INITIAL COIN OFFERINGS: INNOVATION, DEMOCRATIZATION AND THE SEC

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ABSTRACT

Initial coin offerings are a source of controversy in the world of startup fundraising, and their legality is, at best, an open question. Amid soaring valuations and rumors of looming SEC action, investors and issuers alike are scrambling to forge a path forward for the token-based startups of tomorrow. While issuers may soon be forced to comply with United States securities laws, the existing regime is inadequate because it does not allow startups to capture the unique benefits of coin sales and, more importantly, it does not allow eager American investors to take part in funding the world's next generation of technology companies.

INTRODUCTION

In July of 2013,[1] Mastercoin (now Omni Layer),[2] a digital currency and communications protocol platform, conducted the world's first Initial Coin Offering (ICO). The amount raised in the offering was modest—a mere $3.15 million—and featured only about 500 participants.[3] In the four years since, however, ICOs have become enormously popular, growing far beyond their meager beginnings. In January 2018 alone, fewer than thirty-five ICOs raised nearly $800 million.[4]

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[1] Vitalik Buterin, *Mastercoin: A Second-Generation Protocol on the Bitcoin Blockchain*, BITCOIN MAGAZINE (Nov. 4, 2013, 5:15 PM), https://bitcoinmagazine.com/articles/mastercoin-a-second-generation-protocol-on-the-bitcoin-blockchain-1383603310/.

[2] OMNI LAYER, http://www.omnilayer.org/ (last visited Nov. 7, 2017).

[3] Jasper Hamill, *Fed Up with Bitcoin? Here's How to Start Your Own Currency,* FORBES (Nov. 30, 2013, 11:22 AM), https://www.forbes.com/sites/jasperhamill/2013/11/30/fed-up-with-bitcoin-heres-how-to-start-your-own-currency/#7c7cf9ad7909.

[4] *Cryptocurrency ICO Stats 2018,* COINSCHEDULE, https://www.coinschedule.com/stats.php (last visited Feb. 13, 2018).

With this surge in popularity, analysts have increasingly voiced concerns about fraud, volatility and the possibility of a dangerous bubble in the ICO market.[5] Financial regulators around the world have been slow to act,[6] given that these offerings are, by definition, conducted via decentralized cryptocurrencies that have no foundation in traditional banking. Savvy startups, fearing an impending crackdown, have rushed their coins to market, fueling huge valuations and generating splashy headlines about high-profile controversies.[7]

By the beginning of 2018, many regulatory agencies began to more carefully scrutinize ICOs.[8] The SEC took action against some allegedly fraudulent offerings,[9] while a few Asian countries (most notably, China) enacted freezes on all new ICOs.[10] The "Wild West"[11] of coin fundraising is likely in its twilight, but increased regulation does not necessarily mean that ICOs will go away. Without a change in the regulatory landscape, startups will structure their offerings to comply with existing securities laws, which could eliminate many of the benefits of conducting an ICO in the first place. What follows is an examination of the characteristics of the typical initial coin offerings, the existing regulatory space in which startup fundraising occurs in the United States, and proposals for updating securities laws for the age of the ICO.

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[5] John Koetsier, *ICO Bubble? Startups Are Raising Hundreds of Millions of Dollars via Initial Coin Offerings,* INC. (July 14, 2017), https://www.inc.com/john-koetsier/ico-bubble-startups-are-raising-hundreds-of-millio.html.

[6] Jacek Czarnecki, *ICOs in the EU: How Will the 'Slow Giant' Regulate Tokens?,* COINDESK (July 24, 2017), https://www.coindesk.com/icos-eu-will-slow-giant-regulate-tokens/.

[7] Paul Vigna, *Tezos Raised $232 Million in a Hot Coin Offering, Then a Fight Broke Out,* WALL STREET JOURNAL (Oct. 19, 2017), https://www.wsj.com/articles/tezos-raised-232-million-in-a-hot-coin-offering-then-a-fight-broke-out-1508354704.

[8] Stan Higgins, *SEC: US Securities Law 'May Apply' to Token Sales,* COINDESK (July 25, 2017), https://www.coindesk.com/securities-exchange-commission-us-securities-laws-may-apply-token-sales/.

[9] *See, e.g.*, Press Release, U.S. Sec. & Exch. Comm'n, SEC Emergency Action Halts ICO Scam (Dec. 4 2017) (on file with author).

[10] Jon Russell, *China Has Banned ICOs,* TECHCRUNCH (Sept. 4, 2017), https://techcrunch.com/2017/09/04/chinas-central-bank-has-banned-icos/.

[11] *Initial Coin Offering (ICO) – The Wild West of Fundraising,* YAHOO FINANCE (November 23, 2017), https://finance.yahoo.com/news/initial-coin-offering-ico-wild-092102222.html.

I. RAISING CAPITAL WITH AN INITIAL COIN OFFERING

A. How ICOs work

ICOs are not a radical or complicated concept. At their base, they simply exchange newly-created "coins" or "tokens" for an established currency (e.g. Ethereum,[12] Bitcoin,[13] or even U.S. dollars). These "coins" enable holders to participate in a market that a startup is trying to establish. Crucially, most companies are not issuing "coins" as an end to themselves, i.e. with the sole purpose of becoming a new currency. Rather, many have a stand-alone product for which they require customers to pay in the startup's own unique digital token.

As an example, Privatix is a decentralized, autonomous peer-to-peer VPN network company built on blockchain[14] technology[15] that has raised capital with an ICO.[16] Privatix allows individuals with internet-connected devices to sell their spare bandwidth to other users. The only method of payment that buyers of bandwidth are allowed to use on the system is the "coin" (PRIX) that Privatix is offering in its ICO. PRIX, therefore, serves a functional purpose by allowing users to buy and sell bandwidth on the Privatix system.

From a different perspective, these coins serve as an investment vehicle. If Privatix becomes the world's leader in peer-to-peer VPN technology, PRIX will have enormous value, just as the dollar is valuable partially because it is the only acceptable currency in the United States. This functional-investment duality of digital coins is what makes them so difficult to regulate. If coins are merely functional, they are no more securities than they are keys to open a door. If they are investment vehicles, however, coin sales must be registered with the U.S. Securities and Exchange Commission.

B. Network Effects

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[12] *See generally*, Ameer Rosic, *What is Ethereum? A Step-by-Step Beginner's Guide*, BLOCKGEEKS, https://blockgeeks.com/guides/ethereum/ (explaining Ethereum's underlying technology and uses).

[13] *See generally*, Justin Jaffe, *What is Bitcoin? Here's Everything You Need to Know*, CNET, https://www.cnet.com/how-to/what-is-bitcoin/ (explaining what Bitcoin is and how it functions as a cryptocurrency).

[14] *See generally*, Rob Marvin, *Blockchain: The Invisible Technology That's Changing the World*, PCMAG, https://www.pcmag.com/article/351486/blockchain-the-invisible-technology-thats-changing-the-wor (detailing, at a general level, the uses and functionality of blockchain technology).

[15] PRIVATIX, LTD., https://privatix.com/ (last visited Nov. 7, 2017).

[16] *Privatix ICO (PRIX),* COINSCHEDULE, https://www.coinschedule.com/icos/e1192/privatix-ico.html.

Before introducing the regulatory framework within which ICOs exist, it is useful to mention the impact of network effects and their potential benefits for companies conducting an ICO.[17] Many ICOs, in addition to raising capital, also create a proprietary market in which users have only one method of payment available. The holders of that method of payment face a choice: they may either (1) attempt to exchange their coins for some other form of currency by finding a willing buyer, or (2) participate in the market created by the issuer of the coin. Although they may also hold the coin for an indefinite period, hoping to eventually realize its value, this merely delays the same choice. Therefore, when participating in the new economy, the holder of a brand-new, proprietary coin faces high switching costs because she cannot participate in her chosen market using any other currency. If she switches to a different method of payment, she will be shut out and unable to buy or sell within the market.

Conversely, the larger the market is, the more value the coins will possess, given the power of network effects. High switching costs result in profound capture of potential customers, whose best avenue to realizing value from their purchased coins is to participate in the startup company's market. The shared incentive to participate simultaneously multiplies the uses (and therefore, value) of the coins for everyone.

Consequently, a company has a strong incentive to conduct an ICO not only to raise capital, but also to accumulate as many buyers as possible, creating a large and robust market. The more holders of the issued coins, the more potential participants there are for the startup's new market, and increased participants generate increased revenue for the issuer. If the market functions well and provides access to a quality product or service, a high demand for the digital coin will follow. Capturing the benefits of their proprietary coins' high switching costs and network effects make these companies' goals in conducting an ICO much more nuanced than a "traditional" startup's capital raise.

II. REGULATING ICOS

The continued lack of regulation of initial coin offerings will depend on whether the SEC determines that all coins are securities. The Securities Act of 1933 ("the '33 Act") was enacted with the purpose of "regulat[ing] [the] sale of securities in interstate commerce."[18] "Security"

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[17] *See* William J. Luther, *Cryptocurrencies, Network Effects, and Switching Costs*, 34 CONTEMP. ECON. POL'Y. 553–71 (detailing that while network effects are currently inhibiting the growth of Bitcoin and other cryptocurrencies, they stand to benefit cryptocurrencies in the future).

[18] Securities Act of 1933, 15 U.S.C. § 77a et seq. (2012).

was defined as, among many other things, "any note, stock, treasury stock, bond, debenture, . . . [or] investment contract."[19] The long list in the statute suggests a broad scope of what may be considered a "security," and thus subject to regulation. Such a flexible standard has allowed courts to label new articles of speculation and investment "securities" as they have emerged, rather than depending on legislative action.

The most broadly-interpreted term in the definition of security has been "investment contract." Over the last eighty-five years, a wide range of contracts, including a contract to cultivate units of a citrus grove development[20] and even a leasing agreement for payphones with a fixed rate of return,[21] have been determined to fall within the definition. If the coins of ICOs are determined to be "securities," it will most likely be because they are determined to be "investment contracts."

A. What Is an Investment Contract?

The test for determining what constitutes an "investment contract" comes from the 1946 U.S. Supreme Court decision in *SEC v. W.J. Howey Company.*[22] The Court applied a test ("the *Howey* test") to the contract in question to determine whether it fell within the '33 Act's definition of "investment contract." As refined by later courts,[23] the *Howey* test has four factors, each of which must be satisfied for a transaction to be considered an "investment contract" and, thus, a "security":[24]

1. It is an investment of money;
2. The investment of money is in a common enterprise;
3. Any profit comes from the efforts of a promotor or third party; and
4. There is an expectation of profits from the investment.

The third and fourth factors are often combined into "an expectation of profit that comes as a result of the efforts of a third party." Additionally, the term "money" has been interpreted by courts to include

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[19] 15 U.S.C. § 77b.
[20] *See* S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946).
[21] *See* S.E.C. v. Edwards, 540 U.S. 389 (2004).
[22] 328 U.S. 293 (1946).
[23] *See*, *e.g.*, United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975) (refining *Howey*'s "investment of money" prong).
[24] *Howey*, 328 U.S. at 299.

many assets other than cash.[25] Beginning with *Howey*, the Supreme Court has generally embraced the substance of the '33 Act's definition of "security" over its form,[26] paving the way for the SEC to exercise broad powers over a wide-ranging array of transactions.

There is disagreement among analysts as to whether the coins used in ICOs satisfy the *Howey* test. Some prominent commentators have suggested that the functionality of some types of coins puts them solidly outside the category of investment contracts.[27] This reasoning relies principally on case law that distinguishes assets possessing primarily consumptive uses from those that have primarily investment purposes,[28] the result being that assets with consumptive uses are not deemed securities. Therefore, the argument goes, coins that can be shown to have consumptive rather than investment purposes necessarily fail the *Howey* test.

According to these commentators, purchasers of "already-functional" coins—coins that grant access to a system and are already in use prior to the ICO—might not have an expectation of profit, and, thus, these coins fail the fourth prong of *Howey*.[29] While it may be true that these purchasers are receiving something that has a function, however, many initial coin offerings feature "pre-functional" coins. In this context, the coin typically has yet to acquire the functionality that purchasers are hoping for when buying. Thus, the price of the coin reflects the lack of functionality. That being said, even the most innocent purchasers likely expect this functionality to develop and for the value of the coin to increase, giving them a profit. Therefore, even if it exempts "already-functional" coins, it seems very likely that the SEC will classify most coins as securities.

B. 2017 SEC Guidance

The SEC tipped its hand early in the second quarter of 2017. On July 25th, the SEC released an investigative report on The DAO, a "Decentralized Autonomous Organization" created by the German

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[25] *See*, *e.g.*, Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976) ("an 'investment of money' means only that the investor must commit his assets to the enterprise in such a manner as to subject himself to financial loss").
[26] *See Howey*, 328 U.S. at 298 (emphasizing that in state blue sky laws that were contemporary to the '33 Act, "[f]orm was disregarded for substance").
[27] *See* Juan Batiz-Benet et al., *The SAFT Project: Toward a Compliant Token Sale Framework,* PROTOCOL LABS (2017),https://saftproject.com/static/SAFT-Project-Whitepaper.pdf.
[28] *See id.* (citing jurisprudence that suggests a lack of investment purpose when purchasing commodities, such as silver or gold).
[29] *Id.*

corporation Slock.it.[30] The report claimed that the The DAO was an example of "a 'virtual' organization embodied in computer code and executed on a distributed ledger or blockchain."[31] Its purpose was to invest in "projects," becoming a nearly-autonomous, quasi-Venture Capital fund. The DAO sold tokens to investors in exchange for assets to fundraise for these "projects,"[32] and the buyers of the tokens "stood to share in the anticipated earnings from these projects as a return on their investment."[33] In other words, The DAO conducted a prototypical ICO.

The DAO garnered the SEC's attention when it was hacked only one month later, allowing a few users to siphon off one third of the funds to a separate account.[34] This prompted an SEC investigation into the token sale and its compliance with United States securities laws. The investigative report described its findings in unambiguous terms, at least with respect to The DAO token sale:

> Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 . . . . The Commission deems it appropriate and in the public interest to issue this report of investigation . . . to advise those who would use . . . distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws.[35]

While The DAO tokens were deemed securities, and thus the sale should have been registered with the SEC, the Commission chose not to bring charges or make findings of violations in their report,[36] deciding instead to simply caution both investors and issuers about the risks associated with ICOs.[37]

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[30] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, 1 (July 25, 2017) https://www.sec.gov/litigation/investreport/34-81207.pdf [hereinafter "SEC DAO Report"].
[31] *Id.* at 1.
[32] SEC DAO Report at 2–3, *supra* note 30.
[33] *Id.*
[34] Nathaniel Popper, *A Hacking of More Than $50 Million Dashes Hopes in the World of Virtual Currency*, N.Y. TIMES: DEALBOOK (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.
[35] SEC DAO Report at 1–2, *supra* note 30.
[36] Press Release, U.S. Sec. & Exch. Comm'n, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017) (on file with author).
[37] *See generally*, SEC DAO Report, *supra* note 30 (describing the SEC's findings and offering guidance as to SEC's viewpoint of tokens)

The SEC released an investor bulletin on Initial Coin Offerings on the same day as its investigative report.[38] In it, the Commission opted not to issue a blanket determination on the status of coins or tokens,[39] but once again cautioned that ICOs may feature an increased risk of fraud or theft.[40] Most commentators viewed this guidance as the SEC speaking with a firm voice regarding ICOs.[41] The ICO market, however, raised nearly $1.5 billion between August and October of 2017,[42] hardly reflecting a growing fear of regulatory action. Throughout the fall of 2017 and first quarter of 2018, though, the SEC has continued to issue guidance and warnings related to ICOs;[43] meanwhile, other countries (e.g. China)[44] have imposed outright bans.

III. EXEMPTIONS

It is still an open question whether all coins are securities, and thus whether all sales of coins must comply with SEC rules. However, it seems inevitable that some sort of formal regime will eventually apply to ICOs. Startups who hope to raise capital using digital currencies would be wise to develop alternative strategies that are SEC-compliant for fundraising in 2018 and beyond.

Due to the high costs of registration with the SEC, the best strategy for any startup hoping to lawfully raise capital via an ICO is the same as that of a startup raising funds in the traditional way: to claim a transaction exemption from the requirement of registration. What follows is an overview of some of the most common exemptions claimed by startup

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[38] SEC Investor Bulletin: Initial Coin Offerings, July 25, 2017, https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.
[39] *See id*. ("Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities.")
[40] *Id.*
[41] *See, e.g.*, Stan Higgins, *SEC: US Securities Law 'May Apply' to Token Sales*, COINDESK (July 25, 2017), https://www.coindesk.com/securities-exchange-commission-us-securities-laws-may-apply-token-sales/ (stating that the SEC's Investor Bulleting "effectively end[ed] a period of doubt as to what approach the SEC would take.").
[42] *Cryptocurrency ICO Stats 2017*, COINSCHEDULE, https://www.coinschedule.com/stats.php (last visited Nov. 7, 2017).
[43] Roger Aitken, *U.S. SEC Warns Over Crypto ICO's & 'Potentially Unlawful' Celebrity Promotion*, FORBES (Nov. 2, 2017 1:00 AM), https://www.forbes.com/sites/rogeraitken/2017/11/02/u-s-sec-warns-over-crypto-icos-potentially-unlawful-celebrity-promotion/#555cdc021474.
[44] Jon Russell, *China Has Banned ICOs*, TECHCRUNCH (Sept. 4, 2017), https://techcrunch.com/2017/09/04/chinas-central-bank-has-banned-icos/.

issuers, and their applicability to ICOs. As will be seen, none are entirely workable or beneficial in the context of ICOs.

A. 506(b) and (c)

Startups commonly use Rules 506(b)[45] and 506(c)[46] of Regulation D when raising capital via a private placement. Both exemptions allow the issuer to sell to an unlimited number of accredited investors—a formal status conferred only upon financially sophisticated and wealthy individuals[47]—and both restrict general advertising. Both exemptions also preempt state blue sky laws.[48] Under 506(b), the issuer may not generally solicit investors, nor may it sell shares to more than thirty-five non-accredited investors that are sophisticated (and these thirty-five must receive a disclosure document). The benefit of 506(b), however, lies in the fact that issuers may sell to an *unlimited* number of accredited investors. Therefore, so long as the issuer does not generally solicit or advertise, and all but thirty-five of the purchasers are accredited, the issuer may raise an unlimited amount of capital from an unlimited number of investors and still claim a 506(b) exemption. Under 506(c), general solicitation is permitted, provided that all purchasers are accredited. The issuer must take reasonable steps to verify accredited investor status.

Issuers that plan to raise capital via an ICO can claim either of these exemptions, provided they comply with the restrictions. Unfortunately, however, the accredited/unaccredited investor requirements tend to limit the reach of the offering and limit those who can participate in it. While the monetary threshold is unlimited, the burden of ensuring that investors possess accredited status removes some of the original decentralized, democratic allure of ICOs.

B. Regulation Crowdfunding

Title III of the Jumpstart Our Business Startups Act,[49] signed into law in 2012, authorized the SEC to exempt "Regulation Crowdfunding" from the '33 Act's registration requirement. Crowdfunding is a process by which an entity uses an internet portal to raise money from a vast pool of contributors; it is commonly used for charitable fundraising or financing specific product launches. Equity crowdfunding uses the same structure,

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[45] 17 C.F.R. § 230.506(b).
[46] 17 C.F.R. § 230.506(c).
[47] 17 C.F.R. § 230.501 (2017).
[48] Blue sky laws are state-level regulations of issuer transactions in securities. They generally require registration of the security and impose disclosure obligations, but also often feature a more rigorous "merit review" of the offering.
[49] *Id.* at Title III.

but allows investors to buy a small percentage of a startup, so long as the startup and the investor comply with certain rules and the issuer raises no more than a statutory maximum.[50] While Regulation CF[51] was billed as a suitable avenue for a new style of raising capital, the current statutory maximums make large-scale fundraising unworkable.[52]

In the ICO context, however, Regulation CF may still be advantageous given the nature of a coin offering and the startup itself. While "traditional" startups often raise capital to fund functional improvements or strategic hires, a coin-based company's ICO serves an additional purpose: generating the aforementioned network effects. When a newly-issued coin is the exclusive form of payment accepted for a startup's service, the holders of the coin will have an incentive to purchase that service. While the additional infusion of capital is beneficial, the coin issuer is trying to generate a potential customer base as well. This goal dovetails nicely with the crowdfunding exemption, which allows for a large pool of small investors, rather than a small pool of large investors.

C. Rule 147A

In October 2016, the SEC made it easier for digital online companies to raise capital.[53] The existing Rule 147 exempted wholly intrastate offerings (offerings in which the only participants are residents of the same state as the issuer) from registration. In 2016, however, Rule 147 was amended to incorporate a new section, Rule 147A. This new section "further facilitates intrastate offerings by allowing offers to be accessible to out-of-state residents."[54] Essentially, it allows companies claiming the intrastate offering exemption to advertise and solicit out-of-state residents. This has the effect of allowing issuers to advertise their offerings via the internet and social media if they comply with state registration rules and "do business" in the state.[55] Given that they are

[50] Securities Act of 1933, 48 Stat. 74, § 4(a)(6) (1933) (codified as amended at 15 U.S.C. § 77a)
[51] Regulation CF, 17 C.F.R. §§ 200, 227, 232, 239, 240, 249, 269, 274 (2015).
[52] *Id.* (The statutory maximum is currently set at a mere $1,070,000 in 12-month period).
[53] Compliance Guide, U.S. Sec. & Exch. Comm'n, Intrastate Offering Exemptions: A Small Entity Compliance Guide for Issuers (Apr. 19, 2017), https://www.sec.gov/info/smallbus/secg/intrastate-offering-exemptions-compliance-guide-041917.htm.
[54] *Id.*
[55] The SEC defines "doing business" as satisfying *at least one* of: the issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in-state or from the rendering of services in-state, the issuer had at least 80% of its consolidated assets located in-state, the

primarily internet-oriented entities, digital startup companies benefit from this change because it allows them to reach purchasers online, even if it restricts those purchasers to residents of the startup's state.

In theory, given 147A's facilitative nature, startups may now choose to "do business" in a crowdfunding-friendly state and conduct their ICO over the internet from there. As long as safeguards are put in place to restrict those purchasing to only in-state residents and these safeguards comply with state laws, the ICO will be exempt from registration with the SEC and still able to put their coins in the hands of individual investors. In reality, however, the intrastate limitation will likely limit the reach of any ICO, even without federal limits on accredited status. Additionally, many states limit the amount of money that can be raised via crowdfunding rules, so it is unlikely that Rule 147A will have a meaningful impact on the viability of ICOs.

IV. Fixing A Broken System

A. The Costs of Raising Capital

Raising capital in the United States is inherently a capital-intensive process. A traditional initial public offering can cost anywhere from $4 to $28 million in fees, depending on its size.[56] Even small offerings can be wildly expensive if registration with the SEC is required; navigating the legal landscape of the U.S. financial regulatory system can be costly. Still, most companies have no choice but to embrace the complexity (and the costs) in order to gain access to the vast pool of American capital.

Given the costs associated with the SEC's filing and disclosure requirements, most small companies—especially cash-strapped startups—try to avoid registration in any way possible. As mentioned above, however, most of the private placement offering exemptions limit the number of investors who may participate or require that investors be accredited. General solicitation, i.e. reaching out to those with whom the issuer does not have an already-established relationship, is legally limited under nearly all of the exemptions, forcing companies to look for investors privately and without posting anything on the internet. Founders often simply rely on old-fashioned networking, seeking out key influencers to

issuer intends to use and uses at least 80% of the net proceeds from the offering towards the operation of a business or of real property in-state, the purchase of real property located in-state, or the rendering of services in-state, or majority of the issuer's employees are based in-state. *Id.*

[56] PricewaterhouseCoopers LLP, *Considering an IPO? The Costs of Going Public Might Surprise You*, 11 (2012), https://www.strategyand.pwc.com/media/file/Strategyand_Considering-an-IPO.pdf.

secure sources of funding—a process that can be remarkably slow and uniquely challenging, especially in areas outside of investor-rich Silicon Valley.[57]

This regulatory scheme squeezes out a small, but not insignificant number of capital-needy startups. Those who have surpassed self-funding and tapped out their family and friends, but who lack sufficient connections to accredited investors, are stuck between the significant limits on solicitation of most exemptions and the physical limits of raising enough capital via an intrastate offering. This "regulatory Scylla and Charybdis"[58] is a daunting gauntlet that seems remarkably at odds with the ever-expanding opportunities of an increasingly interconnected world.

Initial coin offerings arose partially in response to the SEC's web of rules and exemptions. Coin-based companies and platforms, hoping to avoid the delay and costs of complying with financial regulation, chose to raise capital outside of the "traditional" system. While ICOs may only be "legal" because the SEC has yet to weigh in, the high costs and obstacles associated with traditional fundraising is enough incentive for many to take the risk, hence the booming ICO market in 2017.

B. A New Exemption

Rather than responding to the ICO craze by subjecting coins to the existing regulatory framework, the SEC should consider creating a new exemption that alleviates some of the difficulties that produced the demand for ICOs in the first place. As noted previously, a startup's ability to raise its initial capital is often directly correlated with the accredited investors in the founders' immediate social circle. Although the exemptions available under the '33 Act are useful for those small companies that have access to a pool of wealthy potential investors, the exemptions are not useful for companies without connections.[59] At the same time, those with relatively modest means (and, thus, lacking accreditation) are almost entirely shut out from investing in high-potential startups. The U.S. regulatory scheme, while justifiably protective of the most vulnerable citizens, also perpetuates a status quo in which having money facilitates making money.

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[57] *See*, Rutherford B Campbell, Jr., *Regulation A: Small Business' Search for "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 88 (2006) (describing small business's difficulties in identifying and connecting with potential investors).
[58] James D. Cox, *Who Can't Raise Capital?: The Scylla and Charybdis of Capital Formation*, 102 KY. L.J. 849, 863 (2013) (discussing the regulatory difficulties for small, unconnected companies to raise capital).
[59] *Id.*

The new exemption could take the form of an adapted and updated Regulation CF. While the crowdfunding exemption, as currently written, is largely viewed as a disappointment,[60] the idea of creating an exempt transaction designed to facilitate raising capital via "the crowd" could be a good one. First, crowd-investing protects the investor by spreading risk. Each individual has minimal exposure, as she is merely one among many participants in the offering. Second, as previously mentioned, in the typical ICO, reaching a large pool of potential customers is itself a goal, not merely a means by which a coin-based startup hopes to raise money. An exemption that creates regulatory space for these specially-situated companies to accomplish their capital and distribution goals, while maintaining some investor protections, would prevent the current scheme from strangling the cryptocurrency industry in its infancy.

Regulators need only make a few changes to Regulation CF in order to usher in this new era of legal ICOs:

First, the limit on the amount of capital a company may raise in twelve months must be increased. One million dollars, while surely sufficient in the context of a charity drive, is too low to attract any serious high-potential startups. On the other hand, removing the limit entirely could drive inflated valuations and exploitation by startups with already-deep pockets.

Second, the per-year investment limit for individuals should be lowered. While affording more of the population the opportunity to invest via ICOs is the ultimate goal, investor protections should not be discarded entirely. Lowering the investment limit to a flat $1,500 per year (in aggregate) would simultaneously prevent investors from betting the farm on "the next big thing" and push startups to increase the number of investors in an offering rather than increase the average investment.

Third, the ICO exemption should keep Regulation CF's platform requirement, as long as coin platforms can qualify by fulfilling similar reporting and disclosure requirements. By forcing ICOs to be conducted via a set of specific platforms, the SEC will be able to easily oversee the actions of companies conducting the offerings, and impose new regulations as circumstances warrant.

Finally, the new exemption should continue to allow startups to advertise the offering online and on social media, directing would-be investors to the coin platform for information about the company and the offering. Preventing companies from reaching an online audience would prevent them from reaching as wide a group of investors as possible, one

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[60] *See*, *e.g.*, C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J., 195 (2012).

of the aforementioned principal goals of ICOs. Without the ability to advertise online, ICOs would be almost entirely useless.

ICOs, by their nature, bridge the gap between cash-strapped, isolated startups and eager investors with modest means. Enabling these types of offerings will simultaneously energize and democratize start-up investing in the United States, giving small-town America the chance to participate in funding the world's next revolutionary idea. Moreover, justifying stiff regulations by claiming a dire need to protect unsophisticated investors smacks of misguided paternalism in an age where risk is spread amongst the millions willing to bet on a yet-unproven startup company. A gambler need not be "sophisticated" to bet money in Las Vegas, yet she must comply with minimum income requirements to "throw the dice" by backing a promising startup. The current system funnels investment away from entrepreneurs, leading to diminished innovation and sluggish growth. A new digital fundraising exemption could significantly increase the share of the population that is able to participate in the joys of funding the American dream.

C. Fallback Plan

Absent a new exemption, startups will still have the option of shaping existing exemptions to fit their ICO needs. Indeed, working within the existing framework is likely to be the only way forward for ICOs, at least in the short term. To that end, a few workable alternatives do exist, although most sacrifice essential benefits of conducting an ICO.

As in a "traditional" private placement offering, the exemptions available under Rule 506(b) and 506(c) would likely be the most useful for a startup attempting an ICO. As mentioned previously, both rules allow offerings to an unlimited number of accredited investors, subject to some limitations. This lack of a cap on the number of potential participating investors is attractive for any startup, but especially for a coin-based startup hoping to capture some benefit from network effects. In addition, Rules 506(b) and (c) feature relatively minimal disclosure requirements and preempt state registration rules, making the offerings claiming these exemptions particularly cost-effective.

An offering under Regulation Crowdfunding, as currently written, would be possible but likely less desirable than a Rule 506(b) or (c) offering. While Regulation CF would allow the ICO to reach a large pool of the startup's target coin customer base (unsophisticated investors), the funding cap is too low for this option to truly be attractive to many startups. In addition, the platform requirement and potential for increased liability upon the issuer add unnecessary complexity.

Finally, while Rule 147A allows wholly intrastate offerings to simply register with the state, conducting an ICO in which only residents of a single state may participate would severely limit the appeal of the offering. It is therefore difficult to see how a Rule 147A intrastate offering would be desirable for any startup contemplating an ICO.

Thus, given the downsides of the aforementioned existing exemptions, a new exemption that modifies Regulation CF in a way that specifically benefits ICOs is clearly the best option to adapt the United States regulatory regime in a way that modernizes and democratizes fundraising while simultaneously continuing to protect investors.

CONCLUSION

Initial coin offerings have garnered massive attention and generated soaring valuations in the second half of 2017, and the SEC seems poised to formally regulate ICOs in the near future. Given the massive costs and obstacles related to registration in the United States, the future of ICOs appears to be in danger. Despite the availability of a few existing exemptions, the unique attributes of fundraising via a coin sale, such as network effects and customer capture, make the exemptions of dubious value to digital token companies. Instead of simply forcing ICOs into a framework that is better suited for a more traditional capital raise, the United States should consider a new regulatory regime specific to coin offerings. Policy-makers have a responsibility to adapt regulations to the ever-changing digital world as the second decade of the twenty-first century comes to a close. Initial coin offerings would be a good place to start.