



Rutgers Business Law Review

rutgersbusinesslawreview.com

Volume 14

2018-2019

INITIAL COIN OFFERINGS: STRIKING A BALANCE BETWEEN PROTECTING INVESTORS AND FOSTERING GROWTH

Brian MacNiven¹

I. Introduction

Initial Coin Offerings (“ICOs”) are quickly becoming the preferred method of raising capital around the globe.² Issuers and investors alike are boarding this seemingly unstoppable train.³ Currently, regulators around the world are grappling with how to regulate this new technology.⁴ The United States in particular is implementing a case-by-case approach for determining whether the ICO token is a security.⁵ This has proven wholly inefficient. Fraud is the new norm⁶ and not a single company has registered its token with the SEC.⁷

¹ J.D. Candidate 2019, Rutgers Law School.

² See *infra* Section II.A.

³ See *infra* Sections II & III.

⁴ See *infra* Section IV.

⁵ See *infra* Section V.

⁶ See *infra* Section III.B.

⁷ Tom Zanki, *Regulatory Heat On ICOs Expected To Intensify In 2018*, LAW360 (Jan. 1, 2018), <https://www.law360.com/articles/997046/regulatory-heat-on-icos-expected-to-intensify-in-2018> [hereinafter Zanki, *Regulatory Heat*].

Inherent in ICO regulation is the need for a balance between protecting investors and fostering growth within this promising realm of raising capital. To strike this balance, the United States should declare all ICOs ‘modified securities.’ Modified exemptions must then be developed and applied to the securities regulatory system. If properly evaluated and implemented, the sky is the limit for this new technology.

In this note, Section II will provide an overview of recent ICO growth and explain how ICOs operate. Section III will assess the risks and benefits of this new technology and emphasize the importance of finding a balance between the two competing interests. Then, Section IV will outline how foreign regulators are approaching ICO regulation and address the consequences of fragmented regulation. Section V is devoted to an analysis of the United States’ method. Next, Section VI will outline the current securities laws in the United States and explain why they are unsuitable for ICOs. Finally, Section VII offers a potential solution by creating a new exemption for ICOs.

II. Overview

A. Popularity

ICOs are booming. In less than a year, ICOs became the fastest growing capital market in the world.⁸ Ethereum, an ICO, raised \$18.4 million in just 42 days.⁹ From July 2016 to July 2017 ICOs raised \$331 million compared to only \$140 million raised by venture capitalists.¹⁰

⁸ Randolph Robinson, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings*, 85 TENN. L. REV. 1 (forthcoming Spring 2019).

⁹ Ameer Rosic, *ICO Pros & Cons: Cutting Through The Noise*, HUFFINGTON POST (July 4, 2017, 8:02 AM), https://www.huffingtonpost.com/entry/ico-pros-cons-cutting-through-the-noise_us_595b7f22e4b0c85b96c6646e.

¹⁰ *Id.*; “A venture capitalist is an investor who either provides capital to startup ventures or supports small companies that wish to expand but do not have access to equities markets. Venture capitalists are willing to invest in such companies because they can earn a massive

Approximately \$900 million was raised through ICOs in the second quarter of 2017 compared to \$40 million raised in the first quarter of 2016.¹¹ That figure jumped as ICOs yielded \$740 million globally in November 2017 alone.¹² The total amount raised in 2017 is estimated at \$3.7 billion whereas \$96 million was raised in 2016.¹³ The numbers are an undeniable representation of the recent shift from traditional means towards ICOs to raise capital.¹⁴ In just a few years this entirely new market emerged, grew, and is now becoming the go-to method for companies to raise capital. Such substantial growth in this new method of raising capital has turned heads from everyday investors to governments around the world. Many are looking to capitalize, while many more aim to regulate and control this innovative market. Naturally, a dilemma ensues on how to strike a balance between the two interests.

B. How It Works

Blockchain technology and ICOs are widely recognized for the potential to create a myriad of benefits.¹⁵ But, what are ICOs and how do they relate to blockchain technology? Their purpose is to raise capital for a business.¹⁶ ICOs allow an investor to exchange fiat or virtual currency for

return on their investments if these companies succeed.” *Venture Capitalist*, INVESTOPEDIA: TERMS, <https://www.investopedia.com/terms/v/venturecapitalist.asp> (last visited April 15, 2018).

¹¹ Tom Zanki, *China’s ICO Crackdown Clouds Efforts At Global Consistency*, LAW360 (Sept. 12, 2017, 9:33 PM), <https://www.law360.com/articles/963026/china-s-ico-crackdown-clouds-efforts-at-global-consistency> [hereinafter Zanki, *China’s ICO Crackdown*].

¹² Karsten Wockener et al., *Regulation of Initial Coin Offerings*, WHITE & CASE LLP: PUBLICATIONS & EVENTS (Dec. 15, 2017), <https://www.whitecase.com/publications/alert/regulation-initial-coin-offerings>.

¹³ Morgan J. Hayes, Byungkwon Lim & Gary E. Murphy, *Blockchain Tokens and Initial Coin Offerings: New Year, New Perspective*, DEBEVOISE & PLIMPTON LLP: CLIENT UPDATE (Jan. 25, 2018), <https://www.debevoise.com/insights/publications/2018/01/blockchain-tokens-and-initial-coin-offering>.

¹⁴ Zanki, *Regulatory Heat*, *supra* note 7.

¹⁵ Hayes, *supra* note 13.

¹⁶ *Initial Coin Offerings*, SEC: INVESTOR BULLETINS (Jul. 25, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

a digital asset known as a token.¹⁷ Issuers use this capital to fund the development of their businesses.¹⁸

Unlike traditional Initial Public Offerings (“IPOs”), tokens do not represent an ownership interest or dividend right and do not have the primary goal of value creation.¹⁹ Rather, ICOs offer a more direct benefit derived from the company’s future business.²⁰ The tokens allow the purchaser access to the business, to participate in a share of the returns and provide an opportunity for resale on the secondary market.²¹ For example, an amusement park may sell tokens to investors to raise money for building the park.²² These tokens may then allow the purchaser use of the amusement park.²³ Additionally, the purchaser has the option of trading these tokens on the secondary market to turn a profit.²⁴

¹⁷ Jay Clayton, *Statement on Cryptocurrencies & Initial Coin Offerings*, SEC: PUBLIC STATEMENT (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>; *EBA Opinion on ‘virtual currencies’*, EUROPEAN BANKING AUTHORITY 5 (July 4, 2014) <https://eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf>. (“Virtual Currencies are a digital representation of value that is neither issued by a central bank or a public authority, nor necessarily attached to a Fiat Currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically.”).

¹⁸ *Initial Coin Offerings*, *supra* note 16.

¹⁹ Wockener et al., *supra* note 11; An IPO is defined as a company’s first sale of stock to the public. *Initial Public Offering*, NASDAQ: FINANCIAL GLOSSARY, <https://www.nasdaq.com/investing/glossary/i/initial-public-offering> (last visited April 16, 2018).

²⁰ Wockener et al., *supra* note 11.

²¹ *Initial Coin Offerings*, *supra* note 16.

²² Ian Lopez, *A Market with ‘Zero Regulation’: Experts Disagree on Regulator Role in Cryptocurrency*, LAW.COM: LEGALTECH NEWS (July 21, 2017, 2:05 AM), <https://www.law.com/legaltechnews/sites/legaltechnews/2017/07/21/a-market-with-zero-regulation-experts-disagree-on-regulator-role-in-cryptocurrency/>.

²³ *Id.*

²⁴ *Id.*

Businesses create tokens, register them, then sell the registered tokens to investors.²⁵ The tokens are registered on the blockchain.²⁶ The blockchain is an electronic distributed ledger where information is held on all computers within the network, instead of the traditional central server.²⁷ Typically, a bank sends money to the Federal Reserve or central server.²⁸ From there, the central server takes the money and credits the individual's account.²⁹ By contrast, the blockchain is a distributed ledger, or list of entries, where transactions are electronically recorded in a network of computers and reproduced, without a central authority.³⁰ This allows cryptocurrency or tokens to be sent from one digital wallet to another, creating a novel way to initially issue and subsequently trade on the secondary market.³¹

The record allows everyone in the network to verify and track the moving assets across independent networks.³² "Upon joining the network, each connected computer receives a copy of the blockchain, which has records, and stands as proof of, every transaction ever executed."³³ Each connected computer is called a node.³⁴ Once the transaction is published, it cannot be changed.³⁵

III. Benefits and Risks

²⁵ Lewis McLellan, *SEC puts crypto on notice with DAO verdict*, GLOBAL CAPITAL (July 27, 2017), <https://www.globalcapital.com/article/b141n9b41y6c2n/sec-puts-crypto-on-notice-with-dao-verdict>.

²⁶ *Id.*

²⁷ *Id.*

²⁸ Interview with Ather Williams, Head of Global Transaction Services, Bank of America Merrill Lynch, in Singapore (Jan. 12, 2016) [hereinafter Williams].

²⁹ *Id.*

³⁰ *Initial Coin Offerings*, *supra* note 16.

³¹ Dylan Yaga et al., *Blockchain Technology Overview*, NATIONAL INSTITUTE OF STANDARDS AND TECHNOLOGY: INTERNAL REPORT 4 (Jan. 2018), <http://pages.cs.wisc.edu/~remzi/Classes/739/Fall2018/Papers/blockchain.pdf>.

³² Williams, *supra* note 28.

³³ *Blockchain*, INVESTOPEDIA: TERMS, <https://www.investopedia.com/terms/b/blockchain.asp> (last visited April 15, 2008).

³⁴ *Id.*

³⁵ Yaga et al., *supra* note 31 at 4.

A. Benefits

The substantial growth in ICOs can be attributed to the many benefits available to both investors and issuers. To begin, a large draw to investors is the potential for a substantial payout.³⁶ ICOs allow for investment in the early stages of a company and without an entry threshold.³⁷ This permits everyday investors to invest small amounts of money and reap great profits.³⁸ Unlike traditional investment outlets, where only a select population can participate, ICOs are readily accessible to the average person.³⁹ Typically, an average investor would have to pay a premium at the IPO, after most of the true value has been absorbed by the venture capitalists.⁴⁰ However, with this new approach, all information on the company is open to the general public.⁴¹ Thus, every investor, large or small, has democratized access to investments at their inception.⁴²

Moreover, the ability to immediately liquidate or trade a token is unique and beneficial to investors.⁴³ Distinct from a typical venture capital investment, where the value of an investment can be locked into a company for years, ICO investors can instantly trade tokens on the secondary market.⁴⁴ Token investors have the ability to realize profits immediately, as opposed to potentially

³⁶ *The Truth About ICO: Pros&Cons*, MEDIUM: BONPAY (Nov .14, 2017), <https://medium.com/@bonpay/the-truth-about-ico-pros-cons-a52a736f4d96> [hereinafter *The Truth*].

³⁷ *Id.*

³⁸ *Id.*

³⁹ Samara Malkin, *ICOs in 2018: Do we Need Regulations?*, CRYPTO CURRENCY NEWS: ICOS (Jan. 29, 2018), <https://cryptocurrencynews.com/icos/icos-in-2018-are-regulations-on-horizon/>.

⁴⁰ Jamie Burke, *ICO Pros & Cons: Cutting Through The Hype*, MEDIUM: OUTLIER VENTURES (April 16, 2017), <https://medium.com/outlier-ventures-io/ico-pros-cons-cutting-through-the-hype-d4b58cbd77a8>.

⁴¹ *The Truth*, *supra* note 36.

⁴² *The Truth*, *supra* note 36.

⁴³ Burke, *supra* note 40.

⁴⁴ Burke, *supra* note 40.

waiting years.⁴⁵ As a result, the secondary market provides greater transparency into the company because investors can get real-time pricing based on the progress of the company.⁴⁶

In addition, there are benefits obtained solely by issuing companies.⁴⁷ Founders of ICOs are able to keep all money raised, which is not the case with venture capitalism.⁴⁸ Also, issuers are not required to comply with stringent and costly paperwork.⁴⁹ This permits a wider array of companies to enter the market.⁵⁰ Further, since ICOs are not controlled by the government, they are not subject to any commission or tax.⁵¹ Finally, issuers benefit from increased social enterprise.⁵² Projects that may be unattractive to venture capitalists now have a means to obtain funding.⁵³

B. Risks

This technology may be the future of fundraising, however, as it currently operates, there are many noteworthy flaws. Today, stories of cryptocurrency investors experiencing an unexpected and substantial increase in wealth are widespread.⁵⁴ These tales of success are exploited by fraudsters and promoters of high-risk investment opportunities.⁵⁵ Predators entice investors by promising high returns and an opportunity to enter into this cutting-edge space.⁵⁶

⁴⁵ Burke, *supra* note 40.

⁴⁶ Burke, *supra* note 40.

⁴⁷ Malkin, *supra* note 39.

⁴⁸ Malkin, *supra* note 39.

⁴⁹ Malkin, *supra* note 39.

⁵⁰ Rosic, *supra* note 9.

⁵¹ *The Truth*, *supra* note 36.

⁵² Burke, *supra* note 40.

⁵³ Burke, *supra* note 40.

⁵⁴ *Bitcoin and Other Virtual Currency-Related Investments*, SEC: INVESTOR ALERT (May 7, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html [hereinafter *Bitcoin*].

⁵⁵ *Id.*

⁵⁶ *Id.*

A common tactic is market manipulation, used to cash in with a ‘pump and dump’ scheme.⁵⁷ Fraudsters spread false and misleading information via various mediums to inflate an investment’s value.⁵⁸ Once the value increases or ‘pumps,’ the fraudsters sell or ‘dump’ their block of the investment.⁵⁹ They turn a profit then stop hyping the investment.⁶⁰ At that point, the value of the investment decreases and investors lose their money.⁶¹

Moreover, if a token investor falls victim to fraud or theft, recovery avenues are limited.⁶² The nature of ICOs make it difficult for law enforcement officials to pursue bad actors and recover funds, thus limiting potential remedies.⁶³ Without a central authority, it is difficult to track the flow of money.⁶⁴ The SEC, is forced to rely on less reliable means to obtain user information.⁶⁵

This risk is compounded when the exchange occurs overseas or is unlawfully operated without the investors knowledge.⁶⁶ Foreign issuers are able to sell tokens within the United States.⁶⁷ Thus, these issuers receive proceeds abroad, outside the reach of US regulators.⁶⁸ This type of transaction frequently renders the SEC unable to address the consequences of any

⁵⁷ *Public Companies Making ICO-Related Claims*, SEC: INVESTOR ALERT (Aug. 28, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_icorelatedclaims.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*; The cryptocurrency Bittrex exemplifies this problem. Before the pump, the currency was worth .0046 bitcoin (“BTC”) or \$11.61. Post-pump Bittrex was worth .0438 BTC or \$110. After the dump, Bittrex was back to .0059 BTC or \$14.90. Patrick Thompson, *Pump and Dump in Crypto: Cases, Measures, Warnings*, COINTELEGRAPH: NEWS (Feb. 24, 2018), <https://cointelegraph.com/news/pump-and-dump-in-crypto-cases-measures-warnings>.

⁶² *Initial Coin Offerings*, *supra* note 16.

⁶³ *Initial Coin Offerings*, *supra* note 16.

⁶⁴ *Initial Coin Offerings*, *supra* note 16.

⁶⁵ *Initial Coin Offerings*, *supra* note 16.

⁶⁶ *Initial Coin Offerings*, *supra* note 16.

⁶⁷ Hayes, *supra* note 13.

⁶⁸ Hayes, *supra* note 13.

misconduct by the issuer.⁶⁹ Even if this hurdle is overcome and the asset is located, law enforcement may experience difficulty freezing or securing the virtual currency as the virtual wallets are encrypted.⁷⁰

Additionally, the SEC highlighted some of the unique risks inherent in cryptocurrency investments.⁷¹ Unlike securities accounts at brokerage firms that are insured by the Securities Investor Protection Corporation (“SIPC”) and bank accounts insured by the Federal Deposit Insurance Corporation (“FDIC”), cryptocurrency investments do not have these protections.⁷² Since this market is a recent innovation, it lacks an established record of credibility.⁷³ Virtual currency investments can stop operating, shut down due to fraud, experience technical problems or be stolen by hackers.⁷⁴ Without insurance, investors do not have protection and run the risk of losing their money.⁷⁵ Also, the crypto market has history of extreme volatility.⁷⁶ This means that an investment can change dramatically, either up or down, in a short period of time.⁷⁷ All things considered, purchasing cryptocurrency is a high-risk investment.

a. A Little Bit of Both – White Papers

All companies issuing ICOs are required to complete a white paper. A white paper is defined as “an informational document, issued by a company, to promote or highlight the features

⁶⁹ Hayes, *supra* note 13.

⁷⁰ *Initial Coin Offerings*, *supra* note 16.

⁷¹ *Bitcoin*, *supra* note 54.

⁷² *Bitcoin*, *supra* note 54.

⁷³ *Bitcoin*, *supra* note 54.

⁷⁴ *Bitcoin*, *supra* note 54.

⁷⁵ *Bitcoin*, *supra* note 54.

⁷⁶ The bitcoin exchange rate dropped more than 50% in one day. *Bitcoin*, *supra* note 54.

⁷⁷ *Volatility*, INVESTOPEDIA: TERMS, <https://www.investopedia.com/terms/v/volatility.asp> (last visited April 15, 2008).

of a solution, product or service.”⁷⁸ “The purpose of a white paper is to promote a certain product, service, technology or methodology, and to influence current and prospective customers’ decisions.”⁷⁹ White papers are used as sales and marketing documents to entice customers to purchase the ICO.⁸⁰ Completing and providing this white paper is both a benefit and a risk.

To begin, the current white paper system is advantageous to issuers. Unlike the expensive disclosure required in registered securities offerings,⁸¹ white papers do not require the same mountain of paperwork that has the potential to end a great business idea before it can get off the ground.⁸² A quality white paper typically takes about 24 to 45 hours to produce or can be purchased for \$1,000 to \$3,000.⁸³ Often, ICOs involve technology that is in an early stage of development or application.⁸⁴ This allows for companies that would normally not be able to afford raising capital to enter the ICO marketplace.⁸⁵ Now, a new business plan with groundbreaking potential has the opportunity to succeed by simply completing a short white paper.⁸⁶

However, white papers still have the potential to create problems. White papers are essentially advertisements in that they are used to entice customers and promote a product before a sale takes place.⁸⁷ They are not meant to provide support to the investor after making the

⁷⁸ *White Paper*, INVESTOPEDIA: TERMS, <https://www.investopedia.com/terms/w/whitepaper.asp> (last visited April 15, 2008).

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ Zanki, *China’s ICO Crackdown*, *supra* note 12.

⁸² STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION 540, 830 (University Casebook Series Editorial Board et al. ed., 3rd ed. 2012).

⁸³ *How Much Does a White Paper Cost*, IMITTCOPY: THE WHITE PAPER BLOG, <http://imittcopy.com/Thewhitepaperblog/how-much-does-a-white-paper-cost-prices-revealed/> (last visited April 15, 2008).

⁸⁴ Hayes, *supra* note 13.

⁸⁵ Rosic, *supra* note 9.

⁸⁶ Hayes, *supra* note 13.

⁸⁷ *White Paper*, *supra* note 78.

purchase.⁸⁸ With the sole purpose of solicitation, an ICO white paper can be unbalanced, incomplete and misleading.⁸⁹ Additionally, white papers are not standardized documents subject to regulatory scrutiny.⁹⁰ Although white papers are subject to anti-fraud and information requirements, they are not examined by regulatory authorities nor is there any established case law defining appropriate ICO documentation.⁹¹ Thus, it is doubtful a reasonable investment decision may be based on the white paper alone.⁹²

C. Striking a Balance

It is difficult for a governmental body to strike a balance between protecting investors and promoting technological developments.⁹³ The risks and benefits of this technology must be given adequate weight and compromise must be found to offer the most effective regulatory scheme.

IV. Foreign Strategies

The sudden and substantial growth of ICOs has captured the attention of countries all over the world.⁹⁴ Without a proven regulatory scheme, nations are grappling with how to handle this

⁸⁸ *White Paper*, *supra* note 78.

⁸⁹ *Initial Coin Offerings*, FINANCIAL CONDUCT AUTHORITY: STATEMENTS (Dec. 9, 2017), <https://www.fca.org.uk/news/statements/initial-coin-offerings>; Centra claimed that their token was backed by Visa and MasterCard in their white paper. The SEC investigated and determined that no relationship with Visa or Mastercard existed. The SEC also found that Centra included fictional executives with fake biographies in the white paper. *SEC Halts Fraudulent Scheme Involving Unregistered ICO*, SEC: PRESS RELEASE (April 2, 2018), <https://www.sec.gov/news/press-release/2018-53>.

⁹⁰ Matthew De Silva, *UK's Financial Conduct Authority Issues ICO Warning*, ETH NEWS: CRYPTOCURRENCIES AND TOKENS (Sept. 12, 2017), <https://www.ethnews.com/uks-financial-conduct-authority-issues-ico-warning>.

⁹¹ Wockener et al., *supra* note 11.

⁹² Wockener et al., *supra* note 11. The company Droplex copied the white paper of another ICO word for word, only changing the company name. *The 6 Worst ICO's of All Time*, Coinist, <https://www.coinist.io/6-worst-icos-of-all-time/> (last visited April 17, 2018).

⁹³ Hayes, *supra* note 13.

⁹⁴ Wockener et al., *supra* note 11.

new technology. Some have banned the technology, some have modified their laws to adapt and others seem to still be figuring out how to adjust.

For instance, in September 2017, the Chinese government declared all ICOs illegal and mandated all fundraising be halted.⁹⁵ Soon after, the government ordered every cryptocurrency exchange platform be shut down.⁹⁶ Accordingly, financial institutions were banned from carrying out business related to token-financing transactions.⁹⁷ As a final nail in the coffin, China ordered all token-based financing transactions already completed to repatriate their funds.⁹⁸ The government reasoned that ICOs hurt the market because of potential deception and fraud.⁹⁹ This outright ban of ICO-related activity is the most severe act of regulation to date.¹⁰⁰

In contrast, Japan encourages the development of ICO technology with a more progressive approach.¹⁰¹ Japan, through the Financial Services Agency (“FSA”), recognized Bitcoin as a legal tender.¹⁰² It released a statement declaring that “certain digital tokens issued by ICOs may fall into the definition of virtual currency under the Payment Services Act and thus an operator involving the exchange of such digital tokens as its business must be registered with the FSA.”¹⁰³ In April

⁹⁵ Wockener et al., *supra* note 11.

⁹⁶ Wockener et al., *supra* note 11.

⁹⁷ Zanki, *China’s ICO Crackdown*, *supra* note 12.

⁹⁸ Zanki, *China’s ICO Crackdown*, *supra* note 12.

⁹⁹ Wulf A. Kaal, *Initial Coin Offerings: The Top 25 Jurisdictions and Their Comparative Regulatory Responses*, STANFORD JOURNAL OF BLOCKCHAIN LAW & POLICY (Sept. 19, 2018), <https://stanford-jblp.pubpub.org/pub/ico-comparative-reg>.

¹⁰⁰ Zanki, *China’s ICO Crackdown*, *supra* note 12.

¹⁰¹ David Ramm, *Cryptocurrencies and ICOs – A Rough Global Guide to Regulation*, CCN.COM (Nov. 26, 2017), <https://www.ccn.com/cryptocurrencies-icos-rough-guide-regulation/>.

¹⁰² *Id.*

¹⁰³ *Japan’s FSA Clarifies Regulatory Position on Initial Coin Offerings*, JONES DAY: PUBLICATIONS (Dec. 2017), <http://www.jonesday.com/japans-fsa-clarifies-regulatory-position-on-initial-coin-offerings-warns-of-risks-12-07-2017/>. Virtual Currency is defined as a proprietary value that satisfies all of the following criteria: 1) Between unspecified persons: (i) it can be used to settle payments for goods and/or services and exchanged with legal currency; or (ii) it can be

2017, Japan amended the Payment Services Act to introduce a registration system for operators of “Virtual Currency Exchange Businesses.”¹⁰⁴ Since then, 11 companies successfully completed the registration process and now operate cryptocurrency exchanges on the Virtual Currency Exchange Business.¹⁰⁵

The most popular approach seems to be tackling each cryptocurrency on a case-by-case basis.¹⁰⁶ Singapore confirmed that it would regulate the offering if the cryptocurrency fell within its definition of a security under the Securities and Futures Act.¹⁰⁷ The Financial Conduct Authority in the United Kingdom believe the only way to determine regulatory status is on an individual basis.¹⁰⁸ The Canadian Securities Administrators stated that each cryptocurrency must be reviewed “on its own characteristics.”¹⁰⁹ And finally, The European Securities and Markets Authority issued statements about the risks involved with cryptocurrencies and concluded ICO tokens may fall within the definition of a transferable security depending on their structure.¹¹⁰

Because of the international scope of ICOs, fragmented regulation makes launching an ICO very challenging.¹¹¹ Such disparity is likely to impede further development of the blockchain industry.¹¹² On a positive note, as more jurisdictions around the world weigh in on and provide

exchanged with another virtual currency 2) It can be transferred using an electronic data processing system 3) It is not denominated in Japanese Yen or any foreign legal currency. *Id.*

¹⁰⁴ *Id.*; Virtual Currency Exchange Businesses is defined as businesses engaged in the exchange of virtual currency for legal currency or another virtual currency or brokerage of such exchange.

Id.

¹⁰⁵ *Id.*

¹⁰⁶ Ramm, *supra* note 101.

¹⁰⁷ Ramm, *supra* note 101.

¹⁰⁸ Ramm, *supra* note 101.

¹⁰⁹ Ramm, *supra* note 101.

¹¹⁰ Wockener et al., *supra* note 11.

¹¹¹ Wockener et al., *supra* note 11.

¹¹² Hayes, *supra* note 13.

legal guidance, fewer scam artists will be able to launch fraudulent token sales.¹¹³ In time, the world will be able to observe what works and what does not, ideally coming to a consensus on how to efficiently regulate and promote growth in this new market.

V. United States

A. SEC Statements

The SEC released several statements warning market professionals against the sale of unregistered ICOs.¹¹⁴ The SEC emphasized that replacing “a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance.”¹¹⁵ The SEC stressed that merely calling a token a ‘utility’ token or providing some utility through the token is not dispositive when considering whether the token is a security.¹¹⁶ However, Jay Clayton, Chairman of the SEC, admits that whether a token is a security depends on particular facts.¹¹⁷ The regulatory body then reminded sellers that any sale of a security must be in compliance with securities laws.¹¹⁸ To date, no ICOs have registered with the SEC.¹¹⁹

B. DAO

Additionally, the SEC began taking action against certain companies that raised capital through ICOs. On July 25, 2017, the SEC issued a Report of Investigation under Section 21 (a) of

¹¹³ Joshua Ashley Klayman, *Twice In Two Days: China and Hong Kong Weigh In On Token Sales*, MORRISON FOERSTER: PUBLICATIONS (Sept. 6, 2017), <https://www.mofo.com/resources/publications/170906-china-and-hong-kong-weigh-in-about-token-sales.html>.

¹¹⁴ Clayton, *supra* note 17.

¹¹⁵ Clayton, *supra* note 17.

¹¹⁶ Clayton, *supra* note 17.

¹¹⁷ Hayes, *supra* note 13.

¹¹⁸ Clayton, *supra* note 17.

¹¹⁹ Zanki, *Regulatory Heat*, *supra* note 7.

the Securities Exchange Act of 1934 detailing an SEC investigation of the DAO.¹²⁰ The DAO was a virtual organization that raised capital through the sale of tokens.¹²¹ Investors purchased tokens using Ether, a cryptocurrency, on the Ethereum network where the DAO was built.¹²² The DAO operated as an investment fund, which allowed investors to vote on investment contracts and decide how the funds would be spent.¹²³ The investors then shared in the profits on these projects.¹²⁴ Issued tokens could also be resold on the secondary market.¹²⁵ In June 2016, a hacker stole one-third of the DAO's funds, effectively putting an end to the company.¹²⁶

The report applied the *Howey* test (“Test”) to determine that the DAO tokens were an ‘investment contract,’ thus a security.¹²⁷ The Test defines a security as “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.”¹²⁸ The SEC concluded that “investors put money into the fund with the expectation of profiting from the managerial efforts of it, which created the fund and maintained its code thereafter, and that the tokens were therefore securities.”¹²⁹ With this finding, the SEC highlighted that those who offer and sell securities must comply with federal

¹²⁰ *Initial Coin Offerings*, *supra* note 16; Marc J. Fagel and Alexander H. Southwell, Cyber-Fraud Controls and the SEC, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (November 6, 2018), <https://corpgov.law.harvard.edu/2018/11/06/cyber-fraud-controls-and-the-sec/>. Section 21(a) of the Securities Exchange Act of 1934 empowers the SEC to issue a report of an investigation to advise the public of important issues or address issues of interpretation of federal securities law. *Id.*

¹²¹ *Initial Coin Offerings*, *supra* note 16.

¹²² McLellan, *supra* note 25.

¹²³ McLellan, *supra* note 25.

¹²⁴ Hayes, *supra* note 13.

¹²⁵ Hayes, *supra* note 13.

¹²⁶ McLellan, *supra* note 25.

¹²⁷ McLellan, *supra* note 25.

¹²⁸ SEC v. *Howey* Co., 328 U.S. 293, 301 (1946).

¹²⁹ McLellan, *supra* note 25.

securities laws, even if purchased with virtual currencies.¹³⁰ The DAO neatly fit into the definition of a security, as it created a virtual venture fund and had all the qualities of a security.¹³¹ However, must is still left to be determined because each cryptocurrency is unique.¹³²

C. Munchee

Moreover, the SEC took a significant step toward tightening ICO regulation in its Munchee ruling and subsequent shutdown.¹³³ Munchee sold its tokens worldwide, seeking \$15 million to improve the company's app.¹³⁴ The self-described 'utility' tokens allowed investors to use or access Munchee's services and promised to create a secondary market to trade the tokens.¹³⁵ Munchee marketed its tokens by claiming they would rise in value as the app increased in popularity.¹³⁶

Again, the SEC applied the Test to label Munchee's tokens as securities.¹³⁷ In determining the tokens' status, the SEC focused on the investors' expectations of profits.¹³⁸ Munchee intended to use the proceeds to construct an "ecosystem," creating demand for the tokens and increasing their value.¹³⁹ The promoters' emphasis on the potential profits, along with the promise of the ability to trade the tokens on the secondary market, was enough to satisfy the Test.¹⁴⁰ Munchee

¹³⁰ *Initial Coin Offerings*, *supra* note 16.

¹³¹ McLellan, *supra* note 25.

¹³² McLellan, *supra* note 25.

¹³³ Zanki, *Regulatory Heat*, *supra* note 7.

¹³⁴ Hayes, *supra* note 13.

¹³⁵ Hayes, *supra* note 13.

¹³⁶ Zanki, *Regulatory Heat*, *supra* note 7.

¹³⁷ Hayes, *supra* note 13.

¹³⁸ Hayes, *supra* note 13; *SEC v. Howey Co.*, 328 U.S. 293, 301 (1946).

¹³⁹ Hayes, *supra* note 13.

¹⁴⁰ Hayes, *supra* note 13.

was the first SEC enforcement action regarding an ICO without any allegation of fraud and foreshadows tighter regulation to come.¹⁴¹

a. Putting it All Together

The SEC is alarmed by both the current and looming problems that come with ICOs as they presently operate. The United States, like many other countries, employs case-by-case determinations and appears to be headed towards tighter regulation. This strategy is categorizing ICOs in a binary fashion; securities or not securities. With a rapidly growing market and new types of ICOs consistently surfacing, a question must be raised - is this the most efficient means of regulation? Moreover, if ICOs are deemed securities, should they be regulated like all other securities or have unique requirements?

VI. SEC Registration and Exemptions

A. Overview

Under the Securities Act of 1933 (“Act”), primary market transactions of securities are registered and regulated.¹⁴² The Act has two primary objectives.¹⁴³ The first is to require issuing companies to provide financial and other significant information about the security to the investors.¹⁴⁴ The second objective is to prohibit deceit, misrepresentations, and other fraud involved in the sale of securities.¹⁴⁵

¹⁴¹ Hayes, *supra* note 13.

¹⁴² CHOI & PRITCHARD, *supra* note 82, at 38.

¹⁴³ *Registration Under the Securities Act of 1933*, SEC: FAST ANSWERS, <https://www.sec.gov/fast-answers/answersregis33htm.html> (last updated Sept. 2, 2011) [hereinafter *Act of 1933*].

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

The Act mandates issuers file an intricate registration statement with the SEC that includes a prospectus to disclosure information deemed important to investors.¹⁴⁶ The documents include a description of the company's properties and business, a description of the security offered for sale, information about the management of the company, and financial statements certified by independent accountants.¹⁴⁷ After filing with the SEC, the Act includes an intricate public offering procedure to ensure the prospectus is distributed to investors before other information is provided.¹⁴⁸ To protect investors against fraud, the Act enforces heightened antifraud liability for material misstatements in the disclosure documents.¹⁴⁹ This strict antifraud liability counters the incentive for issuers to commit fraud in an effort to increase proceeds earned in the offering.¹⁵⁰ Further, this liability allows investors who suffer losses to recover if they can prove an incomplete or inaccurate disclosure of material information.¹⁵¹

Notably, registration of a security with the SEC is costly.¹⁵² Underwriters take between five and seven percent of gross proceeds.¹⁵³ The securities counsel are due legal fees for drafting the registration statement and providing other advice on the offering.¹⁵⁴ Independent registered public accounting firms must also be retained and paid to review the registration statement.¹⁵⁵ Moreover, issuers must hire a financial reporting advisor to prepare financial statements and

¹⁴⁶ CHOI & PRITCHARD, *supra* note 82, at 38.

¹⁴⁷ *Act of 1933*, *supra* note 143.

¹⁴⁸ CHOI & PRITCHARD, *supra* note 82, at 38.

¹⁴⁹ CHOI & PRITCHARD, *supra* note 82, at 38.

¹⁵⁰ CHOI & PRITCHARD, *supra* note 82, at 38.

¹⁵¹ *Act of 1933*, *supra* note 143.

¹⁵² *Considering an IPO to fuel your company's future?*, PRICE WATERHOUSE COOPER: IPO SERVICES 5 (Nov. 2017) https://www.pwc.com/hu/szolgalatasok/konyvvizsgalat/szamviteli-tanacsadas/kiadvanyok/cost_of_an_ipo_2017.pdf.

¹⁵³ *Id.* at 13.

¹⁵⁴ *Id.* at 9.

¹⁵⁵ *Id.* at 8.

addresses SEC comments.¹⁵⁶ Finally, there are additional costs for registration with the SEC or State, document management, SEC filing, printing and distribution.¹⁵⁷ The stringent and expensive process forces some issuers to avoid publically selling to investors.¹⁵⁸ Instead, many turn to alternative means for raising capital or decide to forgo an otherwise profitable business opportunity altogether.¹⁵⁹ In these instances, not only is the issuer affected, but the investors also lose an opportunity to invest.¹⁶⁰

Consequently, all companies issuing securities must register with the SEC and follow the requisite procedures unless they fall within an exemption.¹⁶¹ The SEC exempts certain offerings from complying with regulation as a means to bolster capital formation by lowering the cost of offering to the public.¹⁶² However, the current exemptions are insufficient to accommodate ICOs.

B. Regulation D + Rule 144A

To begin, Regulation D is one of the numerous exemptions the SEC has devised.¹⁶³ Under Regulation D, specifically Rule 506, issuers are able to sell to an unlimited amount of accredited investors and up to 35 to non-accredited investors.¹⁶⁴ Typically, accredited investors consist of large entities and institutions, including banks, broker-dealers, and insurance companies.¹⁶⁵ Securities acquired in a 506 offering cannot be resold on the secondary market without registering in accordance with the Act or qualifying for another exemption.¹⁶⁶

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 11.

¹⁵⁸ CHOI & PRITCHARD, *supra* note 82, at 540.

¹⁵⁹ CHOI & PRITCHARD, *supra* note 82, at 540.

¹⁶⁰ CHOI & PRITCHARD, *supra* note 82, at 540.

¹⁶¹ *Act of 1933*, *supra* note 143.

¹⁶² *Act of 1933*, *supra* note 143.

¹⁶³ CHOI & PRITCHARD, *supra* note 82, at 553.

¹⁶⁴ CHOI & PRITCHARD, *supra* note 82, at 553.

¹⁶⁵ CHOI & PRITCHARD, *supra* note 82, at 553.

¹⁶⁶ CHOI & PRITCHARD, *supra* note 82, at 567.

This is where the Rule 144A exemption comes into play. Under Rule 144A, an issuing company may remain exempt from registration and resell securities to Qualified Institutional Buyers (“QIBs”) providing compliance with this rule.¹⁶⁷ QIBs are “an entity that in the aggregate owns and invests on a discretionary basis \$100 million or more in securities of companies.”¹⁶⁸ Notably, Rule 144A imposes a holding period for the resale of these restricted securities once acquired from the issuer or affiliate of the issuer.¹⁶⁹ The holding period is one year for non-reporting issuers.¹⁷⁰

a. ICO Application

First and foremost, Regulation D’s heavy reliance on accredited investors poses a substantial problem given the nature of ICOs. The sale of tokens directly to individual investors is fundamental to the success of the ICO industry for both issuers and investors. ICOs are built to provide an avenue for companies who do not have access to the traditional capital markets through increased social enterprise and create a democratization of investment opportunities.¹⁷¹ Imposing this requirement on ICOs would significantly stunt the growth of the marketplace and undermine the core principles of this technology.

With this exemption, issuers would once again have to rely on traditional methods of raising capital instead of the innovative ways on which ICOs built their foundation. Accredited investors may not see tokens as profitable, deterring them from purchasing at all. Yet, an important benefit of ICOs is their ability to succeed even when unappealing to accredited investors. This is

¹⁶⁷ CHOI & PRITCHARD, *supra* note 82, at 634.

¹⁶⁸ CHOI & PRITCHARD, *supra* note 82, at 644. Typically, QIBs consist of insurance companies, investment companies, corporations, and partnerships. *Id.*

¹⁶⁹ CHOI & PRITCHARD, *supra* note 82, at 634.

¹⁷⁰ CHOI & PRITCHARD, *supra* note 82, at 634.

¹⁷¹ Robinson, *supra* note 8, at 51.

why many issuers turned to the ICO market in the first place. Further, accredited investors often require a certain level of control of the company.¹⁷² Occasionally, this means issuers get kicked out of their own companies.¹⁷³ The inherent reliance on accredited investors can be detrimental to companies and render this exemption unusable.

Likewise, ICOs are praised for allowing equal access to everyone. Everyday investors will once again be locked out of realizing potential substantial profits because they will no longer have the benefit of investing in the company at its inception. Thus, dependency on accredited investors defeats an ICO's core ideal.

Further, the holding period required for resale under Rule 144A significantly hinders ICOs. An important advantage of ICO tokens is their immediate liquidity and development of a secondary market. With immediate liquidity as a staple to the inner workings and benefits of ICOs, it is important that this not be taken away by a mandatory, lengthy holding period. To top it off, even when resale is permitted, only QIBs can purchase the security. Again, leaving the everyday investor without an opportunity to invest. All of these shortcomings make Regulation D coupled with Rule 144A wholly unusable by companies launching an ICO.

C. Regulation A

Next, Tier 2 of Regulation A provides another possible avenue for exemption to SEC registration.¹⁷⁴ A Tier 2 exemption under Regulation A allows a company to raise up to \$50 million every 12 months.¹⁷⁵ Investors are not subject to any holding period limitations, thus they have

¹⁷² *Raising Capital using a Regulation A+ Mini-IPO*, SEEDINVEST: BLOG (Oct. 28, 2016), <https://www.seedinvest.com/blog/jobs-act/raising-capital-reg-a-mini-ipo> [hereinafter *Mini-IPO*].

¹⁷³ *Id.*

¹⁷⁴ *A Primer on SEC Regulation A+* (Gunster Law Firm, FL.) [hereinafter *Primer*].

¹⁷⁵ *Id.*

immediate liquidity.¹⁷⁶ Although there are several forms that must be filled out and updated periodically, the requirements are much less stringent than a registered security.¹⁷⁷ The issuing company must file a prospectus and other documentation subject to SEC review.¹⁷⁸ This can take two to three months to receive regulatory approval.¹⁷⁹ Then, issuers are subjected to annual and semi-annual public reporting, including audited financials.¹⁸⁰ Under Section 12(a)(2) of the Act, the public offering is liable for any material misleading statements or omission in the offering statement.¹⁸¹ Even though the security is not technically registered and cannot be held liable under Section 11 of the Act, the offering statements can still be subject to antifraud provisions of federal securities laws.¹⁸²

a. ICO Application

Regulation A is close to fitting the ICO mold, but not close enough. The ability to raise \$50 million in 12 months provides companies with a lot of room to amass necessary capital. Also, the lack of a holding period allows for the benefit of immediate liquidity. Finally, the liability enforced upon companies offering misleading statements serves the function of inhibiting fraud.

These benefits considered, the initial forms and subsequent maintenance, nonetheless, create an exemption barrier for many ICOs. Many ICOs involve new companies without much capital, thus they are unable to file and maintain the forms required under Regulation A. The legal

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* Form requirements include 1) Form 1-K due 120 days after year-end, 2) Form 1-SA due semiannually after the first 6-month period of year, 3) Form 1-U due 4 business days after critical events, and 4) Form 1-Z due 30 days after termination of offering. *Id.*

¹⁷⁸ *Mini-IPO, supra* note 172.

¹⁷⁹ *Mini-IPO, supra* note 172.

¹⁸⁰ *Mini-IPO, supra* note 172.

¹⁸¹ *Primer, supra* note 174.

¹⁸² *Primer, supra* note 174.

and accounting fees can be higher than traditional offerings from accredited investors.¹⁸³ Initial filings and the ongoing reports can cost up to \$500,000 or more.¹⁸⁴ Moreover, the two to three-month time period necessary for regulatory approval can disadvantage issuers. Companies may miss out on vital opportunities whilst they wait in limbo for approval. All in all, this exemption is promising but still falls short of encompassing key aspects necessary to promote growth within the ICO industry.

D. Regulation S

A third avenue for exemption lies within Regulation S.¹⁸⁵ Generally, Regulation S exempts offerings and sales as long as they are directed outside the United States.¹⁸⁶ Under this exemption offerings are banned from directing solicitation within the United States or toward U.S. persons.¹⁸⁷ Also, the offer or sale must be made in an offshore transaction.¹⁸⁸ Thus, a sale cannot be made to a person physically in the United States at the time of the sale or to any U.S. person.¹⁸⁹ These offering restrictions operate to prevent reasonable fallback into the United States.¹⁹⁰

a. ICO Application

¹⁸³ *Mini-IPO*, *supra* note 172.

¹⁸⁴ Robert Ksiazkiewicz, *Regulation A+: little hype, early promise?*, STATE SCIENCE AND TECHNOLOGY INSTITUTES: BLOG (Feb. 2, 2017), <https://ssti.org/blog/regulation-little-hype-early-promise>.

¹⁸⁵ CHOI & PRITCHARD, *supra* note 82, at 600.

¹⁸⁶ CHOI & PRITCHARD, *supra* note 82, at 600 (“The registration of securities is intended to protect the U.S. capital markets and investors purchasing in the U.S. market. Principles of comity and the reasonable expectations of participants in the global markets justify reliance on laws applicable in jurisdictions outside the United States to define requirements for transactions effected offshore. The territorial approach recognizes the primacy of the laws in which a market is located. As investors choose their markets, they choose the laws and regulations applicable in such markets.”).

¹⁸⁷ CHOI & PRITCHARD, *supra* note 82, at 608.

¹⁸⁸ CHOI & PRITCHARD, *supra* note 82, at 608.

¹⁸⁹ CHOI & PRITCHARD, *supra* note 82, at 608.

¹⁹⁰ CHOI & PRITCHARD, *supra* note 82, at 608.

Regulation S doesn't work for many reasons. To qualify for this exemption, issuers would be restricted from offering ICOs in the United States. This meaningfully disadvantages U.S. investors in the ICO marketplace as they will be barred from participating in offerings. Similarly, one of the essential elements of tokens is the ability to use the token to gain access to the product. If the product is in a foreign language or located in another country, this important use may be compromised.

For this exemption to have any relevance to ICOs, there must be worldwide cooperation. Collaboration among the major ICO market countries could help alleviate the disadvantage to investors. If other countries were to implement a similar exemption, U.S. investors would miss out on domestic ICOs, but be able to capitalize on ICOs offered by foreign countries. With the ever-growing popularity of ICOs worldwide, U.S. investors would not suffer from a lack of investment opportunity. In the event that this cooperation was attained, investors will likely be unable to use the company's product or services because of geographical or language barriers.

On a similar note, the current fragmentation of regulation regarding ICOs around the world is an issue that needs solving. It puts a strain on issuers and generally inhibits growth in this field. For ICO technology to reach its full potential, international cooperation and similar regulatory frameworks are a necessity. This strategy, however unlikely, would be a step in the right direction towards international collaboration.

Regrettably, this solution would take years to implement since international cooperation is very difficult to coordinate. Also, many integral countries do not yet have a regulation similar to that of Regulation S, further complicating the situation. All things considered, there are too many hurdles to overcome for this exemption to become a viable option.

E. Regulation Crowdfunding

Regulation Crowdfunding (“Regulation CF”) was created to facilitate capital raising by small businesses while providing investor protection.¹⁹¹ Transactions are conducted through an Internet-based platform or intermediary.¹⁹² The intermediary must be a broker-dealer or a funding portal registered with the SEC and FINRA.¹⁹³ Under this exemption, a United States issuer can raise up to \$1,070,000 in a 12-month period.¹⁹⁴ Individual investors are limited in the amount they may invest in the 12-month period.¹⁹⁵ Those with an annual income or net worth less than \$107,000 may invest the greater of \$2,200 or 5% of their annual income or net worth.¹⁹⁶ Those above \$107,000 may invest up to 10% of their income or net worth. \$107,000 is the maximum any one investor may invest.¹⁹⁷ To qualify issuers must submit Form C, an offering statement disclosure, Form C-AR annually and post this material on their website.¹⁹⁸ These securities cannot be resold for a period of one year.¹⁹⁹

After issuance, investors simply visit the intermediary website and click ‘Invest.’²⁰⁰ Upon clicking, investors are redirected to a page to verify that they reviewed the educational materials

¹⁹¹ Peter Thomson, *Regulation Crowdfunding*, SEEDINVEST: CAPITAL RAISING (Nov. 8, 2017), <https://www.seedinvest.com/academy/regulation-crowdfunding>.

¹⁹² *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC: CORPORATE FINANCE GUIDE (April 5, 2017), <https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#5> [hereinafter *Crowdfunding*].

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Crowdfunding*, *supra* note 192. Companies must disclose: the price to the public of the securities or the method for determining the price; the target offering amount, the deadline to reach the target offering amount; whether the company will accept investments in excess of the targeting offering amount; a discussion of the company’s financial condition, financial statements of the company; a description of the business and the use of proceeds from the offering; information about key persons at the company and certain related-party transaction. *Id.*; *see also* Thomson, *supra* note 191.

¹⁹⁹ *Crowdfunding*, *supra* note 192.

²⁰⁰ Thomson, *supra* note 191.

and understand the inherent risks.²⁰¹ Once completed, the investment will be funded and held in escrow by a third-party agent.²⁰² Investors may cancel their investment at any time up to 48 hours before a closing.²⁰³ In the event of a material change in the offering, investors are notified and required to confirm their investment.²⁰⁴

a. ICO Application

In general, Regulation CF provides adequate protection to investors and embraces technology. ICOs are currently issued through the Internet, so the format of the offering would remain intact. Also, the ability to cancel a transaction within a certain period of time reduces fraud. Investor's security is furthered by the fact that money held in a third-party escrow account. Perhaps most importantly, limitations are placed on individual investors by capping the amount they can invest. This prevents everyday investors from incurring substantial loss. With these safeguards in place, investors are given much needed protection.

On the negative side, the investment limitations imposed on issuers presents a problem. The ceiling on the amount a company may raise in a 12-month period could be insufficient for an ICO to fully develop its business. A maximum amount may not only render this exemption unusable, but it has the potential to harm investors as well. Companies that seek this exemption and later discover that the funds are insufficient will likely fail and leave investors with nothing. ICOs often involve new companies that may not be able to adequately calculate the amount of capital needed to successfully launch their business. This means that both issuers and investors lose.

²⁰¹ Thomson, *supra* note 191.

²⁰² Thomson, *supra* note 191.

²⁰³ Thomson, *supra* note 191.

²⁰⁴ Thomson, *supra* note 191.

Additionally, both the mandatory holding period and high filing costs further support that this exemption is impractical. As stated above, a mandatory holding period is not compatible with the nature of ICOs. An important benefit derived from ICOs is their immediate liquidity, which is eliminated under Regulation CF. Again, cost is a problem. Issuers will pay anywhere from \$30,000 to over \$100,000 to prepare the requisite documents just for the initial offering.²⁰⁵ Many new companies cannot afford these costs and the ones that can run the risk of shelling out large amounts of money without knowing whether the company will succeed.²⁰⁶ Similarly, the Internet intermediary takes a percentage of the total funds raised to conduct the transaction.²⁰⁷

VII. A New Exemption for ICOs

A. Overview

The United States is trending towards labeling ICOs as securities. As such, issuers will either have to file for registration or fit into an exemption. As addressed above, the current structure of the exemptions is unusable for many ICOs. Hence, the laws must adapt to allow ICOs to take advantage exemptions. ICOs involve a new type of capital raising, different in many ways from that of securities. So, they should be governed by new laws. Although the SEC wants to label ICO tokens as securities, the two just aren't similar enough to fully fit the same mold.

As evidenced by the creation of the current securities exemptions, the SEC has shown willingness to strike a balance between capital formation and investor protection.²⁰⁸ Moving forward, the SEC must take it one step further and create new exemptions to ensure the growth of

²⁰⁵ Tanya Prive, *Why Equity Crowdfunding Could Be Dangerous for Investors and Entrepreneurs*, FORTUNE (May 6, 2016), <http://fortune.com/2016/05/06/equity-crowdfunding-could-be-dangerous/>.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Act of 1933, supra* note 143.

the ICO industry. ICO tokens should be labeled ‘modified securities,’ subject to a modified exemption. This new exemption will borrow and blend pieces from current exemptions in addition to implementing several novel ideas. The new exemption will attack the problem of the current risks and aim to foster further development of the technology.

B. An ICO-Specific Exemption

a. Considerations in Favor of Laxer Regulation

There should be a blanket rule applicable to all ICOs seeking exempt status. To qualify for a ‘modified exemption,’ an ICO must provide the SEC with its own node within the distributed ledger.²⁰⁹ Under the exemption, this node will be unlike other nodes in that it will not hold any investment properties.²¹⁰ However, it will allow the SEC the ability to oversee all transactions within the blockchain, as would any other node.²¹¹ Transaction data will be transparent to the SEC in real time.²¹² This bird’s-eye view will allow the SEC to monitor each company in an unprecedented way, giving direct access to all necessary information.²¹³ In exchange for this transparency, the SEC should allow laxer exemption criteria for ICOs.²¹⁴

Relatedly, the SEC must further consider that each participant within the blockchain also holds the ability to oversee all transactions.²¹⁵ The immediate liquidity and development of a secondary market provides a way for each investor to track the progress of the company.²¹⁶

²⁰⁹ *Blockchain Settlement: Regulation, Innovation and Application*, EUROCLEAR 15, Nov. 2016, <https://www.euroclear.com/dam/PDFs/Blockchain/MA3880%20Blockchain%20S&M%209NOV2016.pdf>.

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Blockchain*, supra note 33.

²¹⁶ Burke, supra note 40.

Because of this inherent transparency, the ICO market serves as a check on itself. Given the vast marketplace the SEC is required to police, some violations are bound to slip through the cracks. Individual investors have the ability to keep a watchful eye on the company as its secondary market fluctuates. Because these individuals invested their money into the company, they have an unparalleled interest in policing the marketplace for bad investments. With this openness among both the SEC and individual investors, the market will no longer have a need for stringent protective measures.

b. Recommendations

As addressed in the Regulation CF framework, ex-ante investment exposure must be implemented to protect investors.²¹⁷ ICOs are risky investments. They are volatile, involve brand new companies and are sometimes fraudulent.²¹⁸ Hence, investors can lose their entire investment.²¹⁹ Because of their democratization, these investments are available to everyday investors.²²⁰ As a whole, ordinary investor lack the sophistication necessary to properly assess investments and the risks they may carry. To limit exposure and potential loss, this exemption will cap the amount investors may contribute.

Furthermore, in addressing the considerable costs to file for and maintain an exemption, ICO issuers must have laxer requirements. Currently, all that is required for an ICO launch is a white paper.²²¹ However, this is not enough. The current white paper system acts as a solicitation instead of a disclosure document, is often misleading and is not subject to regulatory review.²²²

²¹⁷ *Crowdfunding, supra* note 192.

²¹⁸ *Bitcoin, supra* note 54.

²¹⁹ *Bitcoin, supra* note 54.

²²⁰ *The Truth, supra* note 36.

²²¹ Hayes, *supra* note 13.

²²² De Silva, *supra* note 90.

With this current system in place, it is too difficult for investors to make intelligent investment decisions.

To benefit both the issuer and the investor, a standardized form should be filled out, filed and made public. The form will require only the core aspects of the ICO. Information on the form will include the identity of accountable parties for liability purposes, exactly how funds will be spent and how this will help achieve the company's overall goal. This will create a standard within the industry to disclose certain vital aspects an ICO. A set form will compel companies to reveal the pertinent information needed to make an informed investment decision. The described form will be more informative and less of an advertisement for the company.

Further, the form must be simple enough to be completed without excessive cost and understandable enough for an everyday investor to evaluate. With this, complicated filing procedures will be eliminated, allowing new companies that lack resources to raise capital and bring their business to life. Also, investors will become more informed because they can become familiar with the standardized form and properly scrutinize investments.

Additionally, ICOs must have immediate liquidity. Immediate liquidity is essential to both furthering growth in the industry and enhancing investor protection. Once the security is purchased and the offering complete, investors will immediately have the ability to trade their tokens on the secondary market. This way, investors will not have to commit to having their money locked up for years and can realize profits when they choose. Consequently, the much-needed transparency into the company will be achieved. This inside look into the company will provide investors with real-time information on the company's progress, allowing for better investment decisions. It will also allow better insight for the SEC. With its node in the blockchain, it will be easier for the SEC to detect bad actors. Immediate liquidity is a win-win for all parties and must be maintained.

Equally important, preserving democratization of investments is crucial. Information on investments and the investments themselves must be available to all people at the same time. Issuers will enjoy the continued opportunity to market to all investors, increasing the likelihood of receiving funding. Also, it is vital that all investors have the ability to realize profits at the same level as accredited investors. Although everyday investors may in some instances lack sophistication, other safeguards such as the universal form and individual investor limitations will help mitigate this problem.

Finally, companies must be subjected to strict anti-fraud liability. The absence of liability only benefits fraudsters. This liability will serve two important purposes. First, it will allow investors the opportunity to recover funds lost in a fraudulent offering. Recuperation will become much more feasible, especially when coupled with the standardized form identifying responsible parties. Second, it will curb fraudulent offerings altogether. Under the watchful eye of the SEC controlling its own node, it will be more difficult to successfully pursue a fraudulent offering. Hence, fraudsters will get caught and punished. As time passes, bad actors will be less likely to attempt a fraudulent issuance because the consequences will be established and known.

VIII. Conclusion

The SEC must eliminate case-by-case determinations of whether an ICO is or is not a security. This is simply inefficient. There are too many different types of offerings and the issuers are not adhering to the registration procedures. With the way securities laws are currently structured, it is not surprising that companies refuse to register. The SEC must take action and declare all ICOs a ‘modified securities’ subject to a specifically designed modified security exemption. In creating this exemption, both the benefits and risks of ICOs must be given due weight and a compromise must be reached. The SEC must embrace and harness the nature of this

technology to allow for a more relaxed regulatory framework. This will foster growth within the market while still achieving the goals of safeguarding the public and eliminating fraud and deceit. Once the exemption is implemented, it will yield positive results and the rest of the world will follow, maximizing the potential of ICOs.