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Taming the Wild West: How the SEC Can Legitimize Initial Coin Offerings (“ICOs”), Protect Consumers from Bad Actors, and Encourage Blockchain Development

*Kenyon Briggs**

ABSTRACT

An Initial Coin Offering (“ICO”) is the first time a blockchain-based company sells its cryptocurrency to the public. ICOs provide any blockchain entrepreneur the ability to quickly receive funding from anyone in the world. While ICOs show the potential to become a legitimate alternative to traditional early-stage investing, like angel investing and venture capital, ICOs are currently teeming with fraud and bad actors. Recent celebrity-endorsed ICOs have scammed customers, and hundreds of millions of dollars have been stolen from hard-working people. Anything goes in this current, unregulated ICO space.

This article proposes five potential ICO-specific regulations for the Securities and Exchange Commission (“SEC”) to pass in the next 12 months. First, the SEC should broaden the definition of a security to include utility tokens which will allow the SEC to have authority over this space. Second, allow companies conducting an ICO in the U.S. to satisfy a more lenient securities filing requirement. Third, allow people of all backgrounds to participate in ICOs, not just accredited or sophisticated investors. Fourth, create a private right of action for token buyers to sue blockchain companies who make fraudulent statements in its filed white paper or token registration. Finally, extend securities fraud liability to fraudulent ICO advertisements.

The goal of these proposed regulations is to balance the needs of all parties involved: removing fraud from the market, prioritizing investor confidence and security, and increasing development of blockchain technology’s potential. While these regulations will not solve all cryptocurrency-related problems, passing them is a good first step.

* Kenyon Briggs is a J.D. candidate at the University of Missouri—Columbia School of Law, anticipated graduation May 2019. Dual B.A. from Graceland University in Lamoni, IA, 2016, *summa cum laude*. Kenyon is the current Editor-in-Chief of the *Business, Entrepreneurship & Tax Law Review* (“BETR”). The author would like to thank his advisors, Benjamin Kweskin and Professor Randy Diamond, for all of their advice while writing this article. Finally, the author would like to recognize the 2018-2019 BETR editorial staff and associate members for their commitment to perfection.

I. INTRODUCTION

One word likely rang out at your family's Thanksgiving in 2017 amidst the mashed potato passing and food coma napping: Bitcoin.¹ The end of 2017 saw Bitcoin explode into the mainstream.² First, popular news sources like The Wall Street Journal, CNN, and Forbes began covering Bitcoin.³ Then, stories of everyday people becoming overnight Bitcoin millionaires emerged.⁴ "Bitcoin-mania" ensued.⁵ Millions of people hurried to purchase Bitcoin on "cryptocurrency exchanges"—websites created to facilitate virtual currency trading—and many even told their grandmothers to buy while Bitcoin was on the rise.⁶ At its peak, popular cryptocurrency exchanges like Coinbase and Binance were adding more than 100,000 new traders every day.⁷ However, when people realized that Bitcoin, with a price far exceeding \$10,000 per Bitcoin in December of 2017,⁸ would not turn them into millionaires like the people on TV, many began buying other cryptocurrencies with hopes of holding the "next Bitcoin" before it took off.⁹

Bitcoin is a type of cryptocurrency, which is a broad term encompassing any "digital or virtual currency that use[s] cryptography for security" that is created and sold by its developer (a "blockchain company") on the internet.¹⁰ When a cryptocurrency is first sold to the public, this event is called an initial coin offering ("ICO"); the concept of an ICO is similar to when a corporation first sells its stock to the public in an event called an initial public offering ("IPO").¹¹ However, there are significant differences between IPOs and ICOs.

1. Peter Rudegeair & Akane Otani, *Bitcoin Mania: Even Grandma Wants In on the Action*, Wall Street J. (Nov. 29, 2017, 6:04 PM), <https://www.wsj.com/articles/bitcoin-mania-even-grandma-wants-in-on-the-action-1511996653>.

2. *Id.*

3. *Id.*; Tal Yellin, Dominic Aratari & Jose Pagliery, *What is bitcoin?*, CNN, <https://money.cnn.com/infographic/technology/what-is-bitcoin/> (last updated Aug. 8, 2018); Chris Kline, *Five Reasons Bitcoin Will Be Your Best High-Growth Investment For 2018*, FORBES (Nov. 27, 2017), <https://www.forbes.com/sites/forbestechcouncil/2017/11/27/five-reasons-bitcoin-will-be-your-best-high-growth-investment-for-2018/#32d5680347e8>.

4. Chloe Aiello, *Teenage Bitcoin Millionaire: "It's a Wonderful Time to Buy Bitcoin"*, CNBC (Dec. 15, 2017, 6:29 PM), <https://www.cnbc.com/2017/12/15/teenage-bitcoin-millionaire-its-a-wonderful-time-to-buy-bitcoin.html>.

5. Rudegeair, *supra* note 1.

6. *Id.* (Myself included—KB).

7. Joseph Young, *Exponential Growth: Cryptocurrency Exchanges Are Adding 100,000+ Users Per Day*, COINTELEGRAPH (Jan. 7, 2018), <https://cointelegraph.com/news/exponential-growth-cryptocurrency-exchanges-are-adding-100000-users-per-day>.

8. Stan Higgins, *From \$900 to \$20,000: Bitcoin's Historic 2017 Price Run Revisited*, COINDESK, <https://www.coindesk.com/900-20000-bitcoins-historic-2017-price-run-revisited/> (last updated Dec. 30, 2017, 16:20 UTC).

9. Panos Mourdoukoutas, *Ripple Could be the Next Bitcoin*, FORBES (Mar. 7, 2018), <https://www.forbes.com/sites/panosmourdoukoutas/2018/03/07/ripple-could-be-the-next-bitcoin/#2afd5d6f5b39> (Ripple, which shares similarities to Bitcoin, is the name of another type of cryptocurrency.).

10. Richard Kastelein, *What Initial Coin Offerings Are, and Why VC Firms Care*, HARV. BUS. REV. (Mar. 24, 2017), <https://hbr.org/2017/03/what-initial-coin-offerings-are-and-why-vc-firms-care> ("Here's how an ICO typically works: A new cryptocurrency is created on a protocol such as Counterparty, Ethereum, or Openledger, and a value is arbitrarily determined by the startup team behind the ICO based on what they think the network is worth at its current stage.").

11. Bitcoin Magazine, *What is an ICO?*, NASDAQ (Aug. 10, 2017, 3:34 PM), <http://www.nasdaq.com/article/what-is-an-ico-cm830484>.

Unlike an IPO, where the purchaser acquires equity—an actual ownership share of the company—and receives certain legal protections through securities laws, most ICO purchasers receive no equity rights and, instead, usually prepay for blockchain-related services.¹² Additionally, it is unclear whether securities laws apply to ICOs.¹³ Because ICOs currently operate in a regulatory gray area, there is uncertainty whether securities laws can protect ICO purchasers.¹⁴ Amidst this uncertainty, fraudulent ICOs stole hundreds of millions of dollars from ICO purchasers.¹⁵

Many believe an ICO will eventually be a safe and legitimate fundraising tool,¹⁶ but ICOs are currently the “Wild West of financing” because of the uncertainty surrounding potentially applicable laws.¹⁷ Because of this gray area, on February 6, 2018, the chairmen of the Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”) met with the Senate Committee on Banking, Housing, and Urban Affairs in Washington D.C., which represented a first step toward illuminating the ICO space with regulation.¹⁸ Both J. Christopher Giancarlo, Chairman of the CFTC, and SEC Chairman Jay Clayton expressed optimistic views for blockchain and ICOs.¹⁹ However, Giancarlo and Clayton also explained that ICOs need regulation.²⁰ Specifically, the chairmen said that ICOs need additional protection against “fraud and market manipulation.”²¹ The statements from Chairmen Clayton and Giancarlo affirm the thrust of this article: the United States needs a set of ICO-specific laws to protect investors, cut out bad actors, and strengthen the ecosystem so blockchain-based projects may fundraise in the future.

In order for someone to truly understand this article’s arguments, the reader must understand five things: ICOs, blockchain technology, the three different types of cryptocurrency, complex securities laws, and the current landscape this all takes place in. Additionally, three specific concepts must be defined and explored: cryptocurrency, blockchain technology, and ICOs. Unfortunately, a circular organizational problem is present: what should this article define and explore first? An ICO is the initial sale of cryptocurrency, but cryptocurrency is built on blockchain technology, and blockchain technology projects are often funded by ICOs.²² The author

12. *Virtual Currencies: Examining Cryptocurrencies and ICO Markets*, H. Sub. Comm. on Capital Markets, Securities, and Investment, 105th Cong. C-SPAN 00:01:35 (2018) (statement of Bill Huizenga, Chairman, H. Sub. Comm. on Capital Mkts., Sec. & Inv.), <https://www.c-span.org/video/?442556-1/hearing-focuses-cryptocurrency-markets&start=44> [hereinafter *Virtual Currencies*].

13. Kastelein, *supra* note 10.

14. *Id.*

15. See *infra* Part III.B.

16. Dylan Dedi, *SEC and CFTC Hearing: More Legitimate ICOs or “If There Was No Bitcoin, There Would Be No Blockchain”*, COINTELEGRAPH (Feb. 6, 2018), <https://cointelegraph.com/news/sec-and-cftc-hearing-more-legitimate-icos-or-if-there-was-no-bitcoin-there-would-be-no-blockchain>.

17. Kastelein, *supra* note 10.

18. Dedi, *supra* note 16.

19. *Id.* (Giancarlo was more optimistic than Clayton, explaining how a “do no harm” regulatory approach was used during the early days of the internet, and that allowed revolutionary changes in areas like telecommunications, commerce, and transportation. Likewise, Giancarlo believes a “do no harm” approach is appropriate for blockchain technology).

20. *Id.* (while ICOs needed the most regulation, Clayton explained that blockchain technology needed the least regulation, and virtual currencies were somewhere in the middle).

21. *Id.*

22. *What is an ICO?*, *surpa* note 11; *Blockchain*, INVESTOPEDIA, <https://www.investopedia.com/terms/b/blockchain.asp> (last visited Sept. 29, 2018).

found it almost impossible to define one without discussing the other two, but each is an extremely complex concept, and they must be explored one at a time.

An additional organizational problem was whether to first explore the current fraud and market manipulation occurring in the ICO space, or to begin by analyzing existing securities laws, show how it is unclear whether these laws relate to ICOs, and then demonstrate how that ambiguity has contributed to the recent ICO fraud. The author, realizing there is no perfect concept to start with, selected the best place he thought to begin.

Accordingly, Part II explores this article's three fundamental concepts in the following order: cryptocurrency, blockchain technology, and ICOs. A reader should have a *basic* understanding of all three concepts at the conclusion of Part II. While the author attempts to provide enough information to inform most readers, some may find it helpful to consult additional sources if there is still confusion at the end of Part II.

Then, Part III looks at the current state of ICOs and the potentially applicable securities laws. Part III first looks at the laws that may relate to the initial sale of cryptocurrency, and then it analyzes the famous "Howey Test." After the laws are laid out, Part III demonstrates how current securities laws do not apply to ICOs perfectly; this ambiguity allows bad actors to occupy the space. There is too much uncertainty about whether the SEC may regulate cryptocurrency. Understanding this makes it easier to see why new, ICO-specific laws can help clear up the confusion. Additionally, this article's first proposed regulation is introduced in Part III: the SEC should broaden the definition of a security to include utility tokens, which will give token holders the protections that federal securities laws provide.

After all of the fundamental concepts have been defined, the laws have been laid out, and the bad actors have been exposed, Part IV—the crux of this article—recommends new, ICO-specific regulations that the SEC should enact. Part V concludes by looking at how these new regulations could improve the legitimacy of ICOs, cut down on the number of bad actors, and help blockchain technology continue to grow.

This article's intended audience is Congress, the SEC, and anyone who has the ability to influence laws that can clean up the ICO process and protect ICO purchasers. A second audience is any lawyer who practices in securities, cryptocurrency, blockchain, the Internet of Things, venture capital, private equity, or general start up law. While the author would like for lay readers to be able to understand this article, someone who does not have *any* prior understanding of blockchain, cryptocurrency, and securities law may struggle to follow along, unfortunately.

This article's goal is to achieve balance. Regulation must have enough strength to remove bad actors, but also have enough seller-friendly attributes so blockchain developers can continue building on an open blockchain. Regulation must have enough strength to protect investors from fraudulent ICOs, but also have enough investor-friendly attributes so everyone can help propel blockchain development forward.

II. BEFORE MOVING FORWARD: DEFINING AND EXPLORING THREE FUNDAMENTAL CONCEPTS

In order for this article to make sense, three fundamental concepts must be defined and explored: cryptocurrency, blockchain technology, and ICOs. Remember, it is impossible to fully define one without referencing the others. Additionally, due to the complexity of these concepts, countless pages could be written on each. For example, the National Institute of Standards and Technology (“NIST”) published a fifty-plus page document overviewing blockchain technology.²³ This article merely attempts to provide all readers with a low-level understanding of the core concepts before moving forward.

A. *Cryptocurrency: Exploring the Differences Between Coins, Security Tokens, and Utility Tokens*

Cryptocurrency is a broad term. It includes any “digital or virtual currency that use[s] cryptography for security.”²⁴ However, there are several different cryptocurrencies, and they are not all the same. Accordingly, this article attempts to break the general term, cryptocurrency, into three sub-types: coins, security tokens, and utility tokens.²⁵ This taxonomy of cryptocurrency is helpful because understanding the differences between them is key when considering how to regulate their initial sale. Additionally, it is important to grasp the differences because the proposed regulations introduced in Part IV only apply to utility tokens. This article does not propose SEC regulations that apply to coins or security tokens.

A short definition of “coins” is cryptocurrency that is commonly thought of as a form of digital money capable of replacing paper money like the dollar.²⁶ “Security tokens” are usually synonymous with investment contracts or stock in a blockchain company.²⁷ Finally, “utility tokens” are often considered to be the pre-purchase of a blockchain-empowered product or service.²⁸

The lines between the three types of cryptocurrency are not always clear. For example, a cryptocurrency can be a security token in the hands of an investor even though the company intended it to be a utility token.²⁹ Additionally, a cryptocurrency can change over the course of its life.³⁰ This article recognizes that not all

23. Dylan Yaga et al., *Blockchain Technology Overview*, NIST, (Oct. 2018), <https://nvl-pubs.nist.gov/nistpubs/ir/2018/NIST.IR.8202.pdf>.

24. Kastelein, *supra* note 10.

25. Lukas Schor, *8 Important Things to Know About Security Tokens/Token Regulation*, MEDIUM (Nov. 22, 2017), <https://medium.com/@argongroup/8-important-things-to-know-about-security-tokens-token-regulation-3d548a1a6367>; Micha Benoliel, *Understanding the Difference Between Coins, Utility Tokens, and Tokenized Securities*, MEDIUM (Aug. 8, 2017), <https://medium.com/startup-grind/understanding-the-difference-between-coins-utility-tokens-and-tokenized-securities-a6522655fb91> (there is no commonly accepted taxonomy of cryptocurrency).

26. Schor, *supra* note 25; Benoliel, *supra* note 25.

27. Schor, *supra* note 25; Benoliel, *supra* note 25.

28. Schor, *supra* note 25; Benoliel, *supra* note 25.

29. Schor, *supra* note 25 (“This might lead to many projects being classified as securities even though they initially setup their tokens as a utility, just because the economic reality is that the contributors invest primarily because of anticipation of profits.”).

30. *Id.* (“It’s important to note that tokens can change their position on the graph over time. Especially when tokens are being sold prior to having a product / utility in place but develop this use-value at a later

cryptocurrencies are the same, and a taxonomy may help readers to see the differences. Regardless, SEC Chairman Clayton stated that the SEC will regulate substance over form.³¹ So, in the eyes of the SEC, the specific name given to any cryptocurrency has little value.

Coins should be thought of as stores of value, digital gold, or virtual currency.³² Bitcoin is the most well-known example of a coin.³³ However, professionals disagree about *what* someone acquires when they purchase a coin, and *where* Bitcoin draws its value from.³⁴ Some, including former Chairman of the Federal Reserve, Alan Greenspan, argue that Bitcoin has no intrinsic value; as a result, its value is not tied to anything, leaving it susceptible to the “greater fool” theory of demand.³⁵ Others propose a circular line of reasoning that Bitcoin’s only source of intrinsic value is its ability to store value, so the holder of a coin is similar to the holder of real gold.³⁶ And many, including Chairmen Clayton and Giancarlo, think Bitcoin’s value is “tied to [the process of] mining” Bitcoin.³⁷

Security tokens represent cryptocurrencies that “constitute an investment contract, where the main use-case, and the reason for the contributors to buy the tokens, is the anticipation of future profits in [the] form of dividends, revenue share or (most commonly) price appreciation.”³⁸ It is worth noting that the accounting firm Ernst & Young conducted market research of the ICO space, and it concluded security tokens are “rarely used.”³⁹ While a company may not call its cryptocurrency a security token, and may even intentionally create a cryptocurrency without any equity or voting rights, SEC Chairman Clayton said, “I believe every ICO I’ve seen is a security” due to investor desires for price appreciation.⁴⁰

point. This actually applies to most pre-product ICO’s that are currently being launched, which might aim to achieve being a utility token but are in fact an investment contract during the time of issuance.”)

31. Public Statement from Jay Clayton, Chairman, U.S. Sec. & Exch. Comm’n, Statement on Cryptocurrencies & Initial Coin Offerings, (Dec. 11, 2017) <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11> [hereinafter Clayton Statement].

32. Schor, *supra* note 25; Benoliel, *supra* note 25.

33. Zach LeBeau, *What’s the Difference Between an ‘ICO’ and a ‘Token Launch’?*, MEDIUM (Dec. 29, 2017), <https://medium.com/@SingularDTV/whats-the-difference-between-an-ico-and-a-token-launch-d892d4d689a4> (“Coins really only have one utility—to act as simple stores of value with limited-to-no other functionality. By “simple” value, I mean value not represented or manifested through a variety of dynamic functions.”).

34. Jason Bloomberg, *What is Bitcoin’s Elusive Intrinsic Value?*, FORBES (June 26, 2017, 5:22 PM), <https://www.forbes.com/sites/jasonbloomberg/2017/06/26/what-is-bitcoins-elusive-intrinsic-value/#76ac6d4f7194>.

35. *Id.*; *Greater Fool Theory*, INVESTOPEDIA, <https://www.investopedia.com/terms/g/greaterfooltheory.asp> (last visited Oct. 6, 2018) (“If acting in accordance with the greater fool theory, an investor will purchase questionably priced securities without any regard to their quality. If the theory holds, the investor will still be able to quickly sell them off to another “greater fool,” who could also be hoping to flip them quickly. Unfortunately, speculative bubbles burst eventually, leading to a rapid depreciation in share prices.”).

36. Bloomberg, *supra* note 34.

37. Dedi, *supra* note 16; *Bitcoin Mining News*, COINTELEGRAPH, <https://cointelegraph.com/tags/bitcoin-mining> (last visited Oct. 6, 2018) (“Bitcoin mining is a peer-to-peer process of adding data into Bitcoin’s public ledger in order to verify and secure a contract. Groups of recorded transactions are gathered in blocks and then added into the Bitcoin blockchain.”).

38. Schor, *supra* note 25.

39. See generally *EY Research: Initial Coin Offerings (ICOs)*, ERNST & YOUNG, 24 (Dec. 2017), <http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf>.

40. Stan Higgins, *SEC Chief Clayton: ‘Every ICO I’ve Seen is a Security’*, COINDESK (Feb. 6, 2018, 19:30 UTC), <https://www.coindesk.com/sec-chief-clayton-every-ico-ive-seen-security/>.

Finally, utility tokens are the most popular type of cryptocurrency for an ICO to sell, and refer to a pre-purchase of future blockchain services, often initially sold for a discount.⁴¹ Buying a utility token from a blockchain company is like buying Chuck E. Cheese's tokens one year before the arcade opens, but with a \$0.05 per-token discount; because one token entitles the holder to one arcade game, the buyer may either play pinball or sell their token at the market rate of \$0.25 for a profit when the arcade opens a year later.⁴²

B. Blockchain: Exploring Why It is so Important

The second fundamental concept in this article is blockchain technology. While not the direct focus of this article, it is something readers should be familiar with because it has real utility in the world.⁴³ Author Steven Johnson wrote an article in the New York Times Magazine titled "Beyond the Bitcoin Bubble."⁴⁴ Johnson argued that while everyone was distracted with the get-rich-quick "Bitcoin Bubble" at the end of 2017, there was "something much more important than wealth" being built: blockchain ledger technology.⁴⁵

Blockchains are "open," meaning anyone can use and improve it because no single entity is "in charge" of it.⁴⁶ Because blockchain technology is a public ledger that records information spreading out across countless hard drives ("distributed"), it is extremely difficult to tamper with.⁴⁷ Applications can also be built on top of, and powered through, blockchain technology.⁴⁸ Cryptocurrency is one type of blockchain application, but other blockchain applications include smart contracts and data/logistics tracking.⁴⁹ Imagine how accurate financial audits and regulatory compliance would be with a perfect record of everything the client did. Johnson believes the Bitcoin Bubble distracted people from the "revolutionary breakthrough" that is blockchain ledger technology: "History is replete with stories of new technologies whose initial applications ends up having little to do with their eventual use."⁵⁰

41. *EY Research*, *supra* note 39; Josiah Wilmoth, *The Difference Between Utility Tokens and Equity Tokens*, STRATEGIC COIN, <https://strategiccoin.com/difference-utility-tokens-equity-tokens/> (last visited Oct. 6, 2018).

42. Ash Bennington, *Utility Coins or Crypto Assets? Token Terminology Is One Big Grey Area*, COINDESK, <https://www.coindesk.com/utility-coins-crypto-assets-token-terminology-one-big-gray-area/> (last updated Sept. 6, 2017, 9:01 UTC).

43. See Steven Johnson, *Beyond the Bitcoin Bubble*, N.Y. TIMES (Jan. 16, 2018), <https://www.nytimes.com/2018/01/16/magazine/beyond-the-bitcoin-bubble.html> ("The Bitcoin bubble may ultimately turn out to be a distraction from the true significance of the blockchain.")

44. *Id.*

45. Johnson, *supra* note 43.

46. *Id.*

47. *Blockchain*, *supra* note 22 ("A blockchain is a digitized, decentralized, public ledger of all cryptocurrency transactions. Constantly growing as 'completed' blocks (the most recent transactions) are recorded and added to it in chronological order, it allows market participants to keep track of digital currency transactions without central recordkeeping. Each node (a computer connected to the network) gets a copy of the blockchain, which is downloaded automatically.")

48. *Id.* (explaining that blockchain can be a "pretty reliable way" to store many different types of data, including banking transactions, healthcare, property records, smart contracts, supply chains, and even voting).

49. *Id.*

50. Johnson, *supra* note 43.

While the concept of an open, public ledger may not appear exciting, it has the potential to change the way the world does business.⁵¹ In an attempt to put blockchain's potential into perspective, Johnson points out that the internet, email, and GPS also began as open technologies.⁵² Take GPS for example: originally developed and used exclusively by the United States military, it became open in the 1980s and began to be used by the aviation industry.⁵³ Then, individual consumers and businesses soon developed in-car navigation, which quickly led to GPS enabled smartphones.⁵⁴ Now, GPS allows us to do everything from finding “nearby restaurants to playing Pokémon Go to coordinating disaster-relief efforts.”⁵⁵ Imagine how different the world would be today if GPS had not been open.

Encouraging blockchain technology growth should be a goal for policymakers, and the easiest way to allow growth to continue is to keep it open. Chairmen Giancarlo and Clayton agree that of the three crypto-related spaces—ICOs, cryptocurrency, and blockchain technology—blockchain technology needs the least amount of regulation, if any.⁵⁶ Today, people building blockchain-based applications consider ICOs a legitimate option to raise money for their projects.⁵⁷ The author thinks if the fraud that ravaged early ICOs is cleaned up through new SEC regulations, more genuine blockchain-based projects will be funded. This may allow the potential world-changing power of blockchain technology to arrive sooner.

C. *What is an ICO and How Does It Work?*

An ICO is the first time a blockchain company sells its cryptocurrency to the public.⁵⁸ On one side of the transaction, the buyer receives the benefit of having access to the ground floor of a blockchain company, usually at a discount.⁵⁹ On the other side of the deal, entrepreneurs can raise money “on a level playing field,”⁶⁰ allowing them to access “vibrant sources of capital” without having connections in Silicon Valley or New York City.⁶¹ Indeed, an estimated \$4 billion was raised from 210 ICOs conducted in 2017.⁶² Additionally, an estimated 480 ICOs raised \$1.66 billion in the first quarter of 2018 alone.⁶³

Some ICOs can provide significant funding for blockchain-based projects. Take, for example, the ICO that sold a cryptocurrency called “Filecoin,” created by

51. *Id.*

52. Johnson, *supra* note 43.

53. *Id.*

54. *Id.*

55. *Id.*

56. Dedi, *supra* note 16.

57. *What is an ICO?*, *supra* note 11.

58. *Id.*

59. *Id.* (“[B]lockchain developers realized that . . . launch[ing] a token was still much easier than pursuing seed rounds through the usual venture capital model.”)

60. *Virtual Currencies*, *supra* note 12, at 0:15:00 (statement of Mike Lempres, Chief Legal & Risk Officer at Coinbase).

61. *Id.*

62. *Cryptocurrency ICO Stats 2017*, COINSCHEDULE, <https://www.coinschedule.com/stats.html?year=2017> (last visited Sept. 29, 2018).

63. *Virtual Currencies*, *supra* note 12, at 00:02:00 (statement of Bill Huizenga, Chairman, H. Sub. Comm. on Capital Mkts., Sec. & Inv.).

Protocol Labs.⁶⁴ Of the \$257 million raised in the first month of Protocol Labs's ICO, \$187 million was collected within the first hour.⁶⁵ The most impressive part of this record-breaking event is that Protocol Labs's data storage project had no scheduled launch date at the time of its ICO.⁶⁶ So, more than 2,100 investors from 50 countries gave \$257 million to the Filecoin project, and the customers received no Filecoins in return, nor did they know when the Filecoins would be distributed.⁶⁷ Filecoin ICO buyers did, however, receive a Simple Agreement for Future Tokens ("SAFT"), a contract promising coins would be distributed upon the eventual completion of the project.⁶⁸ While the Protocol Labs's ICO shows that ICOs can be a legitimate alternative to traditional fundraising, they are largely unregulated and this uncertainty puts buyers and sellers at risk.⁶⁹

Technically speaking, conducting an ICO is a lengthy and complicated process that is generally conducted in the following manner. First, a blockchain company writes and publishes an electronic white paper detailing the company's vision of the blockchain-enabled project.⁷⁰ Then, the company creates its new cryptocurrency and advertises the ICO.⁷¹ The ICO usually has a set number of tokens capable of being sold, and the ICO ends when the token limit is reached.⁷² However, this is not how it always happens. Problems begin to occur when bad actors enter the space looking for a get-rich-quick opportunity.⁷³ The problems that bad actors created will be explored in more depth later in this article.

For now, it is important to understand the different types of cryptocurrency, the potential benefits of blockchain technology, and how ICOs can provide blockchain-based projects with vibrant sources of capital. While more could be said about each fundamental concept, this article now turns to the current state of everything crypto-related. Fraud was rampant in past ICOs, and part of this is due to the regulatory

64. FILECOIN, <https://filecoin.io/> (last visited Sept. 29, 2018) (Filecoin is an online storage program allowing people to securely store their files on a "decentralized storage network." What this means is if you stored your information on Filecoin, your data would be fragmented and stored across the world thanks to blockchain technology. Filecoin wants to offer you un-hackable storage. To use Filecoin's data-storing services, you pay with "Filecoins.").

65. *Id.*; Stan Higgins, *\$257 Million: Filecoin Breaks All-Time Record for ICO Funding*, COINDESK, <https://www.coindesk.com/257-million-filecoin-breaks-time-record-ico-funding/> (last updated Sept. 8, 2017, 15:00 UTC); Paul Vigna, *Latest Hot Digital Coin Offering: \$187 Million in One Hour for Filecoin*, WALL STREET J. (Aug. 12, 2017, 5:34 PM), <https://www.wsj.com/articles/latest-hot-digital-coin-offering-187-million-in-one-hour-for-filecoin-1502481514>.

66. *Filecoin Sale Completed*, PROTOCOL LABS (Sept. 13, 2017), <https://protocol.ai/blog/filecoin-sale-completed/> ("[W]e are excited and eager to return to what we do best: Building. We have a lot to build before . . . we can launch the network.").

67. *Id.*

68. *Id.* (In their update after the ICO, Protocol Labs explained the SAFT that customers paid for during the ICO would not yield actual coins until the Filecoin network launches.).

69. See generally *EY Research*, *supra* note 39, at 2, 36 (discussing the risks and rewards inherent in ICOs).

70. Cal Evans, *How to Develop White Paper for ICO: Do's and Don'ts*, COINTELEGRAPH (Aug. 21, 2017), <https://cointelegraph.com/news/how-to-develop-white-paper-for-ico-dos-and-donts> (explaining the most important element in an ICO is the White Paper).

71. Ray King, *How to Create a Cryptocurrency*, BITDEGREE, <https://www.bitdegree.org/tutorials/how-to-create-a-cryptocurrency/> (last updated Sept. 17, 2018); Seema Mody, Katie Young & Darren Geeter, *Creating Your Own Cryptocurrency? Here's What You Need to Know*, CNBC, <https://www.cnbc.com/2018/05/09/creating-your-own-cryptocurrency-heres-what-you-need-to-know.html> (last updated May 15, 2018, 11:13 AM).

72. Antonio Madeira, *How Does an ICO Work*, CRYPTOCOMPARE (Jan. 14, 2018), <https://www.cryptocompare.com/coins/guides/how-does-an-ico-work/>.

73. See *infra* Part III.C.

gray area that ICOs operate in. The next part will analyze the laws that potentially apply to ICOs, examine why the regulatory gray area exists, and then look at examples of ICO fraud that may have been exacerbated by this gray enforcement area.

III. THE CURRENT STATE OF CRYPTO-RELATED LAWS AND FRAUD

A. *Who May Regulate the Initial Sale of Cryptocurrency and What Laws May Apply?*

There is current uncertainty about who may regulate coins and tokens, primarily because they do not fit cleanly within pre-defined bodies of law.⁷⁴ However, the SEC has jurisdiction over all “securities.”⁷⁵ The SEC originally defined a “security” as “any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, . . . [or] *investment contract*”⁷⁶ Thus, if an ICO sells securities, the SEC’s federal securities laws apply. So, the key question is whether cryptocurrency sold in ICOs are securities.

The SEC believes that ICOs sell securities, and this is evidenced by three statements. The SEC’s first ICO-specific statement restated the general law that if a blockchain company sells securities in an ICO, it must register those securities with the SEC:

[T]he 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 U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger [blockchain] technology.⁷⁷

Second, the SEC said that most ICOs appear to sell securities:

Prospective purchasers are being sold on the potential for tokens to increase in value—with the ability to lock in those increases by reselling the tokens on a secondary market—or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.⁷⁸

Finally, in February 2018, SEC Chairman Clayton said, “I believe every ICO I’ve seen is a security.”⁷⁹ Thus, the SEC thinks it has clear jurisdiction over ICOs.

74. See Bennington, *supra* note 42.

75. Press Release, U.S. Sec. & Exch. Comm’n, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017) <https://www.sec.gov/news/press-release/2017-131> [hereinafter DAO Tokens].

76. 15 U.S.C. § 77b(a)(1) (2012) (emphasis added).

77. DAO Tokens, *supra* note 75.

78. Clayton Statement, *supra* note 31.

79. Higgins, *supra* note 40.

Congress created the SEC in direct response to the massive stock market crash in 1929 that began the Great Depression.⁸⁰ The SEC's website explains its origin story, and it coincidentally parallels the so-called "Bitcoin Bubble":

Tempted by promises of "rags to riches" transformations and easy credit, most investors gave little thought to the systemic risk that arose from widespread abuse of margin financing and unreliable information about the securities in which they were investing. During the 1920s, approximately 20 million large and small shareholders took advantage of post-war prosperity and set out to make their fortunes in the stock market. It is estimated that of the \$50 billion in new securities offered during this period, half became worthless.⁸¹

Four years later, Congress passed the Securities Act of 1933 ("the 33 Act") to make sure that "investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities."⁸² The 33 Act accomplishes this objective by requiring sellers of securities to disclose certain information to the SEC prior to the sale.⁸³ This information includes a description of the company's business, a description of the security to be sold, and the company's management information.⁸⁴ Filed information is made public prior to the sale so that prospective purchasers may make an informed investment decision.⁸⁵ The 33 Act protects investors by allowing them to recover losses that result from material errors in the disclosure statements.⁸⁶ It is important to note that certain small securities offerings are exempt from filing.⁸⁷

Because the 33 Act governs the initial sale of securities from the company to investors, Congress also passed the Securities Exchange Act of 1934 ("the 34 Act").⁸⁸ The 34 Act allows the SEC to regulate the sale of securities in the secondary market (when the initial investor re-sells their security to another investor).⁸⁹ The 34 Act, among other things, prohibits all fraud in relation to offering, buying, and selling securities in the secondary markets.⁹⁰

The purpose of the 33 Act is to ensure investors have enough information to make informed investment decisions, and to ensure sellers of securities accurately disclose all necessary information.⁹¹ Additionally, the 34 Act allows the SEC to police fraudulent actors in the secondary market and hold them responsible.⁹² These laws, however, only apply if the item in question is indeed a security. Knowing the

80. U.S. Sec. & Exch. Comm'n, What We Do, <https://www.sec.gov/Article/whatwedo.html> (last updated June 10, 2013).

81. *Id.*

82. U.S. Sec. & Exch. Comm'n, The Laws That Govern the Securities Industry, <https://www.sec.gov/answers/about-lawsshtml.html> (last updated Oct. 1, 2013).

83. *Id.*

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

general laws that may apply to cryptocurrency sold in an ICO is important, but the next part addresses the question of whether ICOs actually sell securities. Ultimately, it will show how the law is not clear on this issue.

B. *Is a Utility Token a Security? Why the SEC's Howey Test Does Not Work Well*

As explained above, SEC Chairman Clayton believes *every* cryptocurrency sold in an ICO is a security and should follow SEC regulations.⁹³ This article's taxonomy of cryptocurrency indicated that of the three different types of cryptocurrency, security tokens are the only type of cryptocurrency intended to function as securities.⁹⁴ However, security tokens are rarely used.⁹⁵ This means that Chairman Clayton and the SEC believe the majority of cryptocurrencies not intended to be securities (i.e., utility tokens) are still securities.

The author agrees that utility tokens sold in an ICO *should* be classified as securities under federal securities laws because of the protections that the 33 Act and the 34 Act give investors. Unfortunately, utility tokens do not fit neatly within the existing definition of security.⁹⁶ Therefore, this creates a regulatory gray area.⁹⁷ Accordingly, the SEC should pass two new laws. First, the SEC should expand the definition of a security to include utility tokens. Such expansion will provide federal securities law protection to utility token purchasers, and it will require companies conducting an ICO to disclose material information to the SEC.⁹⁸ Second, a complimentary SEC regulation should be passed that holds utility token sellers to simpler registration requirements than other sellers of securities. This second regulation will be explored in more depth in Part IV. In order to understand why the definition of security should be broadened, this article applies the existing definition of a security to utility tokens sold in an ICO. Like a square peg in a round hole, utility tokens do not perfectly fit under the current definition of a security.

i. *The Howey Test*

Section 2(1) of the 33 Act said “any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, . . . [or] *investment contract*” is a security.⁹⁹ Then, in 1946, the Supreme Court's seminal decision in *SEC v. W.J. Howey* greatly expanded the definition of security.¹⁰⁰ *Howey* relied on the “investment contract” language to hold that an investment in an orange growing business was a security.¹⁰¹ The Court in *Howey* identified that “predominantly business and professional people who lack[ed] the skill and equipment necessary for the

93. Higgins, *supra* note 40.

94. See *supra* Part II.A.

95. *EY Research*, *supra* note 39.

96. Kastelein, *supra* note 10.

97. *Id.*

98. 15 U.S.C. § 77e(a) (this information is filed in a registration statement).

99. 15 U.S.C. § 77b(a)(1) (2012) (emphasis added).

100. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 297 (1946) (“[S]ecurity’ . . . include[s] the commonly known documents traded for speculation or investment.”).

101. *Id.* at 301.

care” of the orange growing business were “attracted by the *expectation of substantial profits*.”¹⁰² Thus, according to the famed “Howey Test,” an investment contract is considered a security when someone makes (1) an investment of money, (2) in a common enterprise, and (3) is led to expect profits (4) primarily from the efforts of others.¹⁰³

The 72-year-old Howey Test is why SEC Chairman Clayton considers utility tokens to be securities.¹⁰⁴ Clayton argues that those who buy cryptocurrency in ICOs, regardless of whether the seller intended it as a security or not, “are being sold on the potential for tokens to increase in value—with the ability to lock in those increases by reselling the tokens on a secondary market.”¹⁰⁵ Obviously, § 2(1)’s definition of security does not mention cryptocurrency.¹⁰⁶ So, it is the catch-all nature of “investment contracts” that may subject utility tokens to SEC authority. Now, this article applies the four prongs of the Howey Test to utility tokens to see if they are securities or not.

ii. Why Expanding the Definition of Security to Include Utility Tokens Eliminates Confusion

The Howey Test requires the “contract, transaction[,] or scheme” at issue to meet all four of its prongs in order to be considered a security.¹⁰⁷ If any prong is not met, there is no security and securities laws will not apply. Because the ICO community would like to know if they must comply with securities laws, legal scholars, practitioners, and blockchain experts have applied the Howey Test to ICOs. However, their conclusions are at odds with each other.

To demonstrate these conflicting views on a key issue, a white paper written by Protocol Labs, the company that created Filecoin, and Cooley, a global law firm (“the Protocol Labs white paper”), will be contrasted with a white paper written by the Cardozo Law School’s Blockchain Project (“the Cardozo white paper”).¹⁰⁸ The purpose of this section is to show how legal experts disagree about the answer to the key question: do securities laws apply to ICOs? Because of a lack of agreement, expanding the definition of security to include utility tokens will eliminate the need to apply the confusing Howey Test in the future.

According to the Protocol Labs white paper, the first prong of the Howey Test—an “investment in money”—is almost always satisfied when an ICO sells utility tokens. This is because case law has held over the years that exchanging

102. *Id.* at 296 (emphasis added).

103. *Id.* at 298-99.

104. Clayton Statement, *supra* note 31.

105. *Id.*

106. 15 U.S.C. § 77b(a)(1) (2012).

107. *W.J. Howey Co.*, 328 U.S. at 298-99.

108. Juan Batiz-Benet, Jesse Clayburgh & Marco Santori, THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK, PROTOCOL LABS (Oct. 2, 2017), <https://saftproject.com/static/SAFT-Project-Whitepaper.pdf> [hereinafter THE PROTOCOL LABS WHITE PAPER]; NOT SO FAST—RISKS RELATED TO THE USE OF A “SAFT” FOR TOKEN SALES, CARDOZO BLOCKCHAIN PROJECT (Nov. 21, 2017), https://cardozo.yu.edu/sites/default/files/Cardozo%20Blockchain%20Project%20-%20Not%20So%20Fast%20-%20SAFT%20Response_final.pdf [hereinafter THE CARDOZO WHITE PAPER].

currency, cryptocurrency, donations, or labor constitutes an investment of money.¹⁰⁹

The second prong of the Howey Test requires money to be invested “in a common enterprise.”¹¹⁰ Because courts apply different tests, the Protocol Labs white paper argues that the common enterprise prong is *sometimes* satisfied when an ICO sells utility tokens.¹¹¹ The majority of courts apply the “horizontal commonality test,” which finds a common enterprise exists when “multiple investors pool assets and share together in the profits and risks of the enterprise.”¹¹² A minority of courts apply the “vertical commonality test,” which can either be applied narrowly or broadly.¹¹³ Under the narrow vertical commonality test, a common enterprise exists “where the fortunes of the investors are bound up with the *actual fortunes* of the promoter or issuer of the security.”¹¹⁴ Compare that to the broad vertical commonality test that finds a “common enterprise exists where the fortunes of the investors are bound up with the *mere efforts* of the promoter or issuer.”¹¹⁵

Focusing on the majority’s horizontal commonality test, the Protocol Labs white paper argues the second prong is met if “[1] [the] tokens are fungible, [(2)] the entity pools all the money raised from selling the tokens, and [(3)] the entity uses the pooled funds to build the network.”¹¹⁶ While a utility token sold in an ICO will usually satisfy the common enterprise prong if courts apply the majority horizontal commonality test, the Protocol Labs white paper says the second prong would rarely be satisfied in a minority jurisdiction.¹¹⁷ However, this is due to nuanced complexities relating to the way ICOs are carried out which are beyond the scope of this article.¹¹⁸ For now, this article moves on without explaining how ICOs fit within the minority test.

The third prong of the Howey Test requires investors to have an “expectation of profits.”¹¹⁹ This means that investors “expect[] capital appreciation resulting from the development of the initial investment or expected participation in earnings resulting from the use of investor funds.”¹²⁰ Citing case law, the Protocol Labs white paper distinguishes that the expectation of profit requirement is not satisfied when the purchaser “is motivated primarily by the desire to use or consume the item purchased,” but is satisfied when “the purchaser’s expectation of profit . . . *predominate[s]* the expectation of using the thing purchased.”¹²¹ The Protocol Labs white paper concludes most ICOs satisfy this prong because “purchasers seem predominantly motivated by a desire to profit from the transaction. Most seem to hope to sell the token at a higher price than they paid.”¹²²

The Protocol Labs white paper argues that the final prong, “from the efforts of others,” is the most controversial because it hinges on two things: (1) whether the

109. THE PROTOCOL LABS WHITE PAPER, *supra* note 108, at 7.

110. *W.J. Howey Co.*, 328 U.S. at 298–99.

111. THE PROTOCOL LABS WHITE PAPER, *supra* note 108, at 7.

112. *Id.*

113. *Id.*

114. *Id.* (emphasis added).

115. *Id.* (emphasis added).

116. *Id.*

117. *Id.*

118. *Id.*

119. *W.J. Howey Co.*, 328 U.S. at 298–99.

120. THE PROTOCOL LABS WHITE PAPER, *supra* note 108, at 8.

121. *Id.* (emphasis added).

122. *Id.*

predominant reason tokens were purchased was a desire for profit, and (2) whether the token is “functional.”¹²³ Protocol Labs goes on to explain that selling functional utility tokens to anyone, regardless of whether they intend to actually use the token or merely profit from their resale on a secondary market, fails the Howey Test.¹²⁴ A blockchain company conducting an ICO—the “others” whose efforts are relied upon—works to create a functional token.¹²⁵ Once the token and project are functional, however, the Protocol Labs white paper argues there are no more efforts to rely upon that will lead to significant profit appreciation.¹²⁶ Additionally, small improvements to the functional project will not greatly impact the value of a utility token. This is because other market factors will equally impact the token’s value by the time the token is functional.¹²⁷ However, the Protocol Labs white paper suggests a pre-functional utility token sold in an ICO to a purchaser with an expectation of profits “is very likely to be predominantly from the ‘efforts of others’” because the blockchain team still has the potential to substantially increase the value of the utility token.¹²⁸

To summarize the Protocol Labs white paper, the investment of money prong is almost always satisfied in an ICO that sells utility tokens. The common enterprise prong is usually satisfied in majority jurisdictions, but is rarely satisfied in minority jurisdictions. The expectation of profits prong is usually satisfied because the Protocol Labs white paper argues most people purchase utility tokens to re-sell at a higher price on the secondary market. Finally, the requirement that the profits come from the efforts of others is not satisfied if the utility token is functional at the time of sale. Remember, an Ernst & Young market research report identified that most ICOs did *not* sell functional utility tokens.¹²⁹ Thus, it appears that if a court applied the Howey Test to a typical ICO in a majority jurisdiction, it would likely conclude that the ICO sold securities. Federal securities laws would then apply.

Although the Protocol Labs white paper makes the Howey Test analysis appear simple, the Cardozo white paper directly disagrees with the Protocol Labs white paper’s conclusion. The Cardozo white paper argues that the Protocol Labs white paper incorrectly simplifies the analysis of whether a token is a security based on whether or not the token is “functional.”¹³⁰ The Cardozo white paper points out that courts do not “turn on bright-line rules” and instead analyze a wide range of factors to determine security status.¹³¹ Additionally, the Cardozo white paper advises ICOs to not rely on the Protocol Labs white paper because it may expose them to future legal trouble.¹³² The Protocol Labs white paper concluded that selling functional utility tokens likely does not satisfy the Howey Test, but the Cardozo white paper

123. *Id.* at 8–9 (the term “functional” refers to whether the token can be redeemed for blockchain services. Some utility tokens, like Filecoin, were sold before the Filecoin data-storage project was operational. So, at the time of the Filecoin ICO, Filecoins would not be functional. Once the project is open for business, however, Filecoins could be exchanged for data storage, and Filecoins would then be functional).

124. *Id.* at 9.

125. *Id.*

126. *Id.*

127. *Id.* at 10.

128. *Id.* at 11.

129. *EY Research, supra* note 39, at 15 (only 5% of ICOs sold its utility tokens when the blockchain project was functional).

130. THE CARDOZO WHITE PAPER, *supra* note 108, at 3–4.

131. *Id.*

132. *Id.*

points out that there is “sparse and controversial legal support” for that conclusion.¹³³ Specifically, the Cardozo white paper highlights that the case law relied on by the Protocol Labs white paper dealt with natural resources and commodities like gold and sugar.¹³⁴ The Cardozo white paper accordingly believes that those cases “are inapposite to the critical question that courts will need to grapple with when dealing with utility tokens: whether the utility tokens, in and of themselves, will be deemed investment contracts under *Howey*.”¹³⁵

The contradicting points made by the Cardozo white paper and the Protocol Labs white paper show that intellectuals disagree on the most important issue: whether federal securities laws apply to ICOs. This shows why there is a current regulatory gray area in the ICO space. Thus, expanding the definition of a security to include utility tokens would eliminate confusion. A blanket approach that classifies all utility tokens as securities is beneficial in three ways: (1) requiring blockchain companies to register its utility tokens with the SEC prior to selling creates more accountability; (2) token purchasers receive the safety given to securities holders under federal security laws; and (3) the SEC receives the convenience of not having to run every ICO through the fact-specific *Howey* Test. This suggestion is further explored in Part IV.

Experts in the field generally agree with this article that the SEC needs new ICO-specific laws. Robert Rosenblum, a leading cryptocurrency attorney from San Francisco, made it clear that it is too early to craft serious, long-term regulations because the ICO space is so new and volatile.¹³⁶ However, in the short term, the SEC needs to “both modify and amend their rules to better assist ICO issuers in meeting the requirements of the federal securities laws” which will help “to facilitate good ICOs and to help guard against fraud.” This is because Rosenblum says the current SEC laws “do not work well” with ICOs.¹³⁷ One reason for this statement may be that complying with federal securities laws requires significant money and time—two resources startup blockchain companies may not have.¹³⁸

C. *Why ICOs Need New Laws: Current Problems in the ICO and Blockchain Space*

Even amidst the regulatory gray area that ICOs operate in, ICOs are here to stay. Reputable venture capitalists, like Brock Pierce and Bart Stephens of Blockchain Capital, and global law firms, like DLA Piper and Cooley, are now working with ICO companies.¹³⁹ ICOs have also provided an opportunity for obsolete companies, like Atari and Kodak, to become relevant again after both saw their stock prices skyrocket following future ICO plan announcements.¹⁴⁰ Even SEC Chairman

133. *Id.* at 6.

134. *Id.* at 6-7.

135. *Id.*

136. *Virtual Currencies: Examining the Cryptocurrencies and ICO Markets*, *supra* note 12, at 00:26:10 (statement of Robert Rosenblum, cryptocurrency attorney).

137. *Id.* at 00:24:55 (emphasis added).

138. *See infra* Part IV.A.

139. Mason Borda, *Beyond the Red Tape: The Path Ahead for Token Sales*, COINDESK, <https://www.coindesk.com/beyond-red-tape-path-ahead-token-sales/> (last updated Jan. 14, 2018, 17:43 UTC).

140. Stan Higgins, *Game Maker Atari is Planning to Launch its Own Cryptocurrency*, COINDESK (Feb. 15, 2018, 19:45 UTC), <https://www.coindesk.com/game-maker-atari-planni>.

Clayton believes ICOs have the potential to be an “effective way[] for entrepreneurs and others to raise funding.”¹⁴¹

However, amidst this growing attention, many ICOs subjected token purchasers to rampant fraud over the past year. For example, in December 2017, the SEC froze the assets of a blockchain company called PlexCoin after its ICO raised \$15 million by fraudulently promising investors a 13-fold return on investment.¹⁴² Then, on January 30, 2018, the SEC froze \$600 million raised by AriseBank’s in-progress ICO.¹⁴³ The SEC alleged that AriseBank fraudulently told investors it was an FDIC-insured bank.¹⁴⁴ To make matters worse, AriseBank’s founder was on probation for felony theft at the time of the ICO.¹⁴⁵ Similarly, on April 2, 2018, criminal charges were filed against the founders of Centra Tech Inc. after it fraudulently raised \$32 million from more than 1,000 ICO purchasers.¹⁴⁶ Centra Tech is the most egregious example of ICO fraud.¹⁴⁷ Endorsed by pop music icon DJ Khaled,¹⁴⁸ Centra Tech tricked investors by promising a debit card backed by Visa and MasterCard that would allow card holders to spend their Bitcoin in stores.¹⁴⁹ These three examples are just a few of the many fraudulent ICOs that have stolen millions of dollars from ICO purchasers. Accordingly, ICOs need regulation to hold these fraudsters accountable.

In addition to the fraudulent ICOs that caught the SEC’s attention, Ernst & Young authored a 44-page ICO report (“the Report”) at the end of 2017 that analyzed 372 total ICOs.¹⁵⁰ The Report shows several problems with the way current ICOs are ran, and it also provides some guidance for the next steps in ICO regulation.

First, the Report concluded “[m]ost ICO white papers lack a clear explanation of the business reasons for blockchain and token currency (utility token). As a result, many projects never move from the ideation state to implementation, or the implementation is flawed.”¹⁵¹ This is because many view ICOs as a “get rich quick”

141. Clayton Statement, *supra* note 31.

142. Laura Shin, *\$15 Million ICO Halted by SEC for Being Alleged Scam*, FORBES (Dec. 4, 2017, 2:46 PM), <https://www.forbes.com/sites/laurashin/2017/12/04/15-million-ico-halted-by-sec-for-being-alleged-scam/#4d9279971569>.

143. Matt Robinson, *SEC Freezes Crypto Assets of \$600 Million Initial Coin Offering*, BLOOMBERG (Jan. 30, 2018, 8:25 AM), <https://www.bloomberg.com/news/articles/2018-01-30/sec-seeks-to-freeze-crypto-assets-of-600-million-coin-offering>.

144. *Id.*

145. *Id.* (Former heavyweight boxing champion, Evander Holyfield, was an actual endorser of the AriseBank project. You cannot make this stuff up.)

146. Press Release, U.S. Sec. & Exch. Comm’n, SEC Halts Fraudulent Scheme Involving Unregistered ICO (Apr. 2, 2018) <https://www.sec.gov/news/press-release/2018-53> [hereinafter Unregistered ICO].

147. Lucinda Shen, *SEC Charges \$32 Million DJ Khaled-Backed Centra ICO With Fraud*, FORTUNE (Apr. 3, 2018), <http://fortune.com/2018/04/03/floyd-mayweather-dj-khaled-centra-tech-ico-sec-fraud/>.

148. *Id.*

149. Unregistered ICO, *supra* note 146.

150. *EY Research*, *supra* note 39, at 1–2.

151. *Id.* at 10.

opportunity, so more work is placed on trying to attract investors.¹⁵² The Report argues utility tokens are rarely needed.¹⁵³

Second, the Report points out that 84% of the ICOs observed sold tokens in the businesses' "idea stage," compared to only 5% who sold after its project was already running.¹⁵⁴ Of the projects still in the idea stage, 32% had no stated anticipated date of completion.¹⁵⁵ Third, ICOs are carried out online via "smart contracts"—programed code designed to automatically carry out the ICO.¹⁵⁶ The problem is that many of these smart contracts contain errors.¹⁵⁷ For example, the Report found one ICO's smart contract contained two lines of code: one was shown to the investor and the other was hidden.¹⁵⁸ The hidden portion had contract terms that allowed the seller to change the duration of the ICO sale (diluting the token value), issue new tokens at any time, and destroy tokens at any time.¹⁵⁹

Fourth, ICOs are popular targets for hackers, and Ernst & Young argues many project founders do not prioritize security.¹⁶⁰ The Report identified that 10% of all ICO funds are lost due to hacking, and the most popular hacking methods include (1) creating a fake website that looks identical to the original ("phishing"), thereby tricking the investor to spend money on the false site, (2) directly hacking the ICO website, and (3) hacking the information of the investors.¹⁶¹ If a bank were hacked, lost funds would be insured, however, "Most exchanges do not disclose policies and controls over personal data storage. . . . This represents great value on the black market."¹⁶²

Finally, the Report recommends three areas of future action to "decrease investor risk" and turn ICOs into an "effective financing tool for quality blockchain projects."¹⁶³ First, project founders must justify the need for their utility token, focus on investor security, and strictly comply with the law in all countries where the tokens will be used.¹⁶⁴ Second, the Report encourages investors to perform due diligence and analyze the smart contract code when possible.¹⁶⁵ Finally, regulators should "standardize minimum requirements for reporting," which should be easy since the blockchain is public and can allow automatic reporting.¹⁶⁶ Regulators are also encouraged to create protections for token buyers while they wait to receive their tokens as the project is built.¹⁶⁷

152. *Id.* at 11 (explaining that many white papers contain "many clichés that attract inexperienced investors" and provides a list of the most commonly used phrases in white papers, including "next-generation platform" and "most undervalued token"); Covesting, *Thousands of Ordinary Investors are getting Rich through ICOs*, MEDIUM (Nov. 27, 2017), <https://medium.com/@Covesting/thousands-of-ordinary-investors-are-getting-rich-through-icos-9100d6b91ed8>.

153. *EY Research, supra* note 39, at 15.

154. *Id.* at 16.

155. *Id.*

156. *Id.* at 18.

157. *Id.*

158. *Id.* at 22.

159. *Id.*

160. *Id.* at 30.

161. *Id.* at 31.

162. *Id.* at 33.

163. *Id.* at 40.

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

Part III showed that the SEC is the regulating agency that most likely has jurisdiction over ICOs. Additionally, Part III showed the different securities laws that may apply to ICOs if an ICO sells a security. Because everything hinges on whether ICOs sell securities, this article analyzed the Howey Test and showed how experts in the field disagree about whether ICOs sell securities or not. Finally, Part III provided a snapshot of some of the problems that ICOs face right now. Some of those problems stem from fraudulent actors, while others stem from the lack of a standardized ICO process. Now that the current legal climate is understood, this article proposes new ICO-specific regulations that should be enacted to fix the above-mentioned problems.

IV. RECOMMENDATIONS FOR NEW, ICO-SPECIFIC REGULATIONS

First, recall that there are three types of cryptocurrency: coins, security tokens, and utility tokens.¹⁶⁸ Utility tokens are the only type relevant to this section of the article. If an ICO intends to sell virtual currency or digital gold (coins), CFTC laws should govern.¹⁶⁹ Likewise, if an ICO sells tokens that give equity or voting rights to its holder (security tokens), that is a security and existing securities law will apply.¹⁷⁰ This part deals with tokens like Filecoin; while some investors will buy a Filecoin hoping the value will appreciate, others desire to pre-purchase blockchain storage services.¹⁷¹

Additionally, “Congress has a responsibility to ensure investors are protected without unduly limiting opportunities for growth.”¹⁷² In his book, *How to Regulate*, Professor Thomas Lambert explains how policymakers should only pass regulations that eventually lead to the “greatest net benefit” for everyone involved.¹⁷³ Applying that framework to ICOs, the author believes that the greatest net benefit is one where fraud is removed from the ICO space, ICOs become a legitimate means of fundraising for blockchain companies, and everyone—not just accredited investors—can access blockchain companies. An indirect benefit of these ICO-specific regulations is an ecosystem that encourages and fosters blockchain technology growth. The author’s view is supported by Mike Lempres, Chief Legal and Risk Officer at Coinbase, the largest cryptocurrency exchange in the world. Lempres told the House Subcommittee on Capital Markets, Securities, and Investment that Coinbase welcomes new regulation to “ensure investor protection.”¹⁷⁴ Lempres supports this article’s regulatory balancing approach as demonstrated by the following statement:

168. *See supra* Part II.A.

169. *Bitcoin Basics*, U.S. COMMODITY FUTURES TRADING COMM’N 1, http://www.cftc.gov/ido/groups/public/@customerprotection/documents/file/oceo_bitcoin-basics0218.pdf (last visited Oct. 6, 2018).

170. *See* 15 U.S.C. § 77b(a)(1) (2012).

171. Joey Krug, *Why Amazon’s Margin Is Filecoin’s Opportunity*, FORBES (Aug. 18, 2017, 9:00 AM), <https://www.forbes.com/sites/joeykrug/2017/08/18/why-amazons-margin-is-filecoins-opportunity/#2f934de324dd> (“Filecoin is a cryptocurrency that is used to pay for storage space on IPFS, a global filesystem that allows storage of large amounts of data.”).

172. *Virtual Currencies*, *supra* note 12, at 00:07:33 (statement of Rep. Randy Hultgren).

173. THOMAS A. LAMBERT, *HOW TO REGULATE: A GUIDE FOR POLICYMAKERS* 14 (2017).

174. *Virtual Currencies*, *supra* note 12, at 00:15:15 (statement of Mike Lempres, Chief Legal and Risk Officer at Coinbase).

In order to fully enable ICOs, investors must have confidence in the integrity of the market. For this reason, we support enforcement actions where they are necessary to weed out *bad actors and to protect investors*. At the same time, we need to be sure we are *not chilling innovation brought about by new technology and good actors*.¹⁷⁵

A. *A More Lenient Filing Requirement: Standardized White Paper and “Token Registration”*

Part III suggested that the definition of a security should be broadened to include utility tokens, which would require blockchain companies to comply with SEC registration requirements before conducting an ICO.¹⁷⁶ Part III also suggested that the SEC should simultaneously create a more lenient registration standard for companies conducting an ICO. This is because it is expensive and time-consuming to comply with existing securities laws in order to legally sell securities. A report issued by PricewaterhouseCoopers estimates companies who follow all registration requirements and carry out an IPO spend \$3.7 million.¹⁷⁷ This includes the legal costs of drafting the SEC registration statements, accounting costs to audit the company, and filing fees.¹⁷⁸ While costs vary significantly depending on the complexity and size of the sale, a small blockchain company could realistically spend \$1 million to comply with all regulations.¹⁷⁹ Then, after initially filing, additional costs are necessary to comply with the SEC’s quarterly and annual filings, conduct annual audits, hire internal and external accountants, and retain a law firm.¹⁸⁰ More research is needed in order to accurately estimate the cost for a small team conducting an ICO.¹⁸¹

Because of the time and money required to comply with current SEC registration requirements, a more lenient registration requirement for ICO companies is needed. Under this new standard, anyone conducting an ICO to sell utility tokens would file a detailed white paper with the SEC, and the SEC should establish minimum white paper disclosure requirements. This proposed regulation is supported by Ernst & Young’s market research that encouraged regulators to “standardize minimum requirements for reporting.”¹⁸² A company conducting an IPO must file a prospectus with the SEC that “clearly describe[s] important information about [the seller’s] business operations, financial condition, results of operations, risk factors, and management.”¹⁸³ Therefore, a standardized white paper should, at a minimum,

175. *Id.* (emphasis added).

176. 15 U.S.C. § 77e(a), (c) (2012).

177. *Considering an IPO?: The Costs of Going and Being Public May Surprise You 4*, STRATEGY&, https://www.strategyand.pwc.com/media/file/Strategyand_Considering-an-IPO.pdf (last visited Nov. 18, 2018) (IPO data must be analyzed because no ICO registration information being available at the time of this writing).

178. *Id.* at 8.

179. *Id.* at 5 (“87% of CFOs participating in PwC’s recent survey of US firms that have gone public in the past several years indicated that their firms spent more than \$1 million on one-time costs associated with the transaction.”).

180. *Id.* at 17-32.

181. *Id.* at 33 (“Additionally, as these costs can vary both in size and type, there is no uniform and consistent methodology used to estimate the costs of being a public company.”).

182. *EY Research, supra* note 39, at 40.

183. U.S. Sec. & Exch. Comm’n, What is a Registration Statement?, <https://www.sec.gov/smallbusiness/goingpublic/registrationstatement> (last updated Nov. 29, 2017).

inform token purchasers about the following: (1) what problems the company's blockchain project solves; (2) what rights a token holder will and will not receive; (3) when the blockchain project will be completed; and (4) why a token is necessary in the first place. Ernst & Young's market research concluded most ICOs "lack[ed] a clear explanation of the business reasons for blockchain and . . . utility tokens."¹⁸⁴

In addition to filing a white paper, this article also recommends that a company conducting an ICO should be allowed to file a device referred to here as a "token registration" in place of a prospectus. A token registration is a document that would contain basic information about the company, its founders, the number of tokens being sold, and the token price. The token registration and white paper should both be filed with the SEC before the ICO through the SEC's electronic data gathering, analysis, and retrieval ("EDGAR") system.¹⁸⁵ Documents filed through EDGAR are made public, and increase accountability.¹⁸⁶ This ICO-specific filing requirement is ICO-friendly because companies conducting an ICO already write white papers,¹⁸⁷ and the cost, while not specifically prescribed here, would ideally be much less than what companies pay to register for an IPO.¹⁸⁸

Support for requiring ICO companies to file a white paper and token registration is found generally with Georgetown University Law Professor Chris Brummer. He explained that one of the key reasons why the U.S. has such an advanced financial capital market is because of how much information is available to investors.¹⁸⁹ However, Professor Brummer identified a gap of quality information available when comparing a securities registration statement and an unregulated blockchain white paper.¹⁹⁰ Professor Brummer then provided a list of disclosures he believes ICO token buyers need to know in order to make an informed decision: (1) the "promoter's location . . . beyond a simple P.O. box," because 32% of identified ICOs do not list this information; (2) a "problem and proposed technology solution," because ICOs should be used to fund a technology-based solution to a problem, written in plain English; and (3) a list of "what legal rights holders of the tokens will [and will not] enjoy."¹⁹¹

B. Allow Everyone to Buy Utility Tokens

As explained earlier, it is illegal for anyone to sell or offer to sell a security unless it is either registered with the SEC or is *exempt from federal securities laws*.¹⁹² So, if a blockchain company did not want to file expensive disclosures with the SEC under current law, it could try to find an exception to filing altogether. The most popular exception is complying with Regulation D ("Reg D"), which creates

184. *EY Research*, *supra* note 39, at 10.

185. U.S. Sec. & Exch. Comm'n, Filings & Forms, <https://www.sec.gov/edgar.shtml> (last updated Jan. 9, 2017) ("Anyone can access and download this information for free.")

186. *Id.*

187. Evans, *supra* note 70.

188. STRATEGY&, *supra* note 177, at 5 ("87% of CFOs participating in PwC's recent survey of US firms that have gone public in the past several years indicated that their firms spent more than \$1 million on one-time costs associated with the transaction.")

189. *Virtual Currencies*, *supra* note 12, at 00:18:05 (statement of Professor Chris Brummer, Georgetown University Law).

190. *Id.* at 00:18:40.

191. *Id.* at 00:19:00 – 00:22:50.

192. See *supra* Part III; 15 U.S.C. § 77e(a), (c) (2012); See 15 U.S.C. § 77d (2015).

a bright-line registration exception for small securities offerings through Rule 504 and Rule 506.¹⁹³ A handful of ICOs, including Filecoin, have started to follow Reg D.¹⁹⁴ However, Reg D imposes strict limits on who can purchase the security and how much money can be raised.¹⁹⁵

This proposed regulation suggests everyone should be able to buy utility tokens in an ICO. This regulation may be applied in one of two ways, depending on what the SEC chooses to do in the next few months. If the SEC expands the definition of security to include utility tokens, as introduced at the end of Part III, then this part should be viewed as introducing a framework for how to regulate ICOs moving forward: new ICO-specific securities laws should allow anyone to buy utility tokens in an ICO. However, if the SEC neither broadens the definition of a security nor creates a more lenient filing requirement, then this part should be viewed as a regulatory compromise: the SEC should simply eliminate the “accredited” and “sophisticated” requirements for a blockchain company following Reg D. In order to understand the merits of the second application—remove the accredited and sophisticated requirements—the limits Reg D imposes through Rule 504 and 506 must be explored.

Rule 504 allows a company to avoid filing with the SEC if it makes less than \$5 million when selling the securities in a 12-month period.¹⁹⁶ Companies following Rule 504 must still electronically file a “Form D” with the SEC, and the securities are “restricted” which means the security cannot be re-sold within the following year.¹⁹⁷

Rule 506 has two different standards, but a Form D must be filed either way, and all securities sold under Rule 506 are also restricted.¹⁹⁸ Rule 506(b) allows a company to raise an unlimited amount of money; however the company cannot advertise the sale, and it must follow strict requirements for who it sells to.¹⁹⁹ An unlimited number of “accredited” and 35 “un-accredited” investors may purchase the unregistered 506(b) securities; an accredited investor is an individual whose net worth exceeds \$1,000,000 or has net income exceeding \$200,000 for the past two years.²⁰⁰ Regardless of whether an investor is accredited or not, all 506(b) investors must be “sophisticated,” which means they “have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.”²⁰¹

Alternatively, Rule 506(c) allows the following: the company may only sell to accredited investors, an unlimited number of accredited investors may participate, sophistication is not a requirement for the investors, and the company may advertise

193. U.S. Sec. & Exch. Comm’n, Fast Answers: Regulation D Offerings, <https://www.sec.gov/fast-answers/answers-regdhtm.html> (last modified Nov. 27, 2017) [hereinafter Regulation D Offerings].

194. JD Alois, *Protocol Labs Files Two Form D’s with SEC Regarding Enormous Filecoin ICO*, CROWDFUND INSIDER (Aug. 26, 2017, 9:32 AM), <https://www.crowdfundinsider.com/2017/08/121075-protocol-labs-files-two-form-ds-sec-regarding-enormous-filecoin-ico/>; Higgins, *supra* note 65.

195. Regulation D Offerings, *supra* note 193.

196. U.S. Sec. & Exch. Comm’n, Fast Answers: Rule 504 of Regulation D, <https://www.sec.gov/fast-answers/answers-rule504.html> (last updated Nov. 27, 2017) [hereinafter Rule 504 of Regulation D].

197. *Id.*

198. U.S. Sec. & Exch. Comm’n, Fast Answers: Rule 506 of Regulation D, <https://www.sec.gov/fast-answers/answers-rule506htm.html> (last modified Nov. 27, 2017) [hereinafter Rule 506 of Regulation D].

199. *Id.*

200. 17 C.F.R. § 230.501 (2018); Rule 506 of Regulation D, *supra* note 198.

201. *Id.*

the sale.²⁰² However, the company must “take reasonable steps to verify that the investors are accredited” which means the company must analyze investors’ tax returns and bank statements.²⁰³

The SEC explains that, “One principal purpose of the accredited investor concept is to identify persons who can bear the economic risk of investing in these unregistered securities.”²⁰⁴ The SEC allows some non-accredited investors to purchase unregistered securities if they are “financially sophisticated or, in other words, have sufficient knowledge and experience in financial and business matters to evaluate the investment.”²⁰⁵

This proposed regulation urges the SEC to allow anyone to purchase utility tokens in an ICO. If the SEC considers utility tokens to be securities while simultaneously creating the more lenient registration process, then this objective will come to fruition because there are no requirements imposed on who may purchase *registered* securities. However, if the SEC does not enact either proposed regulation mentioned above, a compromise is to allow ICOs to operate under Reg D without having to follow the “accredited” and “sophisticated” limitations.

Utility tokens are fundamentally different from traditional investment devices like stock,²⁰⁶ and blockchain technology will grow faster when more people participate in its development.²⁰⁷ Ethereum, today’s most popular blockchain and the blockchain most new ICOs launch projects on, was created by Vitalik Buterin, a 19-year-old from Toronto.²⁰⁸ Additionally, most people who owned Bitcoin in early 2018 were young minorities between the ages of 18-34.²⁰⁹ Young, non-accredited people want to own utility tokens, and new ICO regulations should allow it. Perhaps an attempt to compromise would be to create a blockchain sophistication test, and anyone who passes it can purchase utility tokens in an ICO.

C. *Private Right of Action for Fraud in White Paper and “Token Registration”*

Congress should create a private right of action for individuals who purchase tokens in a fraudulent ICO. Currently, § 11 of the 33 Act, which applies to registered securities, creates civil liability for every director, underwriter, expert who helped to prepare, and every person who signs or is named in a filed registration statement that “contained an untrue statement of a material fact or omitted to state a material fact.”²¹⁰ The SEC should create a similar private right of action for material misstatements and omissions in white paper filings and token registrations.

202. *Id.*

203. *Id.*

204. *Investor Bulletin: Accredited Investors*, U.S. SEC. & EXCH. COMM’N (Sept. 23, 2013), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-accredited-investors> [hereinafter *Accredited Investors*].

205. *Id.*

206. *See generally supra* Part II.

207. *See supra* Part II.B.

208. *EY Research, supra* note 39, at 2; Alyssa Hertig, *Who Created Ethereum?*, COINDESK, <https://www.coindesk.com/information/who-created-ethereum/> (last visited Oct. 18, 2018).

209. Bloomberg, *This is What the Average Bitcoin Owner Looks Like*, FORTUNE (Jan. 24, 2018), <http://fortune.com/2018/01/24/young-men-buying-bitcoin/>.

210. 15 U.S.C. § 77k(a) (1998).

This proposed regulation lines up well with SEC Commissioner Elisse B. Walter's statement in the Harvard Law School Forum on Corporate Governance & Financial Regulation:

Because I believe that enforcement, and therefore statutory effectiveness, depends on a public-private partnership, I also believe that this judicial and Congressional trend away from private rights affects the Commission's ability to enforce the securities laws. Admittedly, the agency's reasons for bringing a case are broader than those of private litigants, and the standards associated with the agency's cases differ from those in private actions. Nevertheless, public and *private rights [of action] are the two pillars on which enforcement rests.*²¹¹

This article merely suggests a private right of action should exist. However, more consideration is necessary regarding how it should look. For example, the necessary pleading standard would need to be established because the burden of proof in pleading a § 11 claim has risen in some circuits over the years.²¹² Additionally, courts would need to decide whether to use § 11 case law as precedent or blaze a new trail with ICO private rights of action.

D. Extend Securities Fraud Liability to Fraudulent ICO Advertisements

Finally, the SEC should either create an ICO truth-in-advertising law or extend Rule 10b-5 (anti-fraud) liability to ICOs.²¹³ Fraudulent ICOs like AriseBank and Centra Tech lied to its customers; AriseBank claimed it was FDIC insured, and Centra Tech promised customers a Visa-backed Bitcoin credit card.²¹⁴ Fraudulent ICO advertisements reached such a boiling point that companies like Facebook decided to ban all cryptocurrency and ICO-related advertisements.²¹⁵ The SEC currently uses Rule 10b-5—which applies to both primary and secondary markets as well as both registered and unregistered securities—to police fraudulent advertisements surrounding securities offerings.²¹⁶ Rule 10b-5 requires the plaintiff to prove five elements: “(1) a material misrepresentation or omission of fact, (2) scienter, (3)

211. Elisse Walter, *The Interrelationship Between Public and Private Securities Enforcement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 11, 2011), <https://corpgov.law.harvard.edu/2011/12/11/the-interrelationship-between-public-and-private-securities-enforcement/> (emphasis added).

212. Matthew Levitt, *First Circuit Strengthens “Traceability” Pleading Requirement for Section 11 Claims*, MINTZ (Nov. 30, 2016), <https://www.securitiesmatters.com/2016/11/first-circuit-strengthens-traceability-pleading-requirement-for-section-11-claims/#more-2313>.

213. 15 U.S.C. § 77k(a) (Rule 10b-5 allows anyone harmed by a misleading or fraudulent statements in connection with the sale of a security to have a private right of action against the party who caused the harm).

214. See *supra* Part III.C.

215. Rob Leathern, *New Ads Policy: Improving Integrity and Security of Financial Product and Services Ads*, FACEBOOK (Jan. 30, 2018), <https://www.facebook.com/business/news/new-ads-policy-improving-integrity-and-security-of-financial-product-and-services-ads> (“We want people to continue to discover and learn about new products and services through Facebook ads without fear of scams or deception. That said, there are many companies who are advertising binary options, ICOs and cryptocurrencies that are not currently operating in good faith.”).

216. 15 U.S.C. § 78j(b) (2010).

a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss.”²¹⁷ If the SEC broadens its definition of a security to include utility tokens, then Rule 10b-5 protection would automatically extend to ICOs.²¹⁸ However, if the SEC does not broaden the definition, this article argues that a separate law should be passed that will protect ICO purchasers from fraudulent statements in ICO advertisements.

E. Other Non-Regulatory Actions Blockchain Companies Can Take to Help Standardize ICOs

There are actions that ICO participants should take to do their part in further securing the space. First, companies conducting ICOs need to prioritize customer security. Ernst & Young explained that ICOs’ failure to prioritize security resulted in approximately 10% of all ICO funds being lost to hackers.²¹⁹ Second, blockchain companies should use reputable ICO facilitators like CoinList to conduct their ICO.²²⁰ CoinList successfully ran the record-setting Filecoin ICO, and has helped more than 20 blockchain teams comply with existing SEC laws like background checking customers’ accredited and sophisticated status for Reg D.²²¹ CoinList only partners with legitimate blockchain companies and maintains a database of vetted investors.²²² Finally, token buyers should receive SAFTs—enforceable contracts guaranteeing the company’s eventual token issuance—from companies who conduct an ICO on one day, but will not issue tokens until the project is complete at a later date. Filecoin’s record-breaking ICO did this.²²³ Ernst & Young identified that 84% of ICOs sold tokens in the “idea stage,” and so giving token buyers SAFTs will protect investors while they wait for their tokens.²²⁴ Ernst & Young called SAFTs a “notable” step towards protecting investors, and it was created by “industry players” to “fill in regulatory gaps.”²²⁵

F. Secondary Market Regulation: Cryptocurrency-Specific Pump-and-Dump Liability

A final suggestion for how the SEC can help legitimize cryptocurrency sales and exchanges is to extend Rule 10b-5 liability to cryptocurrency “pump-and-dumpers” on the secondary market.²²⁶ For example, look at the self-proclaimed pump group, CryptoCalls.²²⁷ CryptoCalls picks an existing token and “skyrockets

217. Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 990 (9th Cir. 2009).

218. 15 U.S.C. § 78j(b) (2010) (this is because Rule 10b-5 only applies to securities).

219. *EY Research*, *supra* note 39, at 30.

220. COINLIST, <https://coinlist.co/> (last visited Oct. 18, 2018).

221. *Id.*

222. CoinList, *Introducing CoinList*, MEDIUM (Oct. 20, 2017), <https://medium.com/@coinlist/introducing-coinlist-16253eb5cdc3> (“We’ve worked to develop an audited, bank-grade compliance process, performing KYC [Know Your Customer] and AML [Anti-Money Laundering] compliance due diligence and investor accreditation . . . We select companies to partner with after a rigorous diligence process.”).

223. *Filecoin Sale Complete*, *supra* note 66.

224. *EY Research*, *supra* note 39, at 16, 36.

225. *Id.* at 36.

226. 15 U.S.C. § 78j(b) (2010).

227. Crypto Calls, *CryptoCalls Elite*, YOUTUBE (Jan. 17, 2018), https://www.youtube.com/watch?v=3wUe2N2_OY (“[p]ump groups,” in the context of this article, pick one specific cryptocurrency and,

the value . . . for six hours at a time.” CryptoCalls tells its members to purchase a token when it is cheap, and then it “will begin advertising it to other investors on social media.”²²⁸ Those advertisements artificially inflate, or “pump,” the value of the token up, and then CryptoCalls coordinates the massive sale, or “dump,” to “maximize profits” at the expense of others who buy CryptoCalls’s overpriced tokens, and it is those other buyers who hold the cryptocurrency as the price plummets back down.²²⁹ This is egregious fraudulent trading.²³⁰ These pumpers only purchase the stock to benefit from rapid price appreciation, which means they are securities, and extending 10b-5 criminal and civil liability would hopefully reduce this kind of fraud.²³¹

V. CONCLUSION

ICOs are here to stay.²³² Although ICO fraud was rampant in early 2018, and many believe cryptocurrency is a “bubble,” the proper goal is legitimizing ICOs to help fundraise blockchain projects, protect investors, and strengthen blockchain technology.²³³ ICOs allow entrepreneurs to raise money for blockchain-related projects, and everyone should have access to those projects. Stronger ICOs will hopefully lead to more blockchain development.²³⁴

This article does not address regulation of virtual currencies like Bitcoin. Additionally, blockchain technology is not the focus of this article, and this article is not an attempt to fix all the problems related to buying and selling cryptocurrency. Finally, it is important to acknowledge that many are still skeptical about cryptocurrency. In his opening statement to the House Subcommittee on Capital Markets, Securities, and Investments, Representative Brad Sherman’s first four words were, “Cryptocurrencies are a crock.”²³⁵ Representative Sherman continued by saying the following:

What social benefit do [cryptocurrencies] provide? Well, they allow a few dozen men in my district to sit in their pajamas on the couch all day and tell their wives they’re going to be millionaires. They help terrorists and criminals move money around the world. They help tax-evaders. They

through social media, falsely inflate the price of that cryptocurrency at the expense of less informed consumers).

228. *Id.*

229. *Id.*

230. *See, e.g.,* United States v. Gordon, 710 F.3d 1124 (10th Cir. 2013) (holding that lawyer who pumped and dumped stock was subject to civil and criminal liability).

231. Higgins, *supra* note 40. (SEC chairman Clayton explained it is the desire for price appreciation that makes these coins and tokens securities).

232. *See supra* Part III.C.

233. Johnson, *supra* note 43 (the Bitcoin bubble may be a distraction from the underlying blockchain technology that is powerful because it is “open,” and the more people working on blockchain technology means it may reach its full potential sooner).

234. *See id.* (explaining “open” technology is most powerful when more people use it, like GPS and email).

235. *Virtual Currencies: Examining the Cryptocurrencies and ICO Markets*, *supra* note 12, at 00:08:50 (statement of Rep. Brad Sherman).

help start-up companies commit fraud, take the money, and 1% of the time they actually create a useful business.²³⁶

Indeed, this is only the beginning for the cryptocurrency regulatory debate.

The end of Part III suggested that regulators should broaden the definition of a security to include utility tokens in order to provide securities law protection to token buyers. The truth is that some buy tokens in hopes of price appreciation, others purchase tokens in order to one day use the blockchain enabled services—like storing information on Filecoin—and some buy with both intents simultaneously.²³⁷ The uncertainty of whether utility tokens are securities under the Howey Test has allowed ICOs to operate in the regulatory grey area, and fraud has run rampant in the meantime. This article then proposed several regulations the SEC should pass, ideally in the next 12 months. These regulations try to balance the interests of reducing fraud while still allowing ICOs to be funded. Hopefully, stories like Arise-Bank stay in the past. Regardless, it seems clear that the first step towards taming the Wild West of ICOs is passing new, ICO-specific regulation.

236. *Id.*

237. THE PROTOCOL LABS WHITE PAPER, *supra* note 108 (explaining that there are two groups of people who tend to buy utility tokens in an ICO: those who intend to actually use the blockchain services, and those who intend to sell the token on a secondary market to profit from price appreciation).