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Capital Markets

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SEC Chairman Sounds Death Knell for ICOs?

Remarks Resonate with International Regulators

At a recent securities law conference, Jay Clayton, the Chair of the Securities and Exchange Commission, challenged the received wisdom that initial coin offerings are not subject to regulation as securities sales. Although Mr. Clayton's November 10 remarks were prefaced as "unscripted" and accompanied by the customary disclaimer that his statements were his own and did not necessarily reflect the views of the other commissioners or the SEC staff, in the days following the speech, the worldwide market price for Bitcoin (the most widely followed cryptocurrency) sank more than 20 percent.

While cryptocurrencies such as Bitcoin and Ethereum generally are recognized as currencies rather than as investment securities, over the past few years, hundreds of millions of dollars have been raised by selling hybrid forms of these digital assets, variously referred to as "tokens" or "utility tokens." Similar to a traditional stored-value card, these tokens can be used to buy services or products on a network or platform once its development is completed and, therefore, they have some qualities of a currency. But to finance the development of the network that makes the tokens (or their related "smart contracts") operational, developers often presell tokens in an ICO, usually at a graduated discount to the value they are intended to represent when the project is complete. In these cases, the token has no value until network development is finished, and the token takes on more characteristics of a security; that is, the token purchaser expects to realize a return based on the development efforts of the issuer's management.

Recognizing the legal risks relating to token presales, issuers have begun conducting ICOs as exempt offerings, frequently using a SAFT (a Simple Agreement for Future Tokens) issued only to "accredited investors." Overstock's widely anticipated ICO for its tZero token is structured this way, together with an assurance that its platform to trade tokens will be compliant with the SEC's Regulation ATS.

It is assumed that no material management effort will be required to maintain a platform once it goes live and that thereafter the predominant motivation for obtaining tokens will be to acquire the goods or services that the platform offers rather than investment returns. What is not necessarily understood, however, is the extent to which ongoing management efforts may be required to provide or continue to improve the products or services or how their quality might drive demand for the tokens. It is conceivable, for example, that a speculator would acquire tokens betting on the future demand for the products or services that the tokens can buy.

When Mr. Clayton likened tokens to securities, he didn't make clear whether he was referring only to tokens sold during a platform's development stage or also once a platform has launched, so an aspiring coin issuer must consider carefully the application of the securities laws to its proposed program.

In the days following the Chair's remarks, a number of regulators, including the Dutch securities regulator, the German BaFin, and the European Securities and Markets Authority, issued additional warnings regarding ICOs. This week, the Monetary Authority of Singapore issued a Guide to Digital Token Offerings, warning that digital tokens may constitute "capital markets products" under Singapore's securities law. The Australian Securities and Investments Commission also issued similar advice two months after the SEC issued its July 2017 report on The DAO (covered in our alert "Cyber-Currency Still Not a Security").

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