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Courts Must Soon Tackle Critical Questions About ICOs

By **Michael Canty and Ross Kamhi** (April 26, 2018, 12:33 PM EDT)

The rapid growth of bitcoin and other cryptocurrencies over the past year has fueled a surge in initial coin offerings — fundraising mechanisms through which founders of cryptocurrency ventures sell "tokens" in exchange for either cryptocurrency (such as bitcoin or ethereum) or traditional fiat currency. As the amount of money raised through ICOs has increased, so too have opportunities for fraud. Over the past several months, a number of class actions have been filed against ICO founders for securities fraud, which means courts will soon begin to grapple with applying the federal securities laws to a new (and potentially groundbreaking) fundraising mechanism.

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What is an ICO?

An ICO is a fundraising mechanism that allows founders of a cryptocurrency company to raise money for a new venture by offering the investing public a "token" in exchange for consideration, whether it be cryptocurrency, like bitcoin, or traditional currency.

A token is a digital asset that is associated with a particular cryptocurrency system or platform. The token's purpose will vary significantly depending on the platform with which it is associated. Some tokens, for instance, serve as virtual currencies or mediums of exchange (these are often more appropriately referred to as "altcoins"), whereas others might entitle the token holder to certain rights in the underlying venture, such as voting rights or an entitlement to profits. A token can also function like a coupon that can be redeemed for the underlying platform's product or service offerings.

Unlike a traditional initial public offering, an ICO does not typically entitle investors to an equity stake in a company. However, an investor can nevertheless exchange tokens on the secondary market and hope to profit from the token's increase in value after the ICO.

The Rapid Rise of ICOs and Associated Regulatory Concerns

The amount of money raised through ICOs has grown substantially over the past two years. In 2016, just over $95 million was raised through 45 ICOs, whereas in 2017, nearly $4 billion was raised through more than 200 ICOs.[1] This number is expected to rise substantially in 2018: So far this year, more than $6 billion has already been raised through nearly 200 ICOs.[2]

Despite the fact that investors are pouring money into ICOs, these fundraising mechanisms are entirely unregulated.[3] There is no indication that a token sale has ever been registered with the U.S. Securities and Exchange Commission, and so opportunities for fraud are rife. Indeed, former commissioner of the SEC, Joseph Grundfest, described ICOs as “the most pervasive, open and notorious violation of federal securities laws since the Code of Hammurabi.”[4] And even for those ICOs that are legitimate (and there are many), there is little in the way of guidance on how to structure the offering in accordance with U.S. law.

Only recently have investors begun to pursue class actions against ICO founders for violations of federal securities laws. As of now, federal courts have not yet ruled on many of the crucial issues these cases will likely raise, including (1) whether and when the tokens sold in ICOs are “securities” for purposes of federal securities law, and (2) whether and when the federal securities laws will apply, including how Morrison v. National Australia Bank Ltd. will factor into a court’s analysis.

Are Tokens Securities?

Federal courts have yet to provide any guidance on whether and when a token issued in an ICO is a “security” for purposes of the federal securities laws, but we know that when courts do first address the issue, the focus will be on the Howey test.

The U.S. Supreme Court famously defined a security in SEC v. W.J. Howey Co., explaining that an “investment contract” (i.e., security) for purposes of the securities laws is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”[5]

Known as the Howey test, this remains the seminal definition of “security,” and courts analyze it as follows: (1) whether there is an investment of money, (2) in a common enterprise, (3) with an expectation of profit, (4) dependent solely on the efforts of others. If all four of these elements are satisfied, then the contract or arrangement at issue is a “security.”

Whether a token issued in an ICO satisfies the Howey test (and therefore is a security) is highly fact-specific and will vary significantly depending on a wide range of factors, including the nature and structure of the company issuing the token, the token’s purpose, the availability of a secondary market, and whether the platform on which the token is to be used is functioning at the time the tokens are issued. If, for instance, tokens are issued before the underlying platform is built, the token’s value will depend heavily on the efforts of the company’s platform developers. This would likely mean the token satisfies the “efforts of others” prong of the Howey test[6] — the prong that is probably the most fact-intensive and that will likely be the most litigated in the ICO context.

Because no court has yet analyzed this issue, there is little guidance for industry stakeholders and ICO participants on how the Howey test and its progeny apply in the ICO context. Although the SEC has briefly weighed in, declaring that tokens are securities in at least certain circumstance,[7] a court’s input would provide much needed clarity.

When do the U.S. Federal Securities Laws Apply to an ICO?

Equally unclear is whether and when U.S. federal securities laws apply to purchases of tokens in an ICO.

In Morrison v. National Australia Bank Ltd., the U.S. Supreme Court held that the Securities Exchange Act of 1934 applies only to transactions in securities listed on domestic exchanges and domestic transactions in other securities,[8] a rule that has since been extended to apply also to the Securities Act of 1933.[9] In analyzing whether a purchase of a security is a “domestic transaction” (and, therefore, whether the federal securities laws apply) courts typically consider (a) the location at which the parties to the transaction become “irrevocably bound” and (b) the location at which title is transferred[10] — i.e., whether these events occurred within the United States.

Applying these factors (and Morrison generally) in the ICO context will be challenging, because the location at which tokens are purchased in an ICO varies significantly and is not necessarily easy to determine.

For instance, in a typical ICO, a participant first transfers cryptocurrency purchased on an exchange (and not necessarily a U.S.-based exchange) into an online cryptocurrency wallet that does not have a clear “location.” The cryptocurrency is then deposited from the participant’s online wallet into an address unique to the specific ICO — the “location” of which will also be hard to establish (and can easily be manipulated to evade U.S. law). Determining where parties to a transaction become “irrevocably bound,” or where title is transferred, is not straightforward, especially considering that these transactions are designed to encourage cross-border participation and are often launched overseas. These issues, and others, will present novel questions for courts.

Conclusion

It is inevitable that courts will soon weigh in on ICOs. Not only have private securities class actions in the ICO context spiked in the past several months, but the SEC has recently begun to more aggressively crack down on ICOs,[11] issuing a wave of subpoenas, and thus we may soon see enforcement proceedings make their way through the court system. The U.S. Department of Justice has also begun to prosecute individuals for launching allegedly fraudulent ICOs,[12] which will present another opportunity for courts to weigh in. Industry participants should welcome more clarity from federal courts. After all, not all ICOs are fraudulent, and investors and companies alike (as well as their attorneys) would benefit from much-needed clarity on how the U.S. securities laws apply.

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[1] See Cryptcurrency ICO Stats, https://www.coinschedule.com/stats.html.

[2] See id.

[3] To the extent that a particular token issued in an ICO is deemed currency rather than a security, a different set of regulations will presumably apply.

[4] Nathaniel Popper, Initial Coin Offerings Horrify a Former S.E.C. Regulator, NY Times (Nov. 26, 2017).

[5] 328 U.S. 293, 299 (1946).

[6] Juan Batiz-Benet, Marco Santori, and Jesse Clayburgh, The SAFT Project: Toward a Compliant Token Sale Framework, Protocol Labs (Oct. 2, 2017).

[7] SEC Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.

[8] 561 U.S. 247, 268 (2010).

[9] See, e.g., S.E.C. v. Goldman Sachs & Co., 790 F. Supp. 2d 147, 164 n.21 (S.D.N.Y. 2011).

[10] See Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 68 (2d Cir. 2012).

[11] Jean Eaglesham and Paul Vigna, Cryptocurrency Firms Targeted in SEC Probe, The Wall Street Journal (Feb. 28, 2018).

[12] See, e.g., Hayley Fowler, Third Person Charged With Fraud In $25M Crypto Card Plot, Law360 (Apr. 20, 2018).