

ICOs: People Are Investing, The Government Is Watching and Others Are Hacking

From the wallet of venture capitalist Peter Thiel (whose fund has bet big on Bitcoin) to the since reconsidered comments of JPMorgan Chase president Jamie Dimon (“it’s a fraud”) to the manicure of pop songstress Katy Perry (a colorful composite of cryptocurrency symbols), cryptocurrencies seem to be on everyone’s mind if not body.

A cryptocurrency (“CC”) is a digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account or store of value. The most popular CC’s include Bitcoin, Ether, Litecoin and Ripple, but there are thousands of others. Cryptocurrency transactions are recorded on a blockchain, which is an electronic distributed ledger that is maintained by a large number of individual computers on a network. Blockchains use cryptography (encoding and decoding of information) to process and verify transactions. Many experts believe distributed ledgers have great commercial potential apart from CC’s in areas as disparate as real estate, health care, entertainment and supply chain management. For an excellent overview of CC’s and blockchains, please see [this article](#) written by four of our FisherBroyles colleagues. Whether one sees CC’s as wondrously unshackling mankind from government-controlled fiat currencies (such as dollars, euros and yen), or instead, sees nothing but an uncanny resemblance to past bubbles in tulips and tech stocks, no one disputes that we are living in an exciting moment.

As the technology spreads, companies are using CC’s and blockchains to raise capital through Initial Coin Offerings or “ICOs,” sometimes referred to as Initial Token Offerings, Tokenized Asset Offerings or Token Generating Events. An estimated \$3.7 billion was raised in ICOs in 2017. In an ICO, purchasers usually exchange fiat currencies or CC for “coins” or “tokens” that represent certain rights in a project such as a computer network, television show, restaurant ecosystem or sports betting club. Whether a company should embark on an ICO is a decision that should be made after careful deliberation. When structuring an ICO, there are a number of factors to consider, including the following:

Study Securities Law. The Securities and Exchange Commission (“SEC”) has determined that the attributes of many coins make them subject to federal securities laws. SEC Chairman Jay Clayton recently advised Congress that “by and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the registration requirements and other investor protection provisions of our federal securities laws.” Federal securities laws define “security” to include “investment contracts,” and courts interpret “investment contract” to mean an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. The more a purchaser looks to a coin as an investment or purchases with the expectation of cash distributions and selling at a profit, the more likely the SEC is to find such coin to be a security. In contrast, certain coins, often referred to as “utility tokens,” may be promoted more for providing access to products or services rather than as providing a return on investment. The SEC has said it will look to economic realities in determining whether a coin is a security, not what a coin is called. Due to the heightened scrutiny in this area, prudent issuers should operate under the presumption that their ICO is a securities offering absent unequivocal expert opinion to the contrary. ICOs may also be subject to state securities or “blue sky” laws. If an issuer uses an intermediary or agent to sell a coin that is a security, such intermediary or agent must be a registered broker-dealer.

Use Available Exemptions. Just because an ICO is deemed a securities offering, it does not necessarily follow that a full registration, costing hundreds of thousands of dollars, is required. An issuer may rely on registration exemptions such as for offerings aimed at accredited investors, limited to one state or made pursuant to the SEC’s crowdfunding rules, Regulation A, Regulation S or Regulation D. In this social media age great care should be taken with Twitter, Facebook and their kin so as to avoid advertising, general solicitations, prefiling offers (“gun jumping”) and other statements that might result in the loss of a desired registration exemption or in other SEC sanctions. Early stage ventures seeking seed

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money through Simple Agreements for Future Tokens should strongly consider structuring their offerings to comply with the SEC's safe harbor provisions for private placements. SAFTs are modeled on Simple Agreements for Future Equity (SAFE) transactions which were discussed in a previous FisherBroyles [Corporate Law Update](#).

Remember Non-Securities Laws. Government officials and private plaintiffs have at their disposal a full set of anti-fraud, consumer protection, unfair competition and other tools to police ICOs and punish wrongdoers. Since the pseudonymous nature of CC's can be appealing to an unsavory element, ICO issuers who accept CC's as payment may also have to comply with laws aimed at fighting money laundering and terrorism finance.

Provide Complete Disclosure. Regardless of whether a coin is deemed a security, issuers should still distribute written disclosure documents (often called "white papers" in the ICO context) before taking payment from purchasers. White papers should clearly state all material information about a coin and the related project, including, without limitation, information about risks, the management team, core technology, relevant market, competition, voting rights (or lack thereof) and secondary trading/liquidity (or lack thereof).

Limit Theft Exposure. In another reminder that CC's are vulnerable to theft, the Japanese exchange Coincheck was hacked in January 2018 with an estimated \$533 million in digital tokens being stolen. Any company looking to raise CC should have a plan for storing such CC to minimize threat of hacks such as "cold storage" (storing cryptocurrency off the web), employing customary digital security techniques such as encryption, firewalls and intrusion detection devices and perhaps purchasing insurance to provide some relief in the event of theft.

Know the Latest. Cryptocurrencies and ICOs are exciting innovations with the potential to upend established patterns of capital formation, greatly facilitating access to funding for start-up companies and other ventures. However, just as this technology is rapidly evolving, so is the law. The SEC, with its Division of Enforcement's newly formed Cyber Unit, is actively monitoring ICOs, and state legislatures are mulling relevant legislation. Issuers should proceed cautiously with the assistance of skilled counsel who can navigate the laws and practices of the US and other relevant jurisdictions. The Corporate Group and FinTech and Blockchain Group at FisherBroyles can provide guidance in analyzing whether a contemplated ICO constitutes a securities offering as well as how to conduct an ICO in compliance with applicable law.

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