CRYPTO-TOKEN SALES:
Securities Regulations and Risks

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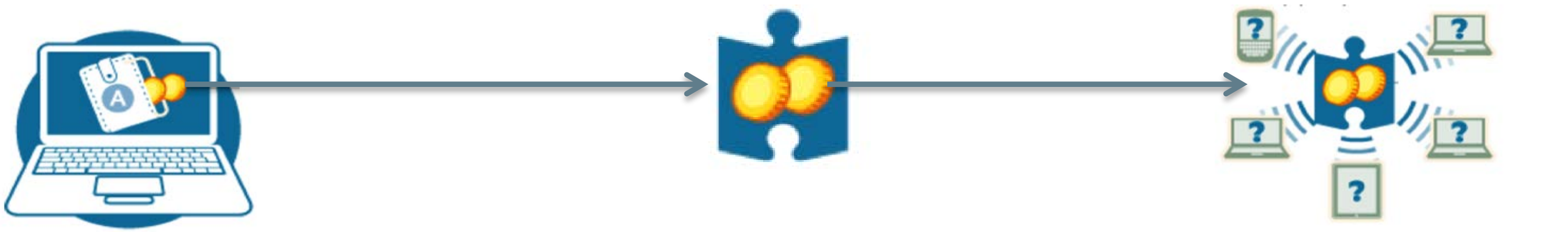
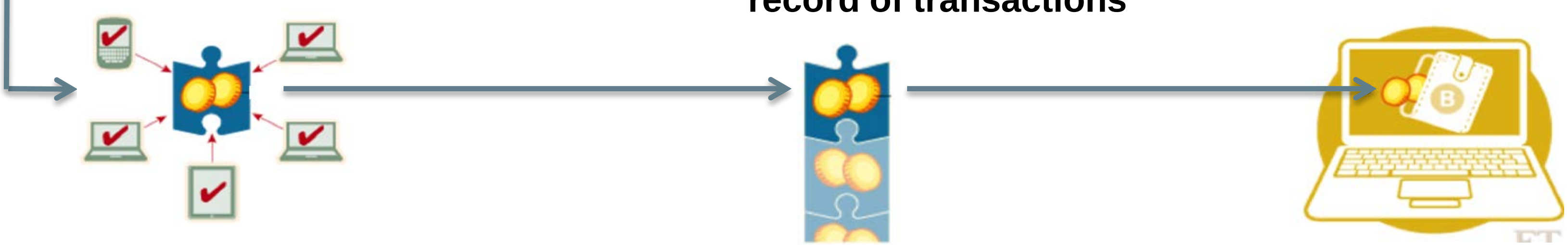
How Blockchain Works

1. A wants to send money to B
2. The transaction is represented online as a "block"
3. The block is broadcast to every party in the network



3. Those in the network approve the transaction is valid
4. The block can be added to the chain, providing an indelible and transparent record of transactions
5. The money moves from A to B



What Is a Crypto-Token?

Tokens come in several forms

- **Protocol Tokens** are used to operate a blockchain

  Example: Network computers that validate blocks ("miners") may receive tokens as a reward

- **Application Tokens** are used in applications built on a blockchain

  Example: A token may be required to obtain services (such as processing time or data storage on the network

Application Tokens

Application Tokens may be further divided

- **“Utility”** tokens grant holders the right to access a given technology or participate in an online organization

- **“Security”** tokens provide holders with economic rights, such as a share of profits generated by a project or organization
  - A security token can be a share of stock or bond that is transferrable on a blockchain
  - A security token can also be a share of profits generated by operation of the blockchain network

Token Sales (Initial Coin Offerings or ICOs)

- Substantial funds are being raised quickly without SEC registration using tokens
  - In 2017: ~$3 billion in proceeds
  - Pre-2017: ~$300m in total

- Regulators are paying attention
  - Securities Laws (SEC)
  - Commodities Laws (CFTC)
  - Money Transmitter / Anti-Money Laundering (Banking Regulators)
  - Tax Law (IRS)
  - Consumer Protection Law (FTC)

Applicable U.S. Securities Laws

The sale and trading of securities tokens must comply with

- Securities Act of 1933
- Securities Exchange Act of 1934
- Investment Advisers and Investment Company Acts of 1940
- State Blue Sky Laws

Utility tokens may need to comply as well, if they represent “investment contracts”

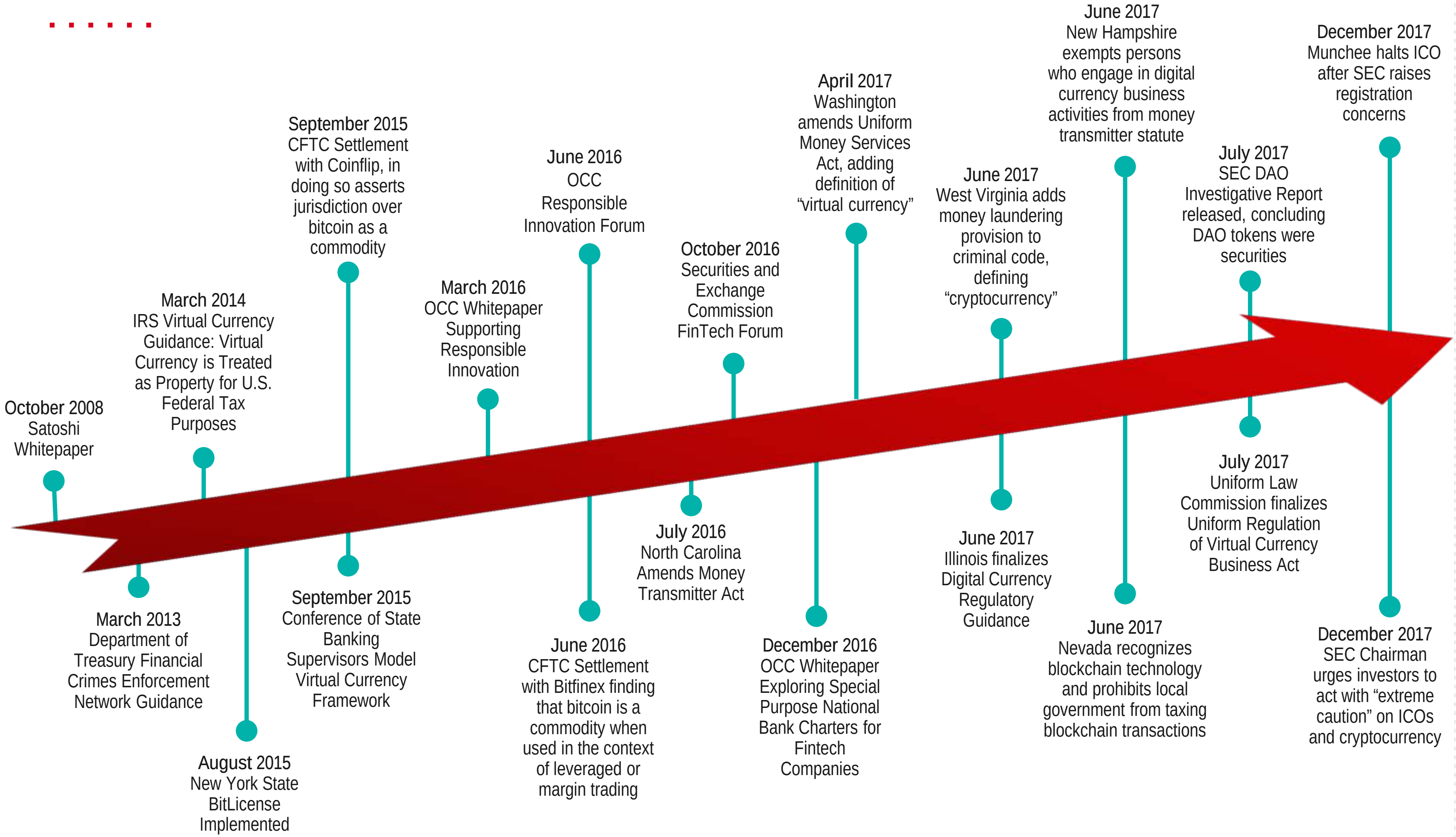
Other Applicable U.S. Laws

- Commodities Exchange Act
  - CFTC has determined that Bitcoin and other cryptocurrencies are commodities
  - Smart contracts that provide for future or optional transfers of tokens or the value of tokens may therefore qualify as commodity contracts or swaps
  - Bitcoin futures are a very recent example
- Tax Laws
  - IRS treats Bitcoin and tokens as “property” for purposes of federal taxes
  - States have followed suit

Other Applicable U.S. Laws

- Money Transmitter / Anti-Money Laundering (Banking Regulators)
- Consumer Protection Law (FTC)
- OFAC and trading embargoes (Treasury Regulations)
- Laws applicable to the token's function (e.g., gaming laws, privacy laws, etc.)

Regulatory Developments



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Emerging SEC Posture

Virtual companies are still companies, and can therefore be issuers of securities (DAO report)

- Returns from projects undertaken by token issuer or pooling of revenues from use of the token are likely to make the token a security

Utility tokens may need to comply with securities laws as well, if they represent “investment contracts”

- Value of token inextricably tied to success of the start-up

What Was DOA?

The DAO was a "Decentralized Autonomous Organization"

- Planned to take proceeds of token sale and invest in profit making projects
- Projects approved by token holders, but "curated" by paid consultants
- Project profits would be distributed to token holders

SEC: Even a virtual organization can be an issuer of securities

Application of *Howey* to the DAO

- Cryptocurrency is money, so there was an investment of money
- The DAO was a common enterprise
  - Pooling of proceeds and projects satisfies horizontal commonality
- Token holders expected to profit from projects
- Success of projects depended on curators and other efforts of the DAO

What Was Munchee?

- Munchee had a restaurant reviewing and advertising application
- Wanted to use tokens to create incentives for those using the application; tokens could be used to:
  - Pay for reviews
  - Buy advertisements
  - Purchase buy meals and “in app” services
- Planned to use proceeds of token sale to integrate token features into app in 2018
- SEC contacted Munchee on the day after the start of the token sale (10/31) and Munchee closed down the sale

Application of *Howey* to Munchee

- Price appreciation is a financial return that satisfies the expectation of profits element
- Promoter **led** purchasers to expect profits thru marketing statements (and links to community statements)
- Token economics – staking and token burn diminished supply – also led purchasers to expect profits
- Exchange listing promises helped satisfy efforts of others element
- Product roadmap for future development helped satisfy efforts of others element

Lessons of Munchee

- If you promote a token as an investment opportunity, it’s likely to be treated as an investment contract

- Tokens need to be sold as products to be treated as utility tokens
  - Token needs to be useful at the time of sale
  - Marketing material should focus on the current use of the token, without promising significant enhancements
  - Sales should be targeted at those who would use the token

Differences between Kickstarter and Token Sales

Delivery

- Kickstarter product is not delivered before it is produced
- Tokens can be created before they have any application

Secondary Trading

- Pre-production rights to Kickstarter product have no secondary market
- A robust secondary market has developed over time for utility tokens and currently appears to be sustainable

Differences between Kickstarter and Token Sales

Business Model

- Kickstarter products tend to be consumer goods; success results in more production rather than appreciation
- Token's value is likely to depend on the popularity of its related application. Because supply is limited, success more likely to result in appreciation

Questions?