditional Reg A offerings show that, of 147 offering statements filed with the SEC, 81 (that is, 55 percent) were ultimately qualified. Across qualified offerings, the median time from initial public filing to qualification is 78 days. Tier 2 offerings are associated with longer qualification times (104 days) than Tier 1 offerings (68 days).[25] The time to qualification depends on the length of time required for SEC staff to review the submission, as well as the time that issuers require to make revisions in response to staff comments. Moreover, ICOs may be required to requalify if the offering prices increase by more than 20 percent relative to the “presale” price. In the quickly growing, competitive ICO arena, these long time frames may be problematic.

Third, ICO issuers who opt for legally compliant Rule 506(c) offerings are not required to qualify their offerings, but they can sell only “restricted” tokens to only accredited investors. This can significantly impede the liquidity of the tokens. However, it may not be an insurmountable obstacle if liquidity does not hinge on having a dispersed base of retail, nonaccredited investors at the time of, or shortly after, the ICO. For example, a simple agreement for future tokens, or SAFT, provides a contractual protocol for developers to issue prefunctional utility tokens through Rule 506(c) offerings to accredited investors. Developers use the funds to develop utility tokens that, once fully functional, are expected to fail the Howey test (meaning they are not investment contracts) — this is the assumption SAFT offerings rely on — and can thus be resold to the public.[26] Note, however, that the SEC has not officially endorsed the SAFT concept.

Finally, those ICO issuers that wish to offer tokens outside the United States can use these exemptions in combination with Regulation S offerings. However, it may be technically challenging to separate a simultaneous ICO to U.S. and non-U.S. persons and enforce the restriction on resale of tokens to U.S. persons.

Conclusions

Recent evidence suggests that more and more ICOs are contemplating Reg A[27] and Rule 506(c)[28] exemptions as mechanisms for raising capital in compliance with securities laws. However, not all ICOs are created equal. Given that the existing regulatory frameworks were established without any of the unique crypto features in mind, the question of whether such frameworks are generally suitable for ICOs remains open.

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[1] Coindesk ICO tracker, accessed Jun. 19, 2018, <https://www.coindesk.com/ico-tracker/>. Coindesk is an open source for ICO funding volume data.

[2] Noelle Acheson, “China’s ICO Ban: Understandable, Reasonable and (Probably) Temporary,” Coindesk, Sept. 12, 2017, available at <https://www.coindesk.com/chinas-ico-ban-understandable-reasonable-probably-temporary>. In September 2017, the People’s Bank of China issued a sharp statement labeling token sales “illegal and disruptive to economic and financial stability.” That action wiped out almost \$35 billion of total capitalization in just four days. In the same month, South Korea also banned ICOs.

[3] Coindesk ICO tracker, accessed Jun. 19, 2018, <https://www.coindesk.com/ico-tracker/>.

[4] EY, “Initial Coin Offerings (ICOs)” (EY Research paper, December 2017), available at <http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf>.

[5] Nathaniel Popper, “An Explanation of Initial Coin Offerings,” New York Times, Oct. 27, 2017, available at <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html>.

[6] Based on data from Coindesk and Crunchbase. Also see Stan Higgins, “\$257 Million: Filecoin Breaks All-Time Record for ICO Funding,” Sep. 7, 2017, available at <https://www.coindesk.com/257-million-filecoin-breaks-time-record-ico-funding>.

[7] The DAO is an 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. See Securities and Exchange Commission, “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO” (Release No. 81207, Jul. 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

[8] Id., at 2. Subsequent enforcement actions have further confirmed the Commission is willing to take action against token offerings. See also US Securities and Exchange Commission, “Cybersecurity Enforcement Actions,” accessed Jun. 19, 2018, <https://www.sec.gov/spotlight/cybersecurity-enforcement-actions>.

[9] Id., at 17-18.

[10] Simona Mola and An Wang, “A Primer on Valuing Cryptocurrencies,” Law360, Apr. 16, 2018, <https://www.law360.com/articles/1033536/a-primer-on-valuing-cryptocurrencies>.

[11] For example, see the Gram Ton Blockchain, “Gram Ton Token Telegram ICO,” <https://ico-telegram.org>.

[12] For example, see the “Basic Attention Token” (Brave ICO), accessed Jun. 19, 2018, <https://basicattentiontoken.org>. See also Jon Russell, “Former Mozilla CEO raises \$35M in under 30 seconds for his browser startup Brave,” TechCrunch, Jun. 1, 2017, available at <https://techcrunch.com/2017/06/01/brave-ico-35-million-30-seconds-brendan-eich/>.

[13] EY, “Initial Coin Offerings (ICOs)” (EY Research paper, December 2017), available at <http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf>.

[14] Id.

[15] Id. Locations of the founders/CEOs are used as a proxy for the location of projects.

[16] Id.

[17] Coindesk ICO tracker, accessed May 15, 2018, <https://www.coindesk.com/ico-tracker/>.

[18] Fabric Ventures and Token Data, “The State of the Token Market. A Year in Review & an Outlook for 2018,” <https://www.fabric.vc/report/>.

[19] ICORating, “ICO Market Research Q1 2018,” accessed May 18, 2018, https://icorating.com/ico_market_research_q1_2018_icorating.pdf.

[20] Camila Russo, “Crypto Exchanges Charge Millions to List Tokens, Report Says,” Bloomberg, Apr. 3, 2018, available at <https://www.bloomberg.com/news/articles/2018-04-03/crypto-exchanges-charge-millions-to-list-tokens-autonomous-says>.

[21] Rich Foreman, “Raising Capital through an ICO (Initial Coin Offering),” Startup Grind, October 2017, <https://www.startupgrind.com/blog/raising-capital-through-an-ico-initial-coin-offering>.

[22] While we acknowledge that there are other available exemptions from registration (such as Rule 147, Rule 504, and Rule 506(b) of Reg D), we focus on these three exemptions because they allow general solicitation without any geographic restriction on sales within the United States.

[23] Shane Shifflett and Coulter Jones, “Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud,” Wall Street Journal, May 17, 2018, <https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115>.

[24] See 17 C.F.R. § 230.501(a) for Accredited Investor standards. An accredited investor is an individual with earned income exceeding \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, or has a net worth over \$1 million, either alone or together with a spouse (excluding the value of the person’s primary residence.) See also U.S. Securities and Exchange Commission, “Accredited Investors” (SEC Pub. No. 158, September 2013), https://www.sec.gov/files/ib_accreditedinvestors.pdf.

[25] Anzhela Knyazeva, “Regulation A+: What Do We Know So Far?” Nov. 2016, available at https://www.sec.gov/files/Knyazeva_RegulationA%20.pdf.

[26] Juan Batiz-Benet, Jesse Clayburgh, and Marco Santori, “The SAFT Project: Toward a Compliant Token Sale Framework,” Oct. 2, 2017, Protocol Labs, available at <https://saftproject.com/static/SAFT-Project-Whitepaper.pdf>.

[27] Tom Zanki, “Reg A+ is becoming a popular path to purse ICOs,” Law360, Jun. 12, 2018, <https://www.law360.com/articles/1053055>

[28] Elementus, “Token Sales: Q1 2018,” available at <https://elementus.io/tokens-q1-2018>. In March 2018, 36 of the 64 new ICOs in Coindesk adopted SAFT agreements.