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SECURITIES OFFERINGS

Contemplating an ICO? It's All Fun and Excitement Until the SEC Comes to Call



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“Everybody’s doing it.” “No one’s getting hurt.” “You’re ruining all the fun.”

Those retorts sound like the arguments a teen makes when her parents forbid her from attending a concert or a party. They’re also what some attorneys are hearing when they counsel startup founders itching to raise capital through an initial coin offering (ICO).

ICOs are unarguably a fast and effective way to secure money: Sales in 2017 totaled \$5.6 billion, Token Data reported, and \$1.2 billion of that was raised in December alone. Companies are making headlines for their highly profitable sales of tokens or coins, which can then be traded in the cryptocurrency ecosystem.

However appealing this sounds, these offerings come with significant risk, and potential token issuers must proceed with caution. While it might seem that the lawyers are spoiling the fun, our job is to protect our clients

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by making sure they understand legal risks and follow the law.

In the case of ICOs, that law is laid down by the U.S. Securities and Exchange Commission (SEC). Over the past few months, this agency has been ramping up its warnings about ICOs that fail to comply with U.S. securities laws.

IPOs vs. ICOs

In an IPO, a company raises capital by selling shares at a set price to investors, who seek to profit from their investment. IPOs and other securities offerings are registered with the SEC (or rely on an exemption from registration) and comply with disclosure and reporting requirements and anti-fraud measures. Many initial coin offerings thus far look—and sound—a lot like IPOs. But there’s one key difference: They have skirted or ignored those registration requirements, or the need for an exemption, in reliance on the idea that securities law doesn’t apply to cryptocurrency coin sales.

The SEC begs to differ, and it did, quite vocally, last year. In December, the SEC stopped an ICO by Munchee Inc., a California-based company selling “MUN tokens” to raise \$15 million in capital. The SEC claimed Munchee, a restaurant-review app, offered and sold unregistered securities because it promoted the coins as an investment vehicle with a potential upside. After the SEC contacted the company, the company

halted sales and returned investors' money, so the agency did not impose any penalties.

That's a cautionary tale—and one that every vigilant lawyer should be sharing with clients contemplating an ICO. The SEC's chairman, Jay Clayton, has made it clear in public statements that he expects the lawyers to be the gatekeepers in this area and do more than hedge or tell clients that this is a gray area. The legal issues are complicated, and while in many cases it will be difficult for the lawyers to conclude that the securities laws do not apply, that does not mean that there is no path forward for the ICO.

Let's say you're committed to staying out of trouble. Working with your lawyer, you can explore options to do your ICO as a securities offering under one of the SEC's exemptions, such as a crowdfunding or an offering only to accredited investors. It may even be possible to register the offering and make the mandatory disclosures and filings. This, however, is a time-consuming and expensive process—which is why no ICOs have ever gone this route.

Consequences and Repercussions

The SEC is monitoring ICOs and has been contacting companies that have announced ICOs to determine whether their securities law analysis holds up. If it doesn't, the SEC can slap cease-and-desist orders on cryptocurrency sellers and impose hefty fines and penalties. A possibly even scarier prospect for startups is the rescission right that would allow anyone who bought the securities from the company in an illegal offering to demand that the company refund their money.

Although the SEC doesn't have the authority to pursue criminal prosecution, it can refer egregious cases, such as those involving outright fraud, to the U.S. Department of Justice. A Brooklyn man last year was charged with securities fraud conspiracy in connection with two ICOs whose coins were backed by . . . nothing.

If you're contemplating an ICO, make sure your legal advice is coming from one of those boring, cautious attorneys who's not going to push the envelope. The SEC insists that lawyers do their jobs, and a big part of our job—and sometimes the best part—is keeping our clients out of trouble.