

# QuickLaunch University Webinar Series

## Legal Landscape Update: The Future of ICOs and Cryptocurrencies

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## Review - What is an ICO?

- An **ICO**, or initial coin offering, is the sale of virtual coins or tokens, often as a means of capital raising by startup companies that are involved in blockchain technology. Depending on the terms of the offering, purchasers may use virtual currencies (such as Bitcoin or Ethereum) or fiat currency to purchase the coins or tokens.
- Even though an ICO raises funds, the "coins" are not currency. Instead, the coins or tokens can be used to transfer value within the sponsor's ecosystem or platform.
- ICOs, token pre-sales (of SAFTs), and similar sales of blockchain-based coins and tokens are quickly becoming an important fundraising option for many early-stage companies.

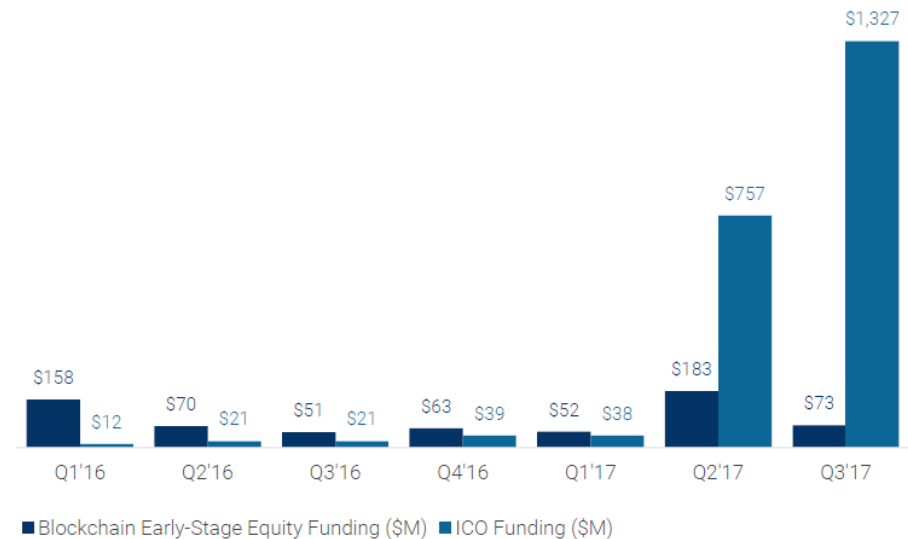




# The Rise of ICOs

- Since 2016, there have been 250+ blockchain startups that have closed ICOs for over \$2B in funding.
- Early-stage “traditional” equity investment (i.e. non-ICO) in blockchain companies by VCs and other investors was \$73 million in Q3 2017, representing only 7 financing rounds (lowest point since Q4 2013).
- By contrast, 150 companies raised an estimated **\$1.3 billion** via ICOs in Q3 2017.

Blockchain early-stage equity funding vs. ICO  
Q1'16 – Q3'17



Note: “Blockchain Early-Stage” includes Angel, Seed, and Series A.  
Sources: CB Insights, TokenData, CoinSchedule.





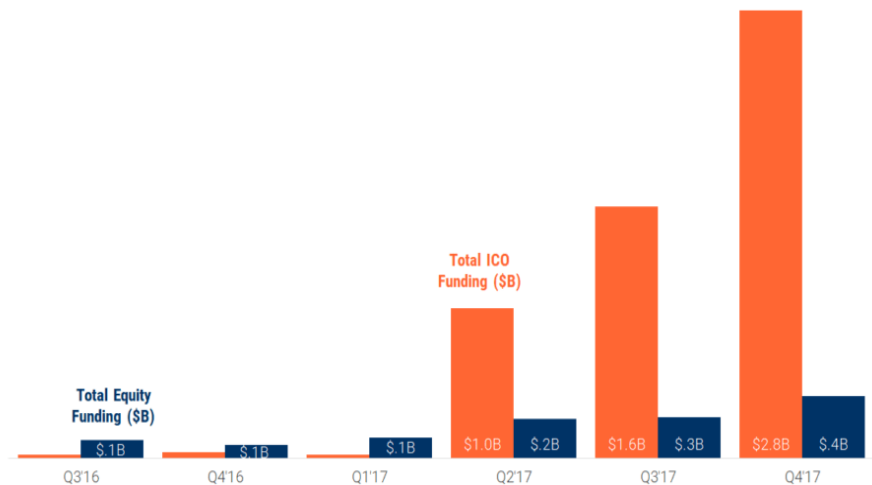
# The Rise of ICOs

- In relation to blockchain startups, 2017 saw over 5x more capital deployed in ICOs vs. traditional equity financings.
- Q4 2017 saw an even more significant jump, with over 7x more capital deployed in ICOs.
- In total, ICOs raised over \$5 billion across approx. 800 deals in 2017 vs. \$1 billion across 215 equity investments in the sector.



## Blockchain equity funding pales in comparison to ICOs

Quarterly blockchain equity and ICO financing. Q3'16 - Q4'17





## Will the Bubble Burst?

- Individuals choose to invest in ICOs typically because they believe that the tokens will have value either in and of themselves as currency (e.g., Bitcoin) or because the tokens will have value on the platform to be created
- Recent purchasers of tokens seem to be simply hoping for a jump in the trading price of the token, much as we've seen from Bitcoin and Ethereum, the two established players. If you bought \$100 of Bitcoin on January 1, 2011, it would be worth over \$1M today.





# Why are ICOs Popular?

- Democratization of access
  - Everyone can participate; no limitations by geography
- Opportunity to invest in accumulated cryptocurrency
  - Limited ways to spend accumulated cryptocurrency except conversion to fiat currency (potential lost value)
- Opportunity to trade tokens immediately
  - Unlike traditional VC investments, new tokens can usually be traded almost immediately on an exchange
- Crypto-community inborn passion for new/modern technologies and applications
  - Support for initiatives that are disrupting existing rules and standards







# What's New?

- **ICO growth** has continued
- Increased regulatory scrutiny
  - **SEC**
    - Chairman Clayton's recent statements and potential gatekeeper liability
    - Official SEC guidance
    - Newly created Cyber Unit and Retail Task Force focused on ICO marketplace
    - SEC issuing a wave of subpoenas seeking information about ICOs
  - **DOJ**
    - First ICO-related arrest in November 2017
    - More arrests will follow
  - **CFTC**
    - Three enforcement actions
    - Joint statement of SEC and the CFTC





# SEC Confirms Some ICOs Are Securities Offerings

- On July 25, the SEC issued its Report of Investigation of an offering of digital tokens by “The DAO.”
- The Report makes clear the SEC’s view that the traditional securities law analysis applies to new technologies, noting that *“the federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using US dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology.”*

SECURITIES AND EXCHANGE COMMISSION  
SECURITIES EXCHANGE ACT OF 1934  
Release No. 81207 / July 25, 2017

**Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934:  
The DAO**

**I. Introduction and Summary**

The United States Securities and Exchange Commission’s (“Commission”) Division of Enforcement (“Division”) has investigated whether The DAO, an unincorporated organization; Slock.it UG (“Slock.it”), a German corporation; Slock.it’s co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.

As described more fully below, The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a “virtual” organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO was created by Slock.it and Slock.it’s co-founders, with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund “projects.” The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms (“Platforms”) that supported secondary trading in the DAO Tokens.

After DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO’s code to steal approximately one-third of The DAO’s assets. Slock.it’s co-founders and others responded by creating a work-around whereby DAO Token holders could opt to have their investment returned to them, as described in more detail below.

The investigation raised questions regarding the application of the U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”).<sup>1</sup> The Commission deems it appropriate and in the public interest to issue this report of investigation (“Report”) pursuant to

<sup>1</sup> This Report does not analyze the question whether The DAO was an “investment company,” as defined under Section 3(a) of the Investment Company Act of 1940 (“Investment Company Act”), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.





# Why It Matters if an ICO Is a Securities Offering

- Under the federal securities laws, any offer and sale of securities must be registered under the Securities Act or conducted under an applicable exemption from registration.
- An ICO that does not meet the requirements of an exemption from registration would likely be an illegal offering and the issuer or individual responsible for promoting it could face civil or criminal liability.
- The purchasers of the securities also have the right under the Securities Act to force the seller to rescind the transaction and repurchase the securities at their original purchase price, plus interest.
- If securities are offered, the activities of exchanges and other intermediaries would also come under scrutiny.





## The DAO – Background

- Over a one-month period in 2016, The DAO offered and sold approximately 1.15 billion DAO tokens in exchange for a total of approximately 12 million Ether (ETH), valued at approximately \$150 million US dollars.
- Investors could hold the tokens as an investment with certain voting and ownership rights or could sell them on web-based secondary market platforms.
- According to promotional materials, The DAO would earn profits by funding projects that would provide DAO token holders a return on their investment. Token holders would receive “rewards” and then vote to either use the rewards to fund new projects or to distribute the ETH to token holders.



## The DAO – Securities Law Analysis

- Both the Securities Act of 1933 and the Securities Exchange Act of 1934 include a broad definition of the term “security” that encompasses a variety of instruments, including an “investment contract.”
- The facts and circumstances test set forth by the US Supreme Court in *SEC v. W.J. Howey Co.* has long been applied to determine whether a particular instrument should be considered an “investment contract” and therefore a “security” for purposes of the Securities Act.





## The DAO – Securities Law Analysis

- The elements to be considered in the application of the *Howey* test are whether the purchasers of the instrument: (i) invested money or valuable goods or services; (ii) were investing in a common enterprise; (iii) with a reasonable expectation of earning profits; (iv) that were to be derived from the efforts of others.
- The SEC Report provides a detailed analysis of the facts and circumstances of the DAO offering and applies the *Howey* test to determine that the DAO tokens were “investment contracts” and therefore subject to the federal securities laws.
- Seen through the lens of the *Howey* test, it is not surprising that the SEC found a security to exist in the DAO offering.





## Munchee, Inc. – Background

- SEC Administrative Cease-and-Desist Order finding violations of Section 5 issued on Dec. 11, 2017
- Munchee, the creator of an iPhone app for reviewing restaurant meals, conducted a sale in October-November 2017 of MUN tokens to raise \$15 million in capital to improve its app and recruit users to eventually buy ads, write reviews, and sell food using MUN.
- Offering materials described the way MUN tokens would increase in value and that token holders would be able to trade MUN tokens on secondary markets.





## Munchee, Inc. – Background

- Offering materials claimed Munchee had done a *Howey* analysis and determined not a significant risk of being a security.
- At the time of the token sale, buyers were not able to use MUN to buy any goods or services on the “ecosystem.”
- Munchee founders made several public statements touting the opportunity for investors to profit from their investment in MUN tokens, and promoted the ICO in forums aimed at investors.





## Munchee, Inc. – Securities Law Analysis

- SEC found that the MUN tokens were securities:
  - Investment of money: investors paid for MUN with Ether or Bitcoin, which the SEC considers a contribution of value
  - Common enterprise/reasonable expectation of profits: proceeds from the offering were intended to be used to build the ecosystem that would create demand for MUN tokens and make the tokens more valuable. Munchee's statements about ensuring secondary trading also an indication that investors could expect to profit from appreciation of value

## Munchee, Inc. – Securities Law Analysis

**Efforts of others:** Profits would be derived from entrepreneurial and managerial efforts of Munchee and its agents in revising the app, creating the ecosystem that would increase the value of MUN, and supporting secondary markets.

SEC also noted marketing of the offering, including comparisons made to prior ICOs and digital assets that had created profits for investors.



## SEC Focus on ICOs

- In recent months, the SEC has ramped up its warning about ICOs that fail to comply with the securities laws.
- SEC Chairman Clayton has repeatedly indicated his view that just about every ICO involves the offer and sale of securities.
- Clayton has also made it clear that lawyers are expected to be gatekeepers and help their clients understand the application of the securities laws.
- Recent news reports indicate the SEC is issuing scores of subpoenas to companies and their advisers seeking information about securities law compliance of ICOs.



## What Do the SEC's Actions Mean for ICOs Going Forward?

- The SEC has not issued a blanket characterization for blockchain tokens as securities
  - It has indicated that such determinations would be made on a case-by-case basis, with some falling in that definition and others outside it.
  - However, it is clear from SEC public statements that they are skeptical of the ability to structure an offering to avoid the securities laws.
- The Munchee order gives some additional clarity on how the SEC is applying *Howey* to these offerings.



## What Do the SEC's Actions Mean for ICOs Going Forward?

- SEC highlighted that even if MUN had practical use at the time of the offering, it could still be a security. The determination does not turn on labeling something as a “utility token” but instead requires assessment of the economic realities of the transaction.
- SEC scrutiny – for example, through the recently reported sweep – is likely to result in increased caution by companies and their advisers.



## What Do the SEC's Actions Mean for ICOs Going Forward?

- Token offerings can be structured to comply with the US federal securities laws.
  - Regulation D
  - Regulation S
  - Reg A+ or '33 Act Registration
- SEC staff has indicated their willingness to work with ICO companies that want to comply.



# **CFTC PRIMER FOR CRYPTO - WEBINAR**



# DEFINITIONS





# Commodity

- **The definition of “commodity” in CEA 1a(9) is very broad:**
  - Specified agricultural contracts (wheat, livestock, etc.);
  - “[A]nd all other goods and articles ...”
  - Except onions and movie tickets;
  - “[A]nd all services, rights, and interests ...”;
  - “[I]n which contracts for future delivery are presently or in the future dealt in.”

**So basically any good, article, service, right or interest that is the subject of a futures contract could be defined as a commodity.**

- **CFTC: All cryptocurrencies are commodities.**



# Swap

**A swap is a contract or transaction that (CEA 1a(47)):**

- 1) Is an option
  - for the purchase or sale, or based on the value, of
  - 1 or more interest or other rates, currencies, commodities ...;
- 2) Provides for any purchase, sale, payment, or delivery
  - that is dependent on the occurrence of an event, or contingency
  - associated with a potential financial, economic, or commercial consequence; or
- 3) Provides for the exchange of 1 or more payments
  - based on the value or level of 1 or more interest or other rates, commodities ...
  - that transfers the financial risk associated with a future change in any such value
  - without also conveying ownership in an asset / liability that incorporates the risk.



# Spot Contract

- Underlying cash market.
- Intent to deliver & actual delivery.
  - If transactions are leveraged, must:
    - Result in actual delivery w/in 28 days; or
    - Be between commercial entities in connection with their business.
  - Commission has proposed interpretation on actual delivery of cryptocurrencies.
- Spot exchanges do not have to be registered with CFTC.
- Activity on spot exchanges does not subject you to registration as an intermediary.
  - BUT if the products on a spot exchange are actually mis-labeled derivatives, your activity on the spot exchange may subject you to registration requirements.



# Actual Delivery (Leveraged Transactions)

## **Proposed Interpretation of Retail Commodity Transactions Involving Virtual Currency:**

- 1) A customer having the ability to:
  - (i) take possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage, or any other financing arrangement, and
  - (ii) use it freely in commerce (both within and away from any particular platform) no later than 28 days from the date of the transaction; and
  
- 2) The offeror and counterparty seller (including any of their respective affiliates or other persons acting in concert with the offeror or counterparty seller on a similar basis) not retaining any interest in or control over any of the commodity purchased on margin, leverage, or other financing arrangement at the expiration of 28 days from the date of the transaction.



## CFTC on SEC's Token Analysis

- “There is no inconsistency between the SEC’s analysis and the CFTC’s determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.”
- “The CFTC looks beyond form and considers the actual substance and purpose of an activity when applying the federal commodities laws and CFTC regulations.”





# CONTRACTS



# TeraExchange Certifies First Bitcoin Derivative (Swap)

- TeraExchange Certification
  - 9/19/13: CFTC's grant of temporary registration to operate as a SEF to TeraExchange became effective.
  - 9/11/14: TeraExchange filed a submission of self-certification for the Bitcoin swap.
  - Valuations of the Bitcoin swap were determined by reference to an index of bids, offers, and executed transactions on a number of Bitcoin exchanges.
  
- CFTC had limited ability to refuse the request because:
  - The “commodity” definition is broad; and
  - The contract approval process:
    - In essence, really only allows the CFTC to disapprove the application if it can show that the application violates the CEA or the regulations.



# Virtual Currencies – Bitcoin Contracts

- In December 2017, the Chicago Mercantile Exchange, Inc. (CME) and the CBOE Futures Exchange (CFE) self-certified new contracts for Bitcoin futures products and the Cantor Exchange self-certified a new contract for Bitcoin binary options.
- On January 4, 2018, Commission issue a Backgrounder on Self-Certified Contracts for Bitcoin Products, highlighting:
  - Limitations of self-certification process; and
  - CFTC’s due diligence.
- On January 19, 2018, Chairman noted that CFTC has engaged in a “heightened review” with the Designated Contract Markets (DCMs) and has been involved in several drafts of the terms and conditions of Bitcoin futures products.
- On January 31, 2018, Technology Advisory Committee considered the process of self-certification of new products and operational rules by DCMs.





# CFTC'S CRYPTO AGENDA



# CFTC Oversight – Commissioners’ Statements

## **Chairman Giancarlo – Testimony before Senate Banking Committee (2/6/18)**

- “DLT is likely to have a broad and lasting impact on global financial markets in payments, banking, securities settlement, title recording, cyber security and trade reporting and analysis. When tied to virtual currencies, this technology aims to serve as a new store of value, facilitate secure payments, enable asset transfers, and power new applications.”
- “The CFTC has been particularly assertive of its enforcement jurisdiction over virtual currencies. It has formed an internal virtual currency enforcement task force to garner and deploy relevant expertise in this evolving asset class.”





# CFTC Oversight – Commissioners’ Statements (continued)

## **Commissioner Quintenz – Technology & Standards Conference (11/30/17)**

- “Although there will always be bad actors willing to engage in manipulative or fraudulent practices, the launch of the bitcoin futures contract provides investors with an opportunity to trade bitcoin exposure in a regulated market.”

## **Commissioner Behnam – MRAC Opening Statement (1/31/18)**

- “I want to do everything in my power to support and promote innovation; however, the Commission must exercise our duties such that when we look back on the record, it shows that we took the necessary steps to fulfill our mission in a careful and deliberative manner.”





# LabCFTC

- “LabCFTC is the focal point for the CFTC’s efforts to promote responsible financial technology (FinTech) innovation and fair competition for the benefit of the American public. LabCFTC is designed to be the hub for the agency’s engagement with the FinTech innovation community.”
  
- “LabCFTC will enable the CFTC to be proactive and forward-thinking as FinTech applications continue to develop. LabCFTC's mission is twofold:
  - To promote responsible FinTech innovation to improve the quality, resiliency, and competitiveness of our markets; and
  - To accelerate CFTC engagement with FinTech and RegTech solutions that may enable the CFTC to carry out its mission responsibilities more effectively and efficiently.”





# Virtual Currencies – Guidance

- **LabCFTC Primer on Virtual Currencies (October 2017)**
  - CFTC has jurisdiction when a virtual currency is used in a derivatives contract, or when there is fraud or manipulation involving a virtual currency traded in interstate commerce.
  - Aside from instances of fraud or manipulation, the CFTC is generally not involved with cash market exchanges and transactions concerning virtual currencies that do not utilize margin, leverage, or financing.
- **Examples of Prohibited Activities:**
  - Price manipulation of virtual currencies traded in interstate commerce.
  - Pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract.
  - A virtual currency futures or option contract or swap traded on a domestic platform or facility that has not registered with the CFTC as a SEF or DCM.
  - Certain schemes involving virtual currency marketed to retail customers, such as off-exchange financed commodity transactions with persons who fail to register with the CFTC.





# Virtual Currencies – Guidance

## **Customer Advisory: Understand the Risks of Virtual Currency Trading (December 2017)**

- Issued to “inform the public about the risks associated with investing or speculating in virtual currencies or recently launched Bitcoin futures and options.”
- Risks associated with virtual currency:
  - Most cash markets are not regulated or supervised by a government agency;
  - Platforms in cash markets may lack system safeguards;
  - Volatile cash market;
  - Cash market manipulation;
  - Cyber risks; and
  - Platforms selling from their own accounts and putting customers at an unfair disadvantage.
- In Feb 2018, also issued advisory on cryptocurrency pump-and-dump schemes.





# ENFORCEMENT



# Enforcement Matters

- **Coinflip (9/17/15) – CFTC issues Order to Coinflip:**
  - Ordering Coinflip, a Bitcoin options trading platform operator, and its CEO, to cease illegally offering Bitcoin options, and to cease operating a facility for trading or processing of swaps without registering.
  - CFTC notes that **“Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.”**
  
- **TeraExchange (9/24/15) – CFTC settles with TeraEXchange:**
  - Alleging, among other things, that TeraExchange engaged in wash trading and pre-arranged trading when it arranged a “test” trade between two traders in a NDF, based on the relative value of the U.S. Dollar and Bitcoin.
  - In order, CFTC notes that **“Bitcoin is a commodity** under Section 1a of the Act ... and is therefore subject as a commodity to applicable provisions of the Act and Regulations.”







# Enforcement Matters

- **Gelfman Blueprint (9/21/17) – CFTC filed complaint alleging:**
  - Among other things, it fraudulently solicited participation in a pooled fund, claiming to use HFT strategy to trade Bitcoin.
  - Created false strategy and performance reports.
  - Gave payouts of false profits using other customers' funds (i.e., Ponzi Scheme).
  
- **Patrick McDonnell & CabbageTech (1/19/18) – CFTC filed complaint alleging:**
  - Fraud and misappropriation involving purchases and trades of Bitcoin and Litecoin.
  - Defendants falsely claimed to provide real-time virtual currency trading advice, when no trading advice was provided.
  - Defendants used their fraudulent solicitations to obtain and misappropriate customer funds.





# Enforcement Matters

- **Dillon Michael Dean & Entrepreneurs Headquarters (1/19/18) - CFTC filed complaint alleging:**
  - Defendants engaged in a fraudulent scheme to solicit Bitcoin, misrepresenting that customers' funds would be pooled and invested in products including binary options.
  - Defendants solicited at least \$1.1 million worth of Bitcoin from more than 600 people.
  - Defendants, instead, misappropriated their customers' funds and used the funds to pay other customers by employing a Ponzi scheme.
  
- **My Big Coin Pay (1/24/18) – CFTC brought complaint alleging:**
  - Defendants misrepresented that MBC was actively being traded on several currency exchanges when it was not.
  - Misrepresented in reports the daily trading price, when in fact no price existed because MBC was not trading.
  - Misrepresented that MBC was backed by gold, when in fact it was not.





# Fundamental Questions

- Is the financial product that you are using a CFTC-regulated product?
- If **yes**, does the way that you are interacting with this financial product subject you to CFTC registration requirements (and therefore other regulatory obligations)?
  - *Platform*: Swap Execution Facility (or Designated Contract Market)
  - *Intermediary*: Introducing Broker, Futures Commission Merchant, Commodity Trading Advisor, Commodity Pool Operator, Swap Dealer
- If you are not required to be registered, are there other requirements that you are nonetheless subject to because you are using this financial product?
  - Recordkeeping
  - Reporting





# Questions

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- Features a growing library of video insights from lawyers, investors and other experts
- Allows entrepreneurs and investors to build knowledge, research topics with everyday impact and connect with dedicated lawyers
- Contains Document Generator

