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Embrace the SEC

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EMBRACE THE SEC

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ABSTRACT

Securities law traditionally only permits corporations that have registered with the Securities and Exchange Commission (SEC) and completed an initial public offering (IPO) to sell equity to the general public—often a long, expensive process. Initial coin offering (ICOs) emerged in 2013 as a fundraising tool for non-public blockchain-based companies to raise billions of dollars while circumventing the SEC and public offering process altogether. But their early success brought the attention of the SEC, and in 2017 the SEC asserted the right to regulate ICOs. Since then, U.S. ICO promoters have struggled to avoid the SEC’s assertion of jurisdiction, contorting their offerings in an effort to avoid regulation. They have largely failed. This piece argues that government regulation is a feature, not a bug for ICOs. If ICO entrepreneurs acknowledge SEC jurisdiction—and if the SEC, for its part, implements creative mechanisms to protect investors—blockchain businesses can raise capital from the general public while continuing to serve the underlying goals of U.S. securities law.

INTRODUCTION

An initial coin offering (ICO) is an offering of specialized crypto tokens, or “coins,” that operate on a blockchain, with the promise that those tokens will operate as the medium of exchange on a digital platform that may exist at the time of offering or be developed in the future.¹ The funds raised in the

* M.E. Kilpatrick Professor of Law, University of Georgia School of Law. I thank Joan Heminway, Dave Hoffman, Don Langevoort, and David Wishnick. Mistakes are my own.

1. Thomas Bourveau, Emmanuel T. De George, Atif Ellahie & Daniele Macciocchi, *Information Intermediaries in the Crypto-Tokens Market* 7-8 (Working Paper 2019), <https://ssrn.com/abstract=3193392> [<https://perma.cc/P89N-ZVM2>].

ICO are used to continue to develop the blockchain technology. Typically, entrepreneurs offer their coins in exchange for existing currencies such as Bitcoin, but they can also be sold for fiat currency, such as U.S. dollars or British pounds.²

The wild success of early ICOs fueled an entire ecosystem of blockchain startups eager to build their own blockchain or blockchain-based application to create value and, in the course of doing so, raise a lot of money from the general public. In July 2013, MasterCoin (now known as Omni Layer³), launched what is regarded as the first ICO,⁴ which raised about \$500,000 in bitcoin.⁵ Ethereum, an early ICO success story, raised about \$18 million in bitcoin.⁶ Similar early successes led the way for the ICO explosion that occurred in 2017.⁷ ICOs raised about \$5.6 billion in 2017,⁸ through more than nine hundred sales.⁹

The ICO acronym may sound like an initial public offering (IPO), but in reality ICOs are more like *anti*-IPOs. There are two traditional methods of raising capital through the sale of securities: 1) to register those securities with the Securities and Exchange Commission (SEC) in an IPO, which costs millions of dollars and takes months to accomplish, and then offer the shares to the general public; or 2) to find an exemption from registration requirements that involves selling the shares privately. ICOs thus offered a radical break from the past—a way to tap general public funding without the cost and delay of an IPO.

2. Kennedy K. Luvai, *The End of the ICO Gold Rush? The Regulatory Squeeze on Token Offerings as a Funding Mechanism for Blockchain-Related Ventures*, 31 UTAH B. J. 20, 20 (2018).

3. Laura Shin, *Here's the Man Who Created ICOs and This is the New Token He's Backing*, FORBES (Sept. 21, 2017), <https://www.forbes.com/sites/laurashin/2017/09/21/heres-the-man-who-created-icos-and-this-is-the-new-token-hes-backing/#3c7ede861183> [<https://perma.cc/3HZC-3FS2>].

4. Chance Barnett, *Inside the Meteoric Rise of ICOs*, FORBES (Sept. 23, 2017, 1:21 AM), <https://www.forbes.com/sites/chancebarnett/2017/09/23/inside-the-meteoric-rise-of-icos/> [<https://perma.cc/4MN5-KNVQ>].

5. Shin, *supra* note 3.

6. Philip, *Initial Coin Offering: Ethereum*, COINSTAKER (Apr. 18, 2017), <https://www.coinstaker.com/initial-coin-offering/ethereum/> [<https://perma.cc/N9FA-H2SD>].

7. Barnett, *supra* note 4.

8. Oscar Williams-Grut, *Only 48% of ICOs Were Successful Last Year — but Startups Still Managed to Raise \$5.6 Billion*, BUSINESS INSIDER (Jan. 31, 2018, 1:44 AM), <http://www.businessinsider.com/how-much-raised-icos-2017-tokendata-2017-2018-1> [<https://perma.cc/T4FR-WHKZ>].

9. Kai Sedgwick, *46% of Last Year's ICOs Have Failed Already*, BITCOIN NEWS (Feb. 23, 2018), <http://news.bitcoin.com/46-last-years-icos-failed-already/> [<https://perma.cc/9YC2-65ZA>].

This innovative type of public offering has rapidly evolved without the blessing of U.S. regulators. Indeed, regulators have proved deeply suspicious of ICOs, because their early success also attracted fraudsters.¹⁰ As this article will describe, the earliest ICOs simply ignored the prospect of running afoul of securities laws, advising would-be investors to consult an attorney. After the SEC's July 2017 report on a blockchain-based organization called the Decentralized Autonomous Organization ("DAO Report"),¹¹ which labeled a defunct token a security, ICO issuers turned to a familiar argument for evading the reach of U.S. securities law: they argued that their offerings were not securities at all.

As a brief sidebar, the *Howey* test enunciated by the Supreme Court in 1946 created a powerful catchall category for securities.¹² As the next Section will describe in greater detail, U.S. securities law imposes numerous restrictions on the purchase and sale of securities. One method of evading these restrictions is to argue that one is not in fact selling securities, and thus need not comply with the law. *Howey* imposed a functional, multi-factor test that has swept up all manner of unlikely investments (earthworms,¹³ payphones¹⁴) as securities. ICOs are but the latest example of creative attempts to structure offerings to evade *Howey*.

After the DAO Report suggested that tokenholders' voting rights were part of what made the offering a security, some subsequent ICO promoters stripped the offerings of governance and ownership features, and characterized them as mere tokens meant for consumption (so-called utility tokens or consumption tokens), rather than investment contracts over which the SEC could legitimately claim jurisdiction under the *Howey* test.¹⁵ By

10. A *Wall Street Journal* study of 1,450 ICOs revealed 271 with signs of fraud including "plagiarized investor documents, promises of guaranteed returns and missing or fake executive teams." Shane Shifflett & Coulter Jones, *Hundreds of Cryptocurrencies Show Hallmarks of Fraud*, WALL STREET J., May 18, 2018, at A1.

11. SEC. & EXCH. COMM'N, RELEASE NO. 81207, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(a) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO (2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf> [<https://perma.cc/E26H-HXBM>].

12. SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

13. Smith v. Gross, 604 F.2d 639, 643 (9th Cir. 1979).

14. SEC v. Edwards, 540 U.S. 389 (2004).

15. James J. Park, *When Are Tokens Securities? Some Questions from the Perplexed*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 13, 2019, 4:05 PM), <https://corpgov.law.harvard.edu/2018/12/20/when-are-tokens-securities-some-questions-from-the-perplexed/> [<https://perma.cc/SV6X-UH4X>].

analogy, imagine a musician who sells tickets to a future concert well in advance in order to raise money for the venue and cost of production. ICO issuers have good reason to try to claim the tokens and coins they sell are not securities: buyers of unregistered securities sold without an exemption from the Securities Exchange Act of 1933's registration requirement are entitled to rescission—that is, a refund of the full purchase price.¹⁶

The problem is that *Howey*'s definition of an investment contract is capacious. The SEC has made good use of the authority that *Howey* grants it, insistently asserting its authority over ICOs and consistently rejecting the utility token workaround. Regulators and good-faith ICO fundraisers thus appear to be at an impasse. The SEC is charged with a tripartite mission: to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation.¹⁷ Right now, the investor protection mandate is steering the agency's policy. From the SEC's perspective, there have been too many fraudulent ICOs, and more importantly, the risk of fraud in these public offerings is considerable. On the other side, good-faith ICO fundraisers have either twisted their offerings into sub-optimal knots to avoid issuing "securities," or are moving offshore. There are two downsides here. First, the United States is stifling an innovative and less costly technique to raise capital—one that, what's more, allows the general public a crack at investments traditionally reserved only for the wealthy. Second, by discouraging entrepreneurs interested in following the rules, they are creating a situation where the only ICO offerings that do go forth are, in fact, fraudulent.

This article seeks to persuade the blockchain community that what it really needs to offer the general public is a security. The *Howey* test is friend, not foe. Rather than bringing undesirable government regulation, acknowledging the offering of a security allows the public a chance to participate in investment gains and take advantage of protective mechanisms like a vote. A regulated offering, in other words, is far more attractive to the general public, not only by virtue of the imprimatur of the SEC, but also because regulation unlocks the possibility of the familiar protections investors enjoy with equity stock offerings. Ideally, at the same

16. Securities Exchange Act of 1933 § 12(a)(1), 15 U.S.C § 771 (2012).

17. The requirement that the SEC consider a rule's effect on capital formation, efficiency, and competition was not added until 1996. *See* H.R. REP. NO. 104-622, at 24 (1996).

time, regulators would be open to ways to structure these offerings that would comport with the goals of securities law—and would acknowledge that it is worthwhile to think through ways technology can lower the cost of capital raising and broaden the investment opportunities for average Americans. This article will describe the problem and outlines a solution—an escrow—that could provide both investor protection and reassurance to honest ICO promoters.

I. THE PUBLIC DESIRE FOR SECURITIES, NOT UTILITY TOKENS

Many in the crypto-community have no interest in governmental regulation of any kind. Indeed, the main attraction of the blockchain for some is its ability to circumvent governmental influence entirely. We've seen this story before, in the early days of the internet, when John Perry Barlow and others advocated for a libertarian cyberspace free from governance by the ruling bodies of the physical world.¹⁸ The blockchain story has so far played out in a similar fashion, with governments inexorably asserting their sovereignty over the blockchain.¹⁹ The aim of this Section is to convince the community that their efforts to evade SEC regulation by way of utility tokens are misguided and self-defeating. Before making that case, let's examine how we got here.

U.S. securities laws are disclosure-based. Neither the federal nor the state government purport to guarantee investors that they will make money, or even not lose money. Instead, the 1933 Securities Act and the 1934 Securities Exchange Act address three basic concerns. The first is the risk that the sellers of securities are crooks from the outset, looking to take the money and run.²⁰ The second is the risk that, once the securities have been sold and are trading on a secondary market, the insiders commit fraud or fail to disclose an adequate amount of information.²¹ The third concern is to foster markets and investment by creating a system of standardized

18. Andrea Slane, *Tales, Techs, and Territories: Private International Law, Globalization, and the Legal Construction of Borderlessness on the Internet*, 71 L. & CONTEMP. PROBS. 129, 133 (2008).

19. See generally JACK GOLDSMITH & TIM WU, WHO CONTROLS THE INTERNET? ILLUSIONS OF A BORDERLESS WORLD (2006).

20. FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 303-04 (1991).

21. *Id.*

disclosure that enables investors to make informed decisions on a level playing field. Unlike the first two concerns, which focus on risks, this third consideration focuses on encouraging prosperity of the system.²²

The Securities Act has given rise to an elegant mechanism to ensure against the first concern, fraud in the initial offering: it puts the deep pockets and reputation of investment banks on the hook.²³ Entrepreneurs must register with the SEC before going public, a lengthy and expensive process that helps ensure that investors have a sufficient quantity of information before sale.²⁴ By assigning underwriters and experts with strict liability for misstatements in a prospectus, subject to a limited due diligence defense, the securities laws effectively deputize the investment banks conducting an offering to police the prospectus for fraud.²⁵ As to the second concern, once public, the securities laws subject public companies to ongoing reporting requirements of increasingly large magnitude, ensuring that post-IPO purchasers of securities are kept well informed. These disclosures occur at regular intervals (supplemented with updates as needed), and follow a standard formula, ensuring investors can assess risks uniformly.

ICOs have rapidly grown in popularity and viability as a fundraising tool. In 2016, ICOs raised \$240 million.²⁶ In 2017, they raised \$5.6 billion.²⁷ In 2018, they raised even more.²⁸ As ICOs have become more common, the SEC has consistently, and stridently, asserted its authority to regulate them.

22. See *id.* Scholars have debated justifications for mandatory disclosure for decades. Some scholars argue that voluntary disclosure suffices, because sellers have an incentive to disclose information to prospective buyers. A key justification for mandatory disclosure, in response to this “the market will provide” argument, is that requiring standardized disclosures makes it easier for investors to compare offerings, benefiting both sellers and investors. See Colleen Honigsberg, Robert J. Jackson, Jr., & Yu-Ting Forester Wong, *Mandatory Disclosure and Individual Investors: Evidence from the Jobs Act*, 93 WASH. U. L. REV. 293, 293 (2015).

23. See Merritt B. Fox, *Regulating Public Offerings of Truly New Securities: First Principles*, 66 DUKE L.J. 673, 688-89 (2016) (discussing market mechanisms that have arisen to cure information asymmetries in IPOs, namely investment bank intermediation).

24. Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. 217, 225.

25. Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1636 (2010).

26. Williams-Grut, *supra* note 8.

27. *Id.*

28. How much more is a subject of some debate. See Justina Lee, *How Much Have ICOs Raised in 2018? Depends on Who You Ask*, BLOOMBERG (Nov. 4, 2018, 6:00 PM), <https://www.bloomberg.com/news/articles/2018-11-05/how-much-have-token-sales-raised-in-2018-depends-on-who-you-ask> [<https://perma.cc/QYK5-6AGN>].

While some ICOs simply defy U.S. regulators, many others are trying to evade its reach. This Part will first describe those evasive efforts, and then make the case for an approach that concedes the SEC's jurisdiction and works within the established framework for U.S. securities.

II. ICO ATTEMPTS TO EVADE SEC REGULATION

Currently, most ICOs are launched by an organization or group of developers.²⁹ Some are traditional business entities or nonprofits.³⁰ Others, like the 2016 DAO, are not formally organized at all.³¹ In the absence of affirmative guidance or regulation, no two ICOs look exactly alike; the design of an ICO is determined solely by the team behind a certain blockchain project.³² They have taken various paths with regard to securities laws. Some have openly flouted the SEC—and the SEC has taken an increasingly active role in actions against them.³³ Others have tried to evade the reach of U.S. securities laws in three ways. First, some ICOs have tried to bar would-be investors from the United States from participating, in the

29. Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets* 18 (Cardozo L. Stud. Res. Paper No. 527, 2018), <https://ssrn.com/abstract=3048104>.

30. See, e.g., Michael del Castillo, *SEC Files 'Emergency' Restraining Order Against \$1.7 Billion Telegram ICO*, FORBES (Oct. 13, 2019, 3:45 PM), <https://www.forbes.com/sites/michaeldelcastillo/2019/10/11/sec-files-emergency-restraining-order-against-17-billion-telegram-ico/#171bdc0e29cb> [<https://perma.cc/HY55-SEPW>]; Joseph Maurice, *Top 7 ICOs for Non-Profits to Watch in 2018*, DISRUPTOR DAILY (Oct. 13, 2019, 3:55 PM), <https://www.disruptordaily.com/top-7-biggest-icos-for-non-profits-to-watch-in-2018/> [<https://perma.cc/HK7V-9R7V>].

31. Zug, a small canton in Switzerland, has been home to a disproportionate number of ICOs, leading to its unofficial title of "Crypto Valley." Ralph Atkins, *Switzerland Embraces Cryptocurrency Culture*, FIN. TIMES (Jan. 25, 2018), <https://www.ft.com/content/c2098ef6-ff84-11e7-9650-9c0ad2d7c5b5> [<https://perma.cc/YDC5-NBY8>].

32. Ameer Rosic, *What is an Initial Coin Offering? Raising Millions in Seconds*, BLOCKGEEKS (2017), <https://blockgeeks.com/guides/initial-coin-offering/> [<https://perma.cc/8TAK-WYCJ>].

33. See, e.g., SEC v. PlexCorps, No. 1:17-cv-07007, 2017 WL 6398722 (E.D.N.Y. Dec. 14, 2017) (granting a preliminary order and asset freeze against Dominic LaCroix and his owned entities for likely violation of securities laws); Press Release, Sec. & Exch. Comm'n, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Release No. 2017-185, Sept. 19, 2017), <https://www.sec.gov/news/press-release/2017-185-0> [<https://perma.cc/2WY2-EKY6>] ("The Securities and Exchange Commission today charged a businessman and two companies with defrauding investors in a pair of so-called initial coin offerings (ICOs) purportedly backed by investments in real estate and diamonds.").

hopes that they will qualify as foreign offerings under Regulation S.³⁴ Second, some ICOs have offered utility tokens, arguing that they do not qualify as securities under the *Howey* test.³⁵ Third, promoters have directed offerings not to the general public, but instead only to accredited investors, the wealthy individuals who qualify to invest in private securities.³⁶ This section will describe each workaround in turn. First, though, a more detailed description of *Howey* is in order.

The *Howey* test defines the catchall “investment contract” category of securities requiring registration under the Securities Act in the absence of an exemption from it. There are three main elements.³⁷ First, *Howey* requires that the investment be “solely from the efforts of others.”³⁸ Courts have not interpreted “solely” literally, but instead have inquired as to whether “the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”³⁹ Second, *Howey* requires that there be an expectation of profit, which the Court defined as (1) capital appreciation resulting from the development of the initial investment or (2) participation in earnings resulting from the use of investors’ funds.⁴⁰ Third, an investment contract requires a “common enterprise.”⁴¹ The nuances of the *Howey* test could consume this entire article, but these basics suffice to orient the reader. The point is that securities law casts a broad net, reaching

34. Lukas Hofer, *Why Token Issuers Exclude U.S. Investors*, ICO.LI (Oct. 13, 2019, 4:00 PM), <https://www.ico.li/us-investors/> [<https://perma.cc/UG36-GLH6>]; see *Offshore Offers and Sales*, 63 Fed. Reg. 9632 (Feb. 25, 1998) (codified at 17 C.F.R. pts. 230 and 249).

35. Park, *supra* note 15.

36. See Randolph A. Robinson III, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings*, 85 TENN. L. REV. 897, 925 (2018).

37. An additional element, only rarely at issue, requires that money be invested.

38. SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946).

39. SEC v. Glenn W. Turner Enter., 474 F.2d 476, 482 (9th Cir. 1973).

40. United Hous. Found. v. Forman, 421 U.S. 837, 852 (1975).

41. *Howey*, 328 U.S. at 301. Courts agree that horizontal commonality, which looks at the relationships between an individual investor and the pool of other investors, meets the *Howey* test, but are less clear on whether the relationship between the investor and the promoter is enough to satisfy the common enterprise element. See, e.g., SEC v. SG Ltd., 265 F.3d 42 (1st Cir. 2001); Teague v. Bakker, 35 F.3d 978 (4th Cir. 1994); Revak v. SEC Realty Corp., 18 F.3d 81 (2nd Cir. 1994); Curran v. Merrill Lynch, 622 F.2d 216 (6th Cir. 1980); Hirk v. Agri-Research Council Inc., 561 F. 2d 96 (7th Cir. 1977); Wasnowic v. Chi. Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd* without majority, 491 F.2d 752 (3rd Cir. 1973). *But see*, e.g., SEC v. ETS Payphones, Inc., 300 F.3d 1281 (11th Cir. 2002); SEC v. Eurobond Exch. Ltd., 13 F.3d 1334 (9th Cir. 1994); SEC v. Koscot Interplanetary Inc., 497 F. 2d 473 (5th Cir. 1974).

just about every likely investment scheme. ICO entrepreneurs have spent countless hours and dollars trying to evade the reach of *Howey*, and thus of the SEC and U.S. securities law. Of course, the easiest way to avoid U.S. regulation is not to sell to U.S. citizens at all.

III. BARRING U.S. CITIZENS FROM PURCHASING TOKENS

First, some ICOs have tried to bar would-be U.S. investors from participating in the offering, in the hopes that they will qualify as foreign offerings under Regulation S.⁴² These offerings use technological mechanisms to help keep U.S. investors out. To ensure that U.S. investors are not participating, some coin offerors have started blocking U.S.-based IP addresses and requiring investors to show their passports.⁴³ Startups are also using other measures to ensure that U.S.-based investors do not

42. Andrew Henderson, *5 Reasons Every Crypto Investor Needs a Second Residency and Second Passport*, NOMAD CAPITALIST (Oct. 13, 2019, 4:30 PM), <https://nomadcapitalist.com/2018/04/06/reasons-crypto-investor-needs-second-residency-second-passport/> [<https://perma.cc/8MAA-AC79>]. For example, although EOS maintains that its tokens are not securities, it has banned U.S. investors because of state regulations and blue-sky laws. Evelyn Cheng, *This Hot Digital Currency Trend Is Minting Millions, But US Investors Aren't Allowed to Play*, CNBC (July 18, 2017, 12:07 PM), <https://www.cnbc.com/2017/07/18/hot-digital-currency-trend-minting-millions-off-limits-to-us-investors.html> [<https://perma.cc/V5EZ-WYRH>].

43. Henderson, *supra* note 42. For example, four ICOs, iOLite, Celsius, ShoCard and Auctus will require investors to show their passports in order to screen-out U.S. investors, with iOLite and Celsius also blocking U.S.-based IP addresses for added protection. Initial coin offerings are no longer using clickwrap to screen out U.S.-based investors. The Monaco Visa ICO employed a clickwrap block so U.S. investors would not join. Clickwrap agreements require the user to click a link before proceeding. Cheryl B. Preston & Eli W. McCann, *Unwrapping Shrinkwraps, Clickwraps, and Browsewraps: How the Law Went Wrong from Horse Traders to the Law of the Horse*, 26 BYU J. PUB. L. 1, 17; Dana-Edwards, *ICOs Are Not for US Citizens? Should ICOs Reject Self-Proclaimed US Citizens as a Way to Reduce Legal and Regulatory Risk?*, STEEMIT (2017), <https://steemit.com/icos/@dana-edwards/icos-are-not-for-us-citizens-should-icos-reject-self-proclaimed-us-citizens-as-a-way-to-reduce-legal-and-regulatory-risk> [<https://perma.cc/WN7Y-BBNL>]. The Cobinhood ICO also banned U.S. investors. See COBINHOOD TERMS AND CONDITIONS 6.1 http://www.cobinhood.com/assets/terms/COBINHOOD_terms_n_conditions.pdf [<https://perma.cc/D6RD-4CL7>] (“The Website, the Platform and COB Tokens are not publicly offered for use to natural and legal persons, having their habitual residence or their seat of incorporation in the following countries: i) Canada; ii) People’s Republic of China; iii) the United States; iv) Taiwan; and v); and countries listed on OFAC sanctions lists (‘Restricted Areas’)”). The belief among the crypto community is that this is not enough to stop the SEC from coming after coin issuers. Anna Irrera & Michelle Price, *Cryptocurrency Issuers Clean Up, Shun U.S. Investors as SEC Gets Tough*, REUTERS (Mar. 21, 2018, 2:17 PM) <http://ca.reuters.com/article/technologyNews/idCAKBN1GX2OX-OCATC> [<https://perma.cc/HSD2-A3SK>].

participate in their ICOs, including enlisting “brokers and platforms that perform know-your-customer and anti-money-laundering due diligence to verify the identification and residency of interested investors.”⁴⁴ These efforts are not foolproof⁴⁵—for example, investors can use virtual private networks (VPNs) to mask their IP addresses⁴⁶—but the efforts do enough to gesture towards compliance and at least potentially assuage regulators’ concerns.⁴⁷

IV. OFFERINGS TO U.S. PURCHASERS THAT ARE NOT “SECURITIES”—*UTILITY TOKENS*

Not all ICO offerings have attempted to evade the reach of U.S. securities law by moving overseas. There has been a concerted effort to develop public token offerings that are not considered securities offerings under the *Howey* test. These token offerings are “utility tokens” or “app coins,” that is, tokens to be used for consumptive purposes, and whose primary purpose is not to be held for future profit.⁴⁸ Utility tokens are more like a right to buy a future product or service than a right to participate in the profits of a future enterprise. For example, Golem is a blockchain company that allows individuals to rent out their computer processing power on demand, similar

44. Andrew Ramonas, *No U.S. Investors Need Apply for Some Digital Coin Offerings*, BLOOMBERG NEWS (Aug. 31, 2017), <https://www.bna.com/no-us-investors-n73014463997/>.

45. *See id.* (“We cannot be sure that every new upcoming transaction is outside the U.S.,” chief executive officer Ingus Staltmanis told Bloomberg BNA in an emailed statement.”).

46. *See* Max Eddy, *What Is a VPN and Why You Need One*, PC MAG (Oct. 13, 2019, 4:45 PM), <https://www.pcmag.com/article/352757/you-need-a-vpn-and-heres-why> [<https://perma.cc/MN65-NU9T>] (discussing how VPNs function to “mask[] your identity and location”).

47. *See* William Suberg, *Bancor Seeks to Exclude US Users From Trading Over Regulatory Uncertainty*, Cointelegraph (June 19, 2019), <https://cointelegraph.com/news/bancor-seeks-to-exclude-us-users-from-trading-over-regulatory-uncertainty> [<https://perma.cc/BUG2-9HXN>].

48. Gertrude Chavez-Dreyfuss, Angela Moon, & Heekyong Yang, *Global Cryptocurrency Crackdown Sparks Search For Safe Havens*, WESTLAW J. COMPUT. & INTERNET, Dec. 15, 2017, at 9, 2017 WL 6452835 at *2 (“Many U.S. startups thought they could avoid such scrutiny by selling ‘utility tokens,’ which gave buyers access to products or services rather than a stake in the company.”); *see also* Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, 70 HASTINGS L.J. 463, 493 (2019) (“Because [utility] tokens entitle the holder to use, consume, or access an online service or serve other functional purposes (for example, participating on a messaging platform or surfing the Internet without ads), elements of a consumption purpose are present.”).

to how Airbnb allows short-term lodging rental on demand.⁴⁹ These transactions take place using GNT, a token that can also be traded on other exchanges. While some individuals are buying and selling GNT for the purpose of using it to purchase processing power, the token at one point rose to a high 116 *times* its initial offering price.⁵⁰ It is unlikely that increased demand for the service itself caused the bulk of that increase.⁵¹

Professor Randolph Robinson likens utility tokens to “pre-paid coupons that will unlock value in yet to be built software programs or platforms.”⁵² If you find this explanation of a utility token somewhat confusing, there is good reason. Buying a utility token in an initial offering generally doesn’t make financial sense. Nevertheless, many of these utility token offerings have had a speculative component—either because investors are betting that their use rights will go up in value, or because they do not understand that they are not receiving an equity interest in the offering.

The market trend of reconfiguring tokens from equity offerings into so-called consumptive goods faces two problems: 1) in general the public is buying tokens or coins not to use them, but as an investment, and 2) the SEC has reiterated that utility tokens are in fact securities, and therefore subject to regulation.

The first problem with utility tokens is that they are disingenuous at best. A member of the general public participates in an ICO because she wants to make money.⁵³ Yet utility tokens are by design not what Jonathan Rohr and

49. Steve Buchko, *What is Golem (GNT)? A Complete Guide to the Decentralized Supercomputer*, COIN CENTRAL (Dec. 7, 2018), <http://coincentral.com/golem-gnt-beginners-guide/> [https://perma.cc/KA5X-N3PD].

50. Cali Haan, *Alleged Price Calculation Errors at Tether Badly Skew Crypto Price Data on CoinMarketCap*, CROWDFUND INSIDER (Aug. 6, 2018, 8:07 PM), <https://www.crowdfundinsider.com/2018/08/137412-alleged-price-calculation-errors-at-tether-badly-skews-crypto-price-data-on-coinmarketcap/> [https://perma.cc/X734-QMW8].

51. As a second example, the STORJ ICO sold tokens to users that enable them to buy or rent cloud storage space and bandwidth. It raised \$30 million in its ICO. Matthew May, *What to Consider in an ICO*, FORBES (Nov. 21, 2017, 9:00 AM), <https://www.forbes.com/sites/forbesfinancecouncil/2017/11/21/what-to-consider-in-an-ico/#9f2e6285c449> [https://perma.cc/XAB2-MEQT]. Max Middelmann, *Why Utility Tokens Will Not Make You Rich*, MISSION STUDIOS (Oct. 22, 2018), <https://medium.com/the-mission/why-utility-tokens-will-not-make-you-rich-646312723104> [https://perma.cc/23W7-P4EC].

52. Robinson, *supra* note 36.

53. Anna Irrera, Steve Stecklow, & Brenna Hughes Neghaiwi, *Special Report: Backroom Battle Imperils \$230 Million Cryptocurrency Venture*, REUTERS (Oct. 18, 2017, 6:06 PM),

Aaron Wright term investment tokens, which “bestow express economic rights on their holders.”⁵⁴ The utility token buyer “invests” in a service that she likely has little interest in actually using. Indeed, a year after its successful ICO, Digipulse is destroying all of its tokens because hardly any were being used.⁵⁵ Its CEO, Normunds Kvilis, blogged that out of 320 sign-ups in the previous six days, “only two people have actually used the DGPT token for its main purpose. This indicates that the token is generally used to pursue quick gains from a speculative standpoint, rather than being used for its main purpose of service use.”⁵⁶ In short, ICO entrepreneurs, in an effort to avoid the reach of securities laws entirely, have created offerings of dubious value that lack the traditional investor protections the securities laws afford. No wonder the SEC is worried.

The net effect of these two problems is that consumptive tokens are suboptimal digital assets which their promoters stripped of key investor protections like voting rights, in a futile effort to avoid regulation.

V. NONPROFITS: THE SWISS FOUNDATION MODEL

Several prominent ICOs have blended the first two approaches and launched overseas nonprofits to avoid the reach of U.S. securities laws. Tezos, Bancor, and Ethereum⁵⁷ organized via nonprofits in Switzerland to evade the reach of U.S. securities law and the law of other jurisdictions.⁵⁸

<https://www.reuters.com/article/us-bitcoin-funding-tezos-specialreport/special-report-backroom-battle-imperils-230-million-cryptocurrency-venture-idUSKBN1CN35K> [<https://perma.cc/8HW8-6RRG>].

54. See Rohr & Wright, *supra* note 29, at 52. Rohr and Wright have offered an insightful and helpful framework for guiding the SEC in weighing which of these offerings should qualify as securities.

55. Sam Town, *Engineered Destruction: One Year Post-ICO, This Startup is Destroying All Issued Tokens Due to Market Speculation*, CRYPTOSLATE (Aug. 7, 2018), <https://cryptoslate.com/engineered-destruction-one-year-post-ico-this-startup-is-destroying-all-issued-tokens-due-to-market-speculation/> [<https://perma.cc/443Y-SW6R>].

56. Normunds Kvilis, *Digipulse—Past, Present and Future*, DIGIPULSE (Aug. 1, 2018), <https://blog.digipulse.io/digipulse-past-present-and-future-5cb6e9c6455c>.

57. Brenna Hughes Neghaiwi, *Top Swiss Cryptocurrency Lawyer Questions 'Stupid' ICO Structure*, REUTERS (Jan. 22, 2018, 9:13 AM), <https://uk.reuters.com/article/uk-swiss-crypto/top-swiss-cryptocurrency-lawyer-questions-stupid-ico-structure-idUKKBN1FB1TM> [<https://perma.cc/Z7TL-8G35>].

58. Atkins, *supra* note 31 (“Of the 10 biggest proposed initial coin offerings—by which startups raise funds by selling tokens—four have used Switzerland as a base . . .”).

Early Swiss ICOs such as Tezos formed nonprofit foundations that offered tokens not for sale, but instead in exchange for nonprofit “donations.”⁵⁹

For example, Tezos’ offering documents called the contributions “a non-refundable donation” and not a “speculative investment.”⁶⁰ The theory is that if Tezos tokenholders truly donated money to a foundation, then the tokens were not securities under the *Howey* test. These evasions may not be successful—the promoters were defendants in two class-action lawsuits seeking rescission and damages, claiming that they sold unregistered securities in the U.S.⁶¹

Notably, Facebook’s new Libra Association, a consortium of powerful for-profit companies including Visa Inc., Mastercard Inc., PayPal Holdings Inc. and Uber Technologies Inc., is organized as a Swiss nonprofit.⁶² Libra Association plans to launch a cryptocurrency whose value is tied to government-issued currencies,⁶³ but these plans have spurred considerable governmental attention and resistance.⁶⁴

59. Irrera, Stecklow, & Neghaiwi, *supra* note 53. Tezos founder Kathleen Breitman once likened Tezos tokens to a tote bag you’d receive in return for a donation to a public TV station. Gideon Lewis-Kraus, *Inside the Crypto World’s Biggest Scandal*, WIRED (June 19, 2018, 6:00 AM), https://www.wired.com/story/tezos-blockchain-love-story-horror-story/?mbid=social_twitter&__twitterimpression=true [<https://perma.cc/D38R-RSB5>].

60. Irrera, Stecklow, & Neghaiwi, *supra* note 53.

61. Anna Irrera & Steve Stecklow, *Tezos Organizers Hit with Second Lawsuit Over Cryptocurrency Fundraiser*, REUTERS (Nov. 15, 2017, 5:58 PM), <https://www.reuters.com/article/us-bitcoin-tezos/tezos-organizers-hit-with-second-lawsuit-over-cryptocurrency-fundraiser-idUSKBN1DF37L?il=0> [<https://perma.cc/37ZP-4E8R>].

62. Kate Rooney, *The Fed is Looking into Facebook’s Libra Cryptocurrency as Powell Flags ‘Serious Concerns’*, CNBC (July 10, 2019, 2:10 PM), <https://www.cnbc.com/2019/07/10/powell-says-facebooks-libra-cryptocurrency-raises-serious-concerns-such-as-money-laundering.html> [<https://perma.cc/N5YK-GMRW>]; THE LIBRA ASS’N, <https://libra.org/en-US/association/> [<https://perma.cc/KCB4-U532>] (“The Libra Association is an independent, not-for-profit membership organization, headquartered in Geneva, Switzerland.”).

63. AnnaMaria Andriotis, Peter Rudegeair & Liz Hoffman, *Facebook’s New Cryptocurrency, Libra, Gets Big Backers*, WALL ST. J. (June 13, 2019), <https://www.wsj.com/articles/facebooks-new-cryptocurrency-gets-big-backers-11560463312> [<https://perma.cc/QR7-69NZ>].

64. Ryan Browne, *Here’s Why Regulators Are So Worried About Facebook’s Digital Currency*, CNBC (Oct. 13, 2019, 4:47 PM), <https://www.cnbc.com/2019/09/19/heres-why-regulators-are-so-worried-about-facebooks-digital-currency.html> [<https://perma.cc/LGM5-VXCK>]; David Concannon, Yvette D. Valdez & Stephen P. Wink, *The Yellow Brick Road for Consumer Tokens: The Path to SEC and CFTC Compliance*, in GLI - BLOCKCHAIN & CRYPTOCURRENCY REGULATION 101 (Josias Dewey ed., 2019), <https://www.lw.com/thoughtLeadership/yellow-brick-road-for-consumer-tokens-path-to-sec-cftc-compliance> [<https://perma.cc/9ZL3-KKWG>].

VI. SAFTS

Finally, some promoters have directed offerings not to the general public, but instead only to accredited investors, the wealthy individuals who qualify to invest in private securities.⁶⁵ The SAFT (simple agreement for future tokens) suggests that one way to avoid liability under the securities laws is to offer the investment opportunity exclusively to accredited investors, who are more sophisticated and better prepared to accept the risk.⁶⁶ In other words, the SAFT promoters acknowledge that SAFTs are investment contracts subject to the 1933 Act, but argue that they qualify for exemption from registration because they are offered only to accredited investors.⁶⁷ SAFT investors fund developers who “develop [a] genuinely functional network, with genuinely functional utility tokens, and then deliver those tokens to the investors. The investors may then resell the tokens to the public, presumably for a profit, and so may the developers.”⁶⁸ The tokens themselves are merely “consumptive products,”⁶⁹ and thus not subject to the reach of U.S. securities law. Thus, accredited investors get in early in the investment phase of the SAFT. The general public buys tokens at a point when they have only consumptive value. The downside of this method is

65. Usha Rodrigues, *Law and the Blockchain*, 104 IOWA L. REV. 679, 725 (2019).

66. Juan Batiz-Benet, Marco Santori & Jesse Clayburgh, *The SAFT Project: Toward a Compliant Token Sale Framework*, SAFT PROJECT, 19 (Oct. 2, 2017), <https://saftproject.com/static/SAFT-Project-Whitepaper.pdf> [<https://perma.cc/GKN2-RBWW>]. The SAFT is modeled on the SAFE, the simple agreement for future equity. The SAFE is a contract in a fledgling corporation that provides that an investor’s interest will convert automatically into equity if the company raises finances in the future, is sold, or goes public. Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-So-Safe Safe*, 102 VA. L. REV. ONLINE 168, 172 (2016), <http://www.virginialawreview.org/volumes/content/crowdfunding-and-not-so-safe-safe> [<https://perma.cc/XA4M-52E4>]. SAFEs were created to offer a simple solution to the problem that often confronts early-stage entrepreneurs who needed to raise funds quickly and cheaply, without the time- and cost-intensive negotiations that surround venture financing and, increasingly, angel investing. *Id.*

67. Batiz-Benet et al., *supra* note 66, at 4.

68. *Id.* at 1.

69. *Id.* Several platforms have used the SAFT framework, including Unikrn, a sports betting platform backed by Mark Cuban, and Kik, which raised \$100 million in Ethereum to develop a new social internet platform. See *Form D*, Securities and Exchange Commission, https://www.sec.gov/Archives/edgar/data/1625681/000162568115000002/xslFormDX01/primary_doc.xml [<https://perma.cc/7YVR-DRRK>]; Eugene Kim, *Crypto Start-Ups are Trying to get Their House in Order Ahead of a Possible SEC Crackdown*, CNBC (Oct. 12, 2017, 12:16 PM), <https://www.cnbc.com/2017/10/12/crypto-start-ups-turn-to-safts-for-ico-s-raising-more-than-350m.html> [<https://perma.cc/SX4H-L54Z>].

that it perpetuates the-haves-versus-the-have-nots divide because only accredited investors can obtain equity under the SAFT model.

VII. THIS ISN'T WORKING

Regulators and blockchain enthusiasts are at an impasse. Entrepreneurs want to create and sell tokens without any regulation, and the SEC wants to tamp down ICOs because of the risk of fraud. To overcome that impasse, each will need to face hard truths. For the SEC, that hard truth is that the genie is out of the bottle. Blockchain technology is agovernmental. Bitcoin, itself a manifestation of the distrust in global financial institutions that emerged from the 2008 financial crisis, represents a fundamental challenge to governmental power as manifest in fiat currency. The pressure on the SEC's role as securities gatekeeper is intense. For a while, at least, ICOs unlocked the power to raise funds from the general public to finance innovation. Elizabeth Pollman and Jordan Barry elaborate on what they call "regulatory entrepreneurship," a model where startups like Uber "move fast and break things," relying on consumer pressure to force local regulators to accommodate their business models.⁷⁰ Early ICO offerings likewise refused to wait for the securities law's blessing. Recent ICOs have not been able to harness public sentiment in their favor, however, because utility tokens are not as widespread as Uber or Airbnb.⁷¹ And the SEC has made clear that it views most token offerings as securities. The choking effect of the SEC's actions, coupled with the anti-regulatory ethos of blockchain, spells frustration, stalled capital raising, and hostility for regulators from the ICO community.⁷²

For their part, ICO enthusiasts need to understand the SEC's perspective. For decades, the SEC has labored to protect the general public from the hype of risky offerings, worried that grandma will lose her savings to

70. Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 446 (2017).

71. See Ankit Kumar, *Hand in Glove: Start-ups and ICOs in 2019*, TECHPLUTO (May 20, 2019), <https://www.techpluto.com/hand-in-glove-start-ups-and-icos-in-2019/> [https://perma.cc/NCP3-YUHZ].

72. Evelyn Cheng, *The SEC Just Made It Clearer That Securities Laws Apply to Most Cryptocurrencies and Exchanges Trading Them*, CNBC (Mar. 7, 2018), <https://www.cnbc.com/2018/03/07/the-sec-made-it-clearer-that-securities-laws-apply-to-cryptocurrencies.html> [https://perma.cc/5K5E-2HFS].

unscrupulous promoters. The SEC *has* targeted extremely troubling offerings. To give some examples: AriseBank claimed to be the world's first decentralized bank and began raising money through an ICO sale of its own cryptocurrency, AriseCoin, in November 2017.⁷³ AriseBank made numerous false claims and advertisements, as well as misled investors,⁷⁴ promising that the coin would appreciate.⁷⁵

Or take PlexCorps, which raised about \$15 million from thousands of investors through an ICO selling "PlexCoins,"⁷⁶ and promised investors that they would receive a return of 1,324% in twenty-nine days.⁷⁷ The SEC alleged that PlexCoin had virtually no one working on the project, that proceeds were being used to fund its officers' home decor projects, that it repeatedly misled investors about the value of the coin, and that it was an unregistered security trading on cryptocurrency exchanges.⁷⁸

Finally, the SEC alleged that REcoin Group Foundation, LLC,⁷⁹ and one of its officers, Maksim Zaslavskiy, fraudulently misled hundreds of investors in violation of securities law, raising \$300,000.⁸⁰ The SEC alleges that they made false representations about private investments they had thus far,⁸¹ including that investors could expect a return of 10-15%.⁸² Yet REcoin never assigned any coins to investors.⁸³ On November 15, 2018, Zaslavskiy pleaded guilty to federal criminal charges in the Eastern District of New York.⁸⁴

73. Complaint at 1, SEC v. AriseBanks, No. 3:18-cv-00186 (N.D. Tex. Jan. 25, 2018).

74. The complaint alleges that AriseBank never possessed any of the purported technology or assets, for example, the complaint asserts that AriseBank falsely claims that it purchased a 100-year old bank and its association with an AriseBank branded visa card. *See id.* at 2.

75. *Id.*

76. Complaint at 1, SEC v. PlexCorps, No. 1:17-cv-7007, 2017 U.S. Dist. LEXIS 2016145 (E.D.N.Y. Dec. 1, 2017).

77. *Id.* at 2.

78. *Id.* at 1, 3.

79. Complaint at 1, SEC v. RECoin Grp. Found., LLC, No. 1:17-cv-05725, (E.D.N.Y. Sept. 29, 2017).

80. *Id.* at 2.

81. Defendants claimed that they had raised \$2 million, and later \$4 million, when none had actually been raised. *Id.*

82. *Id.* at 3.

83. *Id.*

84. Press Release, U.S. Attorney's Office, E. Dist. of N.Y., Brooklyn Businessman Pleads Guilty to Defrauding Investors Through Two Initial Coin Offerings (Nov. 15, 2018) (on file at <https://www.justice.gov/usao-edny/pr/brooklyn-businessman-pleads-guilty-defrauding-investors-through-two-initial-coin> [<https://perma.cc/BC22-6TU3>]).

There are signs that these three examples are merely the tip of the iceberg. A *Wall Street Journal* examination of offering documents from 1,450 ICOs found 271 with major red flags.⁸⁵ These red flags included documents copied from earlier offerings, promises of guaranteed returns, and even missing or fake executive teams.⁸⁶ The case of Denaro, described in the *Wall Street Journal* article, illustrates the grave fraud risks crypto offerings can pose for investors:

“Jeremy Boker” is listed as a co-founder of Denaro, an online-payment project. In investor documents for a public offering in March, which claimed to have raised \$8.3 million, Mr. Boker boasted of his cryptocurrency startup’s “powerhouse” team. In his biography, he noted a “respectable history of happy clients” in consulting before he launched Denaro.

In fact, Mr. Boker’s bio image was a stock photo, there is no evidence he exists and the rest of his team appears to be fictional, except for two freelancers who said they were paid by people unknown to them to market the project.⁸⁷

These examples highlight the problems the SEC confronts. The spectacular success of early ICOs fed the enthusiasm of a host of blockchain entrepreneurs.⁸⁸ But it also attracted unscrupulous individuals intent only on making a quick buck through fraud.⁸⁹ The SEC is charged with protecting the investing public, and thus is understandably worried about these fraudsters.⁹⁰ Right now, it can see no clear way to separate genuine offerings from fraudulent ones and is using the U.S. securities laws to tamp down the whole ICO market because of the rampant risks it presents.

The second problem is that the SEC has rejected all the creative attempts to evade *Howey*’s reach. SEC Chair Jay Clayton stated in December 2017, “Merely calling a token a ‘utility’ token or structuring it to provide some

85. Shifflett & Jones, *supra* note 10.

86. *Id.*

87. *Id.*

88. *See supra* notes 26-28 and accompanying text.

89. Shaanan Cohn, David Hoffman, Jeremy Sklaroff, & David Wishnick, *Coin-Operated Capitalism*, 119 COLUM. L. REV. 591, 594 (2019).

90. *See supra* notes 20-22 and accompanying text.

utility does not prevent the token from being a security.”⁹¹ Clayton further noted that offerings that “emphasize the potential for profits based on the entrepreneurial or managerial efforts of others to contain the hallmarks of a security under U.S. law.”⁹² At an SEC town hall, Clayton said: “Much of what I have seen in the ICO . . . space, is a security offering . . . I don’t know how much more clear I can be about it.”⁹³ In a subsequent U.S. Senate hearing, he indeed was clearer, stating: “I believe every ICO I’ve seen is a security.”⁹⁴

The solution is simple: blockchain entrepreneurs should accept that they are offering securities, and work with regulators to come up with investor safeguards in the offering itself. This suggestion will raise the hackles of the cryptoanarchist set, who entertain visions of a blockchain free from government regulation of any kind. But the history of internet regulation teaches us that governments inevitably will assert jurisdiction over the new spaces technology creates.⁹⁵ Better to be part of the regulatory framework than resisting completely and having regulation thrust upon the blockchain without input from the community.

VIII. REGULATION ISN’T PERDITION, IT’S SALVATION

Conceding that token offerings are securities would likely *strengthen* ICOs immeasurably. There’s always been a wink and a nod accompanying utility token offerings. Their claims that the offerings are solely for

91. Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, SECURITIES AND EXCHANGE COMMISSION (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11> [<https://perma.cc/E47W-ZGPU>].

92. *Id.*

93. Jack Mathis, *ICOs are Securities, ‘Don’t Know How Much More Clear I Can Be’: SEC Chairman*, CCN (June 14, 2018, 2:00 AM), <https://www.ccn.com/icos-are-securities-dont-know-how-much-more-clear-i-can-be-sec-chairman/> [<https://perma.cc/FSY4-9ZTS>]. The SEC has already said that payment tokens like Bitcoin and Ether are not securities. Jonathan Shieber, *SEC Says Ether Isn’t a Security, but Tokens Based on Ether Can Be*, TECHCRUNCH (June 14, 2018), <https://techcrunch.com/2018/06/14/sec-says-ether-isnt-a-security-but-tokens-based-on-ether-can-be/> [<https://perma.cc/5SJD-CC7C>]. The SEC has acknowledged that cryptocurrencies themselves may not be securities. For example, Bill Hinman, Director of the SEC’s Division of Corporate Finance, while comparing Ether to Bitcoin, stated that “current offers and sales of Ether are not securities transactions.”

94. Stan Higgins, *SEC Chief Clayton: ‘Every ICO I’ve Seen Is a Security’*, COINDESK (Feb. 6, 2018), <https://www.coindesk.com/sec-chief-clayton-every-ico-ive-seen-security> [<https://perma.cc/JF7W-F7ML>].

95. *See, e.g.*, GOLDSMITH & WU, *supra* note 19.

consumptive use ring hollow. In general, people want to buy these token offerings to trade them, to speculate on their future value.⁹⁶ If they were truly for consumptive value, developers could code nontransferability into the blockchain. If tokens could not be transferred, there could be no possibility of a secondary market. Currently, they do not.⁹⁷

A fundamental contradiction exists at the core of the utility token concept: scarcity determines value for assets, but for tokens or units of exchange to have value, people must be willing to spend them. A classic, if homely, example is the babysitting cooperative that existed on Capitol Hill in the 1970s. Staffers created a kind of barter economy, where they would babysit in exchange for “scrip” that could be redeemed for babysitting services later.⁹⁸ A “crisis” of sorts arose because the scrip became scarce, and people began to hoard, valuing the promise of future nights out over actually using the currency.⁹⁹ Put simply, if everyone is buying tokens as speculative investments rather than to use them, then fewer people will actually use the service. As the network effects spiral downward with fewer and fewer users, the service itself will cease to be viable.

Summing up, here’s where we are. Blockchain offerors contorted their offerings into utility tokens to avoid being labeled as securities. This “solution” is unsustainable for two reasons. First, the SEC has rejected the argument.¹⁰⁰ Second, it’s keeping the general public from an equity interest in these exciting offerings. At best, with the SAFT offerings, accredited investors receive the benefits of investment, while the have-nots remain on the outside.¹⁰¹

I offer a radically different approach. Rather than trying to dream up increasingly contorted coin offerings that evade the *Howey* test, the cleanest

96. Bill Carmody, *The Top Initial Coin Offerings to Watch in 2018*, INC. (Nov. 17, 2017), <http://www.inc.com/bill-carmody/top-10-initial-coin-offerings-icos-to-watch-heading-into-2018.html> [https://perma.cc/84TC-NU28].

97. See FENNIE WANG, PRIMAVERA DE FILIPPI, ALEXIS COLLOMB & KLARA SOK, FINANCING OPEN BLOCKCHAIN ECOSYSTEMS: TOWARD COMPLIANCE AND INNOVATION IN INITIAL COIN OFFERINGS 34-35 (2019), <https://hal.archives-ouvertes.fr/hal-02046793/document> [https://perma.cc/S9SX-EBR3] (describing why, despite its feasibility, the option of encoding nontransferability into the blockchain is “unlikely to be . . . actually applied in practice”).

98. Joan Sweeney & Richard J. Sweeney, *Monetary Theory and the Great Capitol Hill Baby Sitting Co-op*, 9 J. MONEY, CREDIT & BANKING 86, 87 (1977).

99. *Id.* at 87.

100. See *supra* Section II.B.

101. See *supra* text accompanying notes 65-68.

move would be to acknowledge that any investment tokens and any offerings of utility or consumptive tokens that cannot be exercised right away (that is, those redeemable only for a service yet to be built) are all securities. Indeed, I would go farther and label functional utility tokens as securities as well. As I have already described, utility tokens are suboptimal offerings whose sole *raison d'être* is to avoid the *Howey* test.¹⁰² As I argue below, calling token offerings “securities” offers more benefits than costs, and makes utility tokens practically obsolete. The downside, from the promoter’s perspective, is this move would cede SEC power to regulate. That’s not much of a downside, considering that U.S. ICOs are basically in a state of paralysis now, trapped in regulatory limbo.

More importantly, conceding tokens’ status as securities would empower entrepreneurs to conduct offerings that look more like traditional offerings, giving voting rights and distribution rights to the public in a way that some communities are already experimenting with.¹⁰³ Crucially, it would give the public what it wants: a real chance to invest in this innovative technology in a manner previously only available to the wealthy. Ultimately, government regulation is a path to standardized disclosure that allows blockchain entrepreneurs to access the general public. And that’s where the money is.

IX. THE PATH FORWARD

The SEC staff have issued a “Framework for ‘Investment Contract’ Analysis of Digital Assets” to help analyze whether a digital asset qualifies as a security.¹⁰⁴ But this framework merely clarifies the application of the law—it does not attempt to flex to adapt securities law to blockchain technology. The SEC’s immediate concern with ICO is fraud. These traditional protection mechanisms are not, however, the only mechanisms available to address the problems of offering and post-offering fraud. This

102. See *supra* Section II.A.2.

103. See DAOSTACK, WHITE PAPER V1.1.2 (Apr. 22, 2018), <https://daostack.io/wp/DAOstack-White-Paper-en.pdf> [<https://perma.cc/M3HL-28AC>].

104. Bill Hinman & Valerie Szczepanik, *Statement on “Framework for ‘Investment Contract’ Analysis of Digital Assets,”* SEC. & EXCH. COMM’N (Apr. 3, 2019), <https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets> [<https://perma.cc/6WWG-SHS7>].

section gestures (but no more than gestures) toward a path for U.S. securities offerings on the blockchain.

There are mechanisms that could assuage the SEC's concerns, grant entrepreneurs access to new sources of capital, and allow the general public to participate as investors in early stage blockchain ventures. In another work,¹⁰⁵ I identify venture capital financial contracting mechanisms—some of which ICOs already employ—that could make crowdfunding viable. I will here suggest that tailoring some already common mechanisms—such as an escrow—may enable them to meet the SEC's concerns.

To appreciate how an escrow might work, it helps to start with the fundamental problems each new venture seeking outside investors faces. Two are disadvantages a potential investor has vis-à-vis the entrepreneur. Investors face an information asymmetry—entrepreneurs will always paint the venture's prospects in glowing terms, and investors do not know whether to believe rosy projections or treat them as mere puffery.¹⁰⁶ Similarly, investors risk agency costs—the danger that the entrepreneur will shirk or slack, and fail to do the work needed to make the project a success.¹⁰⁷ Finally, both parties suffer from uncertainty—neither investor nor entrepreneur knows what the future holds.

The escrow is a mechanism for addressing these problems. Put simply, an escrow involves a trusted third party (a bank or similar agent) that holds funds for a period of time and allows payouts only upon the fulfillment of certain pre-arranged conditions.¹⁰⁸

Currently, some ICO promoters implement an escrow to address a specific concern. ICOs often include in the blockchain code a vesting schedule, tying up their tokens so they cannot be sold at once.¹⁰⁹ This feature does offer investors some protection—otherwise an unscrupulous

105. Usha Rodrigues, *Financial Contracting with the Crowd* (U. Ga. Sch. of Law Research Paper Series, Paper No. 2019-21, 2019) (forthcoming in EMORY L.J.), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3427249&download=yes [<https://perma.cc/MHR6-JT2K>].

106. See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076-77 (2003).

107. See generally Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57 (1989).

108. Justin Pritchard, *What Is Escrow?*, BALANCE (Apr. 19, 2019), <https://www.thebalance.com/what-is-escrow-315826> [<https://perma.cc/A7R6-ZLPR>].

109. Rodrigues, *supra* note 105, at 42.

promoter could sell the public tokens on the promise of building a network, and then immediately sell their own tokens and exit stage right without ever having built the platform. The self-imposed vesting schedule protects against that risk of a quick scam—if the promoter must wait to sell her tokens for a period of months or even years, then she has to work to make the network viable. Otherwise her tokens will be worthless by the time she can sell them.

ICO promoters could, using this same principle, create a real-life escrow for the funds raised at a financial institution. They could articulate key milestones in the development of their project, and tie funding to the achievement of these milestones. They could, in short, accomplish via escrow the staged financing common in the venture capital world. With their funds securely housed in escrow, the company would not face the risk of running out of funding (as long as it made good on its promises). At the same time, investors would reduce agency costs, uncertainty, and information asymmetry by delaying some payouts until the company had met its milestone requirements.

Staged financing is but one example of how an escrow, coupled with the voting rights made possible when the tokens sold in an ICO are acknowledged to be securities, can protect investors and empower entrepreneurs. This simple concept of an escrow is a powerful one. By allowing for funds to be securely amassed, but not dispersed, it can simultaneously reassure the entrepreneur that funds are available, while at the same time leaving the investors with some strings to pull.

While there is much more to say on these topics, the goal of this piece is not to offer detailed solutions. Instead, this piece has meant chiefly to articulate the problem ICOs now present, and to suggest that both the regulator and the regulated need to acknowledge the perspective of the other side. On the part of ICO promoters, that truth is that circumventing securities regulation is a losing game, one not worth playing. Regulation offers legitimacy and the prospect of larger capital markets. On the part of the SEC, the hard truth is that ICOs represent a persistent hunger for easier ways to access capital than the status quo—and that creative investor mechanisms may be readily implemented to respond that need. The best way forward is regulation that fosters markets precisely because it protects investors from fraud, while allowing the general public the chance to invest in private markets.