Digital Coin Offerings: Recent SEC Guidance and Tax Considerations

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Background

What Is a Blockchain?

- An immutable, decentralized ledger
- Key characteristics that differentiate a blockchain from traditional distributed databases:
  - Transactions authenticated and tracked via nodes on network
  - A node determines if a transaction is valid and follows consensus rules
  - Cryptographic techniques prevent tampering or manipulating transactions
  - Can be public (anyone can participate) or permissioned (only authorized participants)
  - Application-agnostic (not limited to digital currencies)
- Popular blockchains today include the payment network Bitcoin and the smart contracts platform Ethereum, which create and track transactions in bitcoin and ether

"Smart Contracts"

- An automatically executing computer program that is linked to a distributed ledger
- When triggering variables arise that are coded within the "smart contract," the program executes and the resulting transactions are automatically digitally executed

Smart Contracts: A Deeper Dive

- *"'Smart contracts' are embedded with computer protocols that can automatically verify and execute the terms of the contract without relying on a centralized business logic engine. The proponents of 'smart contract' solutions typically envision removing intermediaries through their solutions to achieve greater efficiency while maintaining auditability of the transactions. [. . . .]"*

  —David Treat, Managing Director, Accenture Capital Markets – Blockchain Lead

Smart Contracts Basics

```solidity
pragma solidity ^0.4.0;

contract SimpleStorage {
    uint storedData;

    function set(uint x) {
        storedData = x;
    }

    function get() constant returns (uint retVal) {
        return storedData;
    }
}
```

```solidity
pragma solidity ^0.4.0;

contract Coin {
    // The keyword "public" makes those variables
    // readable from outside.
    address public minter;
    mapping (address => uint) public balances;

    // Events allow light clients to react on
    // changes efficiently.
    event Sent(address from, address to, uint amount);

    // This is the constructor whose code is
    // run only when the contract is created.
    function Coin() {
        minter = msg.sender;
    }

    function mint(address receiver, uint amount) {
        if (msg.sender != minter) return;
        balances[receiver] += amount;
    }

    function send(address receiver, uint amount) {
        if (balances[msg.sender] < amount) return;
        balances[msg.sender] -= amount;
        balances[receiver] += amount;
        Sent(msg.sender, receiver, amount);
    }
}
```
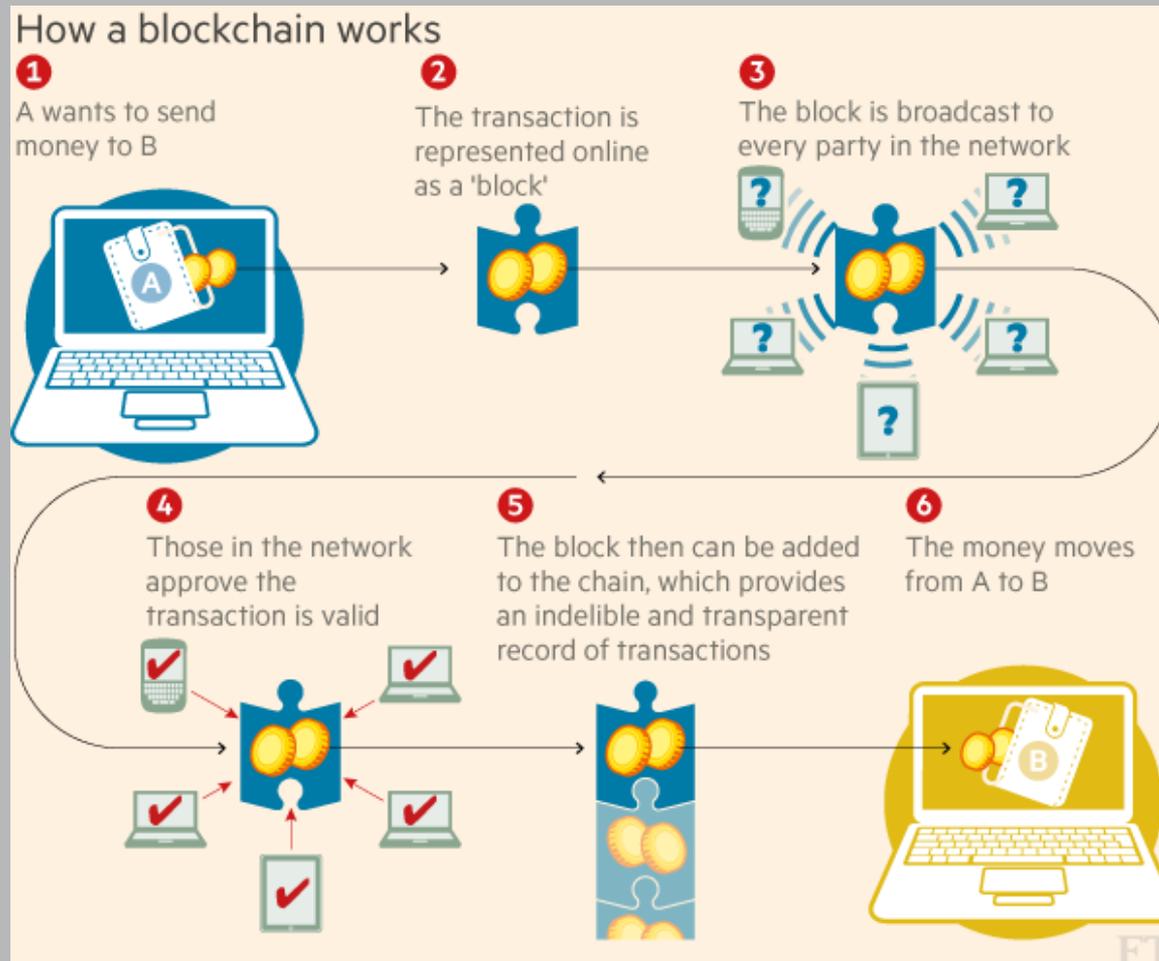
How a blockchain works

1 A wants to send money to B

2 The transaction is represented online as a 'block'

3 The block is broadcast to every party in the network

4 Those in the network approve the transaction is valid

5 The block then can be added to the chain, which provides an indelible and transparent record of transactions

6 The money moves from A to B

Blockchain Use Cases

- Store of value

- Asset tracking/supply chain management

- Securities ledgers

- Voting systems/prediction markets

- B2B transactions using smart contracts

Cryptocurrencies

- Popular focus is on the use of blockchain technology as **store of value**, often referred to as **digital currencies**, **virtual currencies**, or **cryptocurrencies**
- Value of tokens built on these blockchains has rapidly increased over the past year

$6,145.00
BITCOIN PRICE

+$5,441.22
SINCE LAST YEAR (USD)

+773.14%
SINCE LAST YEAR (%)

$6,007 $6,007

$700 $700
Oct 30   Dec 29   Feb 27   Apr 28   Jun 27   Aug 26   Oct 29

$307.58
ETHEREUM PRICE

+$296.64
SINCE LAST YEAR (USD)

+2711.52%
SINCE LAST YEAR (%)

$390 $390

$7 $7
Oct 30   Dec 29   Feb 27   Apr 28   Jun 27   Aug 26   Oct 29

Source: Coinbase, 10/30/2017

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Terminology and Its Limitations

- **ICO** = Initial Coin Offering = Initial Token Sale = Token Generation Event = TGE = Token Sale

- **SAFT** = Simple Agreement for Future Tokens

- **(U.S.)** = Apptoken = Appcoin = Utility Token = Utility Coin = Trying to say "not a security"
  - **(Non-U.S.)** Some view utility as (nearly) irrelevant for classification purposes

General Market Practice

- More than **$2.5 billion** has been raised in token sales in 2017, compared to less than $240 million for all of 2016
- For funding blockchain companies, token sales have outpaced traditional VC in 2017
- Tokens are offered in exchange for fiat currency or other tokens (typically bitcoin or ether)
- Tokens are often pre-sold privately to select investors prior to the public offering or ICO
- Issuers may also use SAFTs and/or convertible promissory notes that are convertible into preferred stock of the issuer and/or tokens upon the TGE
- Tokens also often issued as compensation to service providers and employees

Utility Tokens

- Developers are now building application-specific tokens, also referred to as appcoins or utility tokens, which practitioners argue should not be considered securities

- Key distinction between utility tokens and other tokens (such as digital currency or a debt or equity interest denominated in tokens) is that the former have **non-incidental utility** with respect to the platform or system issuing the token

- As outlined by a popular legal whitepaper, such utility may include:
  - Rights to program, develop or create features for the system or to "mine" things that are embedded in the system
  - Rights to access or license the system
  - Rights to charge a toll for such access or license
  - Rights to contribute labor or effort to the system
  - Rights to use the system and its outputs
  - Rights to sell the products of the system
  - Rights to vote on additions to or deletions from the system in terms of features and functionality

Security Tokens

- On the other hand, issuers are in some cases simply moving traditional securities to blockchain distributed ledgers

- What is more common – and more complicated – is that developers are building application-specific tokens that, in addition to non-incidental utility, also have features similar to equity, debt and other investment contracts, which cause them to be treated as securities

- These tokens may, for example:
  - Be redeemed at specified times for a portion of net revenues in a given year
  - Grant holders a pro rata portion of a percentage of revenues from contracts entered into on the platform
  - Bear a coupon
  - Grant holder a right to participate in other investment opportunities

Recent Securities Law Developments

The DAO Report: Background on the DAO

- The Decentralized Autonomous Organization (or "The DAO") began as an effort to create a crowdfunding smart contract

- Supporters sent ether to The DAO in exchange for DAO Tokens, which would permit the supporter to vote on which projects The DAO would fund and would entitle the supporter to "rewards" if those projects later succeeded

- At the time the DAO Token offering closed, the total ether raised by the DAO was valued at approximately $150 million

- One of The DAO's founders described the model as similar to "buying shares in a company and getting . . . dividends"

- The project's organizers and supporters were geographically dispersed

- There were no restrictions on the resale of DAO Tokens

- Security vulnerabilities in The DAO ultimately caused a "hard fork" of the Ethereum Blockchain to restore funds stolen from The DAO

The DAO Report: Legal Analysis

- Status of DAO Tokens as "securities"
  - Analysis of the definition of the term "investment contract" under the 1933 Act, as interpreted by *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and its progeny
    - Investment of money
    - Common enterprise (horizontal or vertical)
    - Expectation of profits
    - Efforts of others

    From the SEC Report: "*The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was 'crucial' to the DAO Token holders' investment decision . . . . The DAO was 'responsible for the success or failure of the enterprise,' and accordingly was the entity about which the investors needed information material to their investment decision.*"

- Status of DAO Platforms as "exchanges"
  - Analysis of Section 3(a)(1) of the 1934 Act and related exemptions
- Status of The DAO as an "investment company"
  - **No analysis**, but would have been under Section 3(a) of Investment Company Act of 1940 (ICA)

U.S. States

- U.S. states haven't commented, but…
  - Most follow *Howey*
  - Some also apply "family resemblance" test
  - Others, including California, also apply "risk capital" test

Certain Non-U.S. Jurisdictions

- The "Wild West" is shrinking day by day
- Similar concerns expressed:
    - Fraud and investor protection
    - Know Your Customer ("KYC")/Anti-Money Laundering ("AML")
    - Certain tokens may be securities (or general equivalent)
- Varying approaches by jurisdiction:
    - Token sales are subject to existing regulatory frameworks:
        - Singapore, Canada, Hong Kong, Switzerland, Australia, Malaysia[?], Gibraltar, etc.
    - Some jurisdictions have expressed desire to become or remain a token launch destination:
        - Gibraltar (possible Token Framework), Isle of Man, Cayman, Switzerland
    - Some jurisdictions have banned ICOs, required repayment of proceeds from completed ICOs, etc.:
        - China and South Korea

Legal Framework

Tax Considerations

- Not outside the reach of the IRS!

IRS Notice 2014-21

- Convertible virtual currencies treated as property

IRS Info Letter 2016-0036

- Section 61 principles apply
- Generally includible in income if not (1) indebtedness; (2) equity; or (3) gift

Tax Issues and Challenges

- Equity?
- Debt?
- Capital asset?
- Barter exchange?
- Prepaid goods or services?
- Subpart F Issues: CFC/PFIC?
- Deferral?
- Open-transaction?
- Forward contract?
- Executory Agreement to Sell?
- Information Reporting
- FATCA
- FBAR

Key Securities Law Implications

- Three key questions to consider (as to laws of each applicable jurisdiction):
    - Is *this token* a "security"?
    - Is *this platform* an "exchange"?
    - Is *this project* an "investment company"?
- Structure token accordingly
- Structure offering accordingly

Analyzing the Token

- Apply *Howey*
  - Investment of money
  - Common enterprise (horizontal or vertical)
  - Expectation of profits
  - Efforts of others
- Conduct risk assessment

Securities Offering

- Conducting the ICO:
  - Register with the SEC *or*
  - Rely on exemptions (e.g., Regulation D, Regulation S, Rule 701 and Section 4(a)(2)) and verify purchasers
- Resale Issues:
  - Rule 144 compliance (12-month holding period, information requirement)
  - Section 12(g) – and Rule 12g3-2(b)

Some Practical Considerations

- **Consult Tax Counsel** – consider the particular circumstances of the founder and the business in determining the most appropriate structure (i.e., bespoke rather than off-the-shelf)
- **Consult Legal Counsel –** remember that the security question is just the beginning of the inquiry (money transmitter laws, etc.); consider what jurisdictions' laws may apply
- **Disclosure** – publish a white paper or other disclosure regarding the company, the platform, the token, the ICO and the use of proceeds
- **Transparency** – open blockchain, auditable code
- **Engage Teams** – undertake independent security audit (of smart contracts, whitepaper, etc.) before launch, KYC/AML/accredited investor checks, marketing
- **Promotion** – treat the sale like a sale of products; do not promote the token as an investment if trying to establish that a token is not a security

Investment Company Considerations

- Issuers that hold tokens that are securities may fall within the definition of an investment company
    - An investment company must register under the ICA unless it can rely on one of many exceptions to the definition of an investment company
    - Even if tokens are not securities under the Securities Act, need to consider whether they may be securities for purposes of the ICA
- Investment company status gives rise to many operating and compliance restrictions and requirements that may make it difficult, if not impossible, for the fund to achieve its business purposes

Investment Advisers Act Considerations

- Companies that give advice with respect to the advisability of buying tokens fall within the definition of an investment adviser
    - The definition turns on whether a token is a "security"
- Investment advisers that give advice with respect to tokens or cryptocurrencies face challenges:
    - Custody requirements
    - Fiduciary obligations
    - Code of ethics compliance
    - Principal transactions

Other Legal Considerations

- Commodities laws
  - CFTC asserts broad jurisdiction over derivatives related to cryptocurrency
    - CFTC also claims jurisdiction involving retail customers concerning transactions that are leveraged, margined or financed
      - Example – Bitfinex case (2016)
  - Is issuer serving as Commodity Pool Operator/Commodity Trading Advisor required to register with the NFA?
  - What about Associated Persons and Principals?
- Money transmitter and virtual currency business laws
- KYC/AML

Presenters

Jay Baris is based in New York and is the chair of the Firm's Investment Management Practice. He represents investment companies, broker-dealers, investment advisers and other financial institutions in the full spectrum of financial services regulation. He helps clients develop new financial products that cross over banking, commodities, insurance and securities law. He is an active speaker and writer on issues concerning investment management and the regulation of financial institutions and has been published in a variety of trade and general interest publications.

Shiukay Hung is based in New York and is a member of the Firm's Tax Department and the Firm's Blockchain + Smart Contracts Group. He has a broad-based transaction-oriented practice focused on U.S. federal and international income tax matters. He advises on the tax aspects of sophisticated capital markets transactions (including token sales), financial instruments (including structured products and derivatives), cryptocurrencies, REITs, real estate loans, syndicated loans, mergers and acquisitions and private equity transactions.

Daniel R. Kahan is based in Northern Virginia and is a member of Morrison & Foerster's Emerging Companies and Venture Capital Practice. His practice focuses on venture capital and private equity investments, strategic technology transactions, mergers and acquisitions, divestitures and spin-offs, public securities offerings and corporate governance matters. Mr. Kahan is a member of Morrison & Foerster's Blockchain + Smart Contracts Group, as well as the Wall Street Blockchain Alliance's Legal Working Group and the Enterprise Ethereum Alliance's Legal Industry Working Group.

Joshua Ashley Klayman is based in New York and is co-chair of the Firm's Blockchain + Smart Contracts Group, as well as a member of the Finance + Projects Group. She also chairs the Wall Street Blockchain Alliance's Legal Working Group. In her finance practice, she represents lenders, investors, issuers and borrowers in leveraged finance transactions involving senior, mezzanine and subordinated debt and equity offerings and co-investments and general lending matters. In her corporate practice, she represents public and private organizations in a broad array of commercial transactions, capital raising and corporate governance matters. She speaks and writes frequently about blockchain and cryptocurrency matters.

Alfredo B. D. Silva is based in San Francisco and represents public and private companies and investors in a broad range of corporate and securities law matters. His practice includes initial public offerings, primary and secondary offerings, private placements, preferred stock financings and public and private mergers and acquisitions. In his public company practice, he also counsels issuers on corporate governance issues, compliance with the U.S. federal securities laws and compliance with the listing standards of Nasdaq and the New York Stock Exchange. In his private company practice, he has served as company or investor counsel in venture and late-stage financings, minority strategic investments and impact investments in dozens of private companies.