

INITIAL COIN OFFERINGS: GETTING RID OF THE VENTURE CAPITALIST

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I. INTRODUCTION

One sector of cryptocurrency that is also very important to understanding the new wave of blockchain integration into the market today is the surge of Initial Coin Offerings (ICOs). ICOs are a way for companies to raise capital virtually instead of through traditional angel investors, series funding, or initial public offerings of stock certificates.¹ A start-up can create a new cryptocurrency or digital token via a platform (such as Ethereum).² Then, during the start-up's ICO, investors can buy these tokens using other cryptocurrencies, allowing the offeror to raise capital.³ In a true ICO, instead of gaining actual equity in the company like with conventional fundraising strategies or equity token offerings (ETOs), these tokens can later be exchanged for a product that is eventually created.⁴ Also, these tokens can be traded for a profit if the token becomes more highly desired by other investors.⁵ Thus, choosing the path of an ICO can be a way for start-ups to raise capital without having to be tied to the demands of conventional investors. Amy Wan, a crowdfunding and syndication lawyer, has described an ICO "coin" as a "symbol of ownership interest in an enterprise—a digital stock certificate."⁶ Thus, ICOs are almost a digital, unregulated form of an IPO.

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¹ Arjun Kharpal, *Tokenization: The world of ICOs*, CNBC: THE BLOCKCHAIN REVOLUTION (July 16, 2018), <https://www.cnbc.com/2018/07/13/initial-coin-offering-ico-what-are-they-how-do-they-work.html>.

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ Amy Wan, *Why Your Initial Coin Offering Is Probably Regulated By Securities Law*, CROWDFUND INSIDER (March 6, 2017),

Over the past few years, ICO investments have exploded. While the first recorded ICO took place in 2013, ICOs did not become popular until 2017, where in one year, ICOs have become one of the fastest growing capital markets in the world. \$5.1 billion was raised by ICO's in 2017 and that number grew even further in 2018.⁷ In May 2017, Brave, a company developing a decentralized web browser, raised an unbelievable \$35 million in 30 seconds.⁸ Brave and other companies that have conducted ICOs avoided regulatory compliance is because their "tokens" were sold for cryptocurrency which was later sold again for legal tender.⁹ All of this money has been raised through ICOs and little government action had been taken to ensure that they were regulated in a particular way, except one instance in July 2017 where the SEC ruled on a company named DAO.¹⁰

The DAO—short for decentralized autonomous organization—raised over \$160 million during its ICO in 2016.¹¹ The DAO's purpose was to serve as a decentralized venture capitalist fund and invest in the development of new software applications.¹² The DAO was not registered as an entity in any country; it had no board of directors, no CEO, and no management team.¹³ Because of these issues, it was impossible for any court to obtain jurisdiction over the company or its members when a

<https://www.crowdfundinsider.com/2017/03/96598-initial-coin-offering-probably-regulated-securities-law/>.

⁷ Nick Chong, *ICOs Raise Over \$9 Billion Six Months into 2018, Surpassing 2017 Figures*, NEWSBTC (June 2, 2018), <https://www.newsbtc.com/2018/06/02/icos-raise-over-9-billion-six-months-into-2018-surpassing-2017-figures/>.

⁸ Jon Russell, *Former Mozilla CEO raises \$35M in under 30 seconds for his browser startup Brave*, TECHCRUNCH (Jun. 1, 2017), <https://techcrunch.com/2017/06/01/brave-ico-35-million-30-seconds-brendan-eich/>.

⁹ *Id.*

¹⁰ *See generally* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017).

¹¹ Richard Waters, *Automated company raises equivalent of \$120M in digital currency*, FINANCIAL TIMES (May 17, 2016), <https://www.ft.com/content/600e137a-1ba6-11e6-b286-cddde55ca122>.

¹² *Id.*

¹³ *Id.*

dispute would arise.¹⁴ Only a month after its funding, the DAO lost a third of its assets to a calculated attack that siphoned about one third of the organization's currency into a single account.¹⁵ Thankfully, the company had a way to invalidate this fraudulent transaction and give investors back their money. However, the company folded to prevent another attack from occurring.¹⁶ While here there was an opportunity, albeit extremely arduous, to get investors' money returned, this amendable situation could have turned into a disaster if the large amount of stolen currency could not have been retrieved.

II. GOVERNMENT ACTION

In July 2017, the SEC released a report on its investigation into the DAO and concluded that the DAO "tokens" sold at its IPO were securities under the *Howey* test.¹⁷ While some may say the question of regulation and ICOs is now settled law, other scholars find the SEC's report was full of holes and conclude it only applies to DAO's "tokens" singularly and not to the broad spectrum of ICOs in the digital market today.

In the year since it issued its DAO report, the SEC has brought enforcement actions against companies issuing tokens and has released consumer fraud alerts and other warnings related to ICOs.¹⁸ However, these actions and alerts cannot carry much weight when infringing companies have no bank accounts, no agents, and in a lot of circumstances, no single person that can be identified who works for such a company. Also, the companies who have had SEC action brought

¹⁴ Sec. and Exch. Comm'n, No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO 3 n.5 (July 25, 2017).

¹⁵ Nathaniel Popper, *A Hacking of More Than \$50 Million Dashes Hopes in the World of Virtual Currency*, N.Y. TIMES (June 17, 2016), <https://www.nytimes.com/2016/06/18/business/dealbook/hacker-may-have-removed-more-than-50-million-from-experimental-cybercurrency-project.html>.

¹⁶ See, e.g., Popper, *supra* note 15.

¹⁷ *Id.*

¹⁸ Una Dean & Adam Yefet, *ICOs One Year After the SEC's DAO Report*, N.Y. L. J. (Aug. 28, 2018), <https://www.law.com/newyorklawjournal/2018/08/28/icos-one-year-after-the-secs-dao-report/>.

against them all were fraudulent companies created to steal investors assets, not legitimate organizations similar to the DAO.¹⁹

III. WHAT DOES THE DAO DECISION MEAN FOR ICOS?

While an ICO for a company may seem like a good way to avoid Series A, Series B, and further funding, along with having to answer to venture capitalists, investing in and starting an ICO is a very risky business. ICOs are highly uncertain: fewer than half of all ICOs survive four months after the offering.²⁰ When an ICO fails, its investors fail as well. This rate of failure is much higher than that of initial public offerings on the stock market, and thus much riskier, due to the legal requirements that companies must complete before offering equity on a global market. Usually doomed IPOs are terminated before the actual IPO date and even if they are terminated afterwards, initial investors are entitled to have their money returned pursuant to SEC regulations.²¹ Therefore, investing in an ICO or new currency can be equated to investing in a startup, with high risk that it will fail and high reward if it succeeds. However, the difference between investing in startup and an ICO is the risk that your investment will be squandered illegally, with no recourse. While investors can recoup some of their losses if a startup defrauds investors, there is rarely such an avenue for crypto-investors. Also, the SEC still has not really figured out how exactly ICOs will be regulated, and add all of this to the falling cryptocurrency prices that were much more inflated toward the end of 2017. Nonetheless, a record \$7 billion was invested through ICO's from January to June of 2018.²²

IV. CONCLUSION

ICOs are an incredibly wild market, and yet more money is being poured into them every day. Any business litigator or transactional attorney must understand the impact of this new kind of investment strategy, and the simple advice to “stay away” will not suffice to a client

¹⁹ *Id.*

²⁰ Lubomir Tassev, *Less than Half of ICOs Survive Four Months After Sale, Study Finds*, BITCOIN.COM (July 10, 2018), <https://news.bitcoin.com/less-than-half-of-icos-survive-four-months-after-sale-study-finds/>.

²¹ Joel Lewin, *IPO failures soar to record high*, FINANCIAL TIMES (March 30, 2016), <https://www.ft.com/content/8e3e113d-ec8c-3da7-9f1d-bca59dc80b6f>.

²² Chong, *supra* note 8.

who is tired of dealing with investors. The simple fix created by the SEC of treating these tokens and cryptocurrencies as securities will most likely not last. New legislation and regulations will have to be drafted because of the vast differences between cryptocurrencies and securities and every attorney dealing with the electronic business sector must be aware of their impact when they are written.