THE SEC RIDES INTO TOWN: DEFINING AN ICO SECURITIES SAFE HARBOR IN THE CRYPTOCURRENCY "WILD WEST"

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This Note recommends a viable way for the Securities and Exchange Commission (SEC) to apply the Regulation S foreign-issuer safe harbor to Initial Coin Offerings (ICOs). In the last two years, cryptocurrencies and blockchain-based companies have witnessed dramatic rises in price and value. New entrants to the crypto-markets often use ICOs as virtual public offerings to earn capital and develop their projects.

The SEC has signaled that they plan to fold ICOs and blockchain offerings into existing securities law. How these new virtual capital-raising mechanisms will fit into this framework is still largely unknown. As a defensive measure, many ICOs have banned US investors in an attempt to become foreign offerings that are outside the SEC's reach. Regulation S is the existing safe harbor that conventional securities offerings utilize to ensure that they are "foreign offerings." While ICOs are novel and do not fit perfectly into Regulation S's language, the safe harbor can be adapted to appropriately set parameters for ICOs. This Note suggests the correct interpretation that both protects US consumers and sets acceptable requirements for corporations seeking to fall within Regulation S.

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I. INTRODUCTION

On October 4, 2017, the Securities and Exchange Commission (SEC) Chairman Jay Clayton sat in front of the House Financial Services Committee to clarify the SEC's agenda, operations, and budget. Two hours into the hearing, Colorado Congressman Ed Perlmutter expressed concerns of fraud in Initial Coin Offerings (ICOs).[1] He said that the new electronic offerings "remind[ed him] of the old days with penny stocks."[2] Chairman Clayton then agreed with Perlmutter's characterization and added: "I'm cautiously optimistic about the enforcement division's approach to [Initial Coin Offerings]. They know that this is a ripe area for pump-and-dump. Pump-and-dump—it's actually even easier here than it is in the penny stock area because it's all electronic, it's all anonymous, it's harder to catch the bad guys at the end of the day."[3]

Initial Coin Offerings are a new cryptocurrency-based fundraising method, which tech companies use to generate capital.[4] While ICOs vary in form, they are essentially initial public offerings that raise capital from contributions on a blockchain (an electronic distributed ledger), and the projects are almost universally geared toward blockchain development.[5]

After their appearance in 2014, ICOs largely operated without regulatory oversight. While startups raised money without regulatory restrictions, suspicions developed that ICOs provided a haven for empty investment schemes.[6] Taking its first step into the fray, the SEC published a report on a project called the Decentralized Autonomous Organization (DAO) in July 2017.[7] The report ruled that the DAO's ICO was an unregistered sale of

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[1] *Examining the SEC's Agenda, Operations, and Budget Before the H. Financial Servs. Comm.*, 115th Cong. (Oct. 4, 2017), 2:33:00–2:35:00, https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=402349.

[2] *Id.*

[3] *Id.*

[4] *What is An Initial Coin Offering?*, BLOCKGEEKS, https://blockgeeks.com/guides/initial-coin-offering/ (last visited Oct. 7, 2018).

[5] *Id.*

[6] Oscar Williams-Grut, *'Market Manipulation 101': 'Wolf of Wall Street'-style 'pump and dump' scams plague cryptocurrency markets*, BUSINESS INSIDER (Nov. 14, 2017, 2:00 AM), http://www.businessinsider.com/ico-cryptocurrency-pump-and-dump-telegram-2017-11 (describing scams in the crypto-market as "an open secret").

[7] SEC. & EXCH. COMM'N, DAO 21(A) REP., No. 81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.

securities under the Securities Act of 1933, marking the first time that the SEC labeled an ICO as a securities offering.[8]

The SEC requires companies offering securities to register their offerings with the agency, a process that requires disclosure of corporate financial condition and other relevant metrics.[9] Following the SEC's ruling on the DAO, it was uncertain whether several startup ICOs would similarly be subject to SEC Section 5 filing requirements (companies issuing securities must either file certifications and information with the SEC or fall within an exemption) and face SEC enforcement. In response to this uncertainty, tech businesses constricted their ICO breadth to prohibit contributions from U.S. investors.[10] By eliminating U.S. contributions, the ICOs may avoid the SEC's jurisdiction and forego the filing requirements of the Securities Act.[11]

Securities offerings exclusively outside the U.S. have traditionally sought exception to SEC registration requirements under Regulation S of the Securities Act.[12] ICOs too might seek this safe harbor. However, the SEC's expansion into ICO regulation is so young that entrepreneurs and regulators alike are uncertain of how blockchain projects will fit into the existing regulatory infrastructure.

This Note argues that the Regulation S "safe harbor" can apply to foreign ICOs without straining the Securities Act's statutory language.[13] It also discusses the obligations that foreign ICO projects must meet to mitigate SEC enforcement risk.[14] Along with those issues, this Note will outline practices that the SEC will likely find insufficient for Regulation S compliance and discuss best practices for ICO offerors conducting their ICOs outside the SEC's reach. [15] ICOs do not fit perfectly into Regulation S's structure. ICOs

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[8] *Id.* at 1.

[9] *See generally* Securities Act of 1933—Registration of securities, 15 U.S.C. § 77f (2012).

[10] Wendy McElroy, *Some ICOs Now Ban Americans- Who Should Expect More Ostracism*, BITCOIN.COM (July 18, 2017), https://news.bitcoin.com/some-icos-now-ban-americans-who-should-expect-more-ostracism/.

[11] *Id.* ("'[I]f I happen to create a service in the crypto world, I am sure to exclude USA citizens because I don't have money to pay lawyers and then [be] offered a deal to plead guilty' over an unforeseen or obscure requirement.") (alterations in original).

[12] SEC Regulation S, 17 C.F.R. §§ 230.901–905 (2007).

[13] *See infra* Part III.

[14] *See infra* Part III.B.

[15] *See infra* Part III.C.

allow for anonymous investing, and they permit easy transfer across national borders. Still, the exemption can be adjusted to adequately address crypto-markets without requiring an entirely new exemption.

That said, this Note is confined to analyzing foreign ICO projects seeking the Regulation S exemption under the Securities Act of 1933. It will not address obligations or liabilities for ICOs offerings to U.S. investors. Nor will it discuss obligations or liabilities under the Securities Exchange Act of 1934 or individual state requirements under Blue Sky laws. In that vein, this Note will also avoid discussing liabilities for ICO fraud, though it will address SEC actions involving fraud to demonstrate the agency's current stance. Finally, while this Note will consider crypto-token exchanges to examine security flowback, it will not examine an exchange's obligations to comply with either the 1933 or the 1934 Acts.

In Part II, this Note provides background on blockchain technology, cryptocurrencies, and ICOs. Part III addresses the SEC's ruling on the DAO and how ICOs responded by banning U.S. investors. Part IV outlines a workable methodology for applying Regulation S to Initial Coin Offerings and suggests best practices for ICOs seeking filing exemptions as foreign offerors.

II. THE BRAVE NEW CRYPTO WORLD

A. WHAT IS BLOCKCHAIN?

Blockchain is the foundational technology upon which cryptocurrencies like Bitcoin and Ethereum were created.[16] Also known as "Distributed Ledger Technology," blockchain is an electronic version of a conventional ledger (think check books or library records).[17] Aside from being digital, the primary features that make blockchain different and more desirable than a well-organized filing cabinet are decentralization, immutability, and (often) anonymity.[18]

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[16] Patrick Murck, *Who Controls the Blockchain?*, HARV. BUS. REV. (April 19, 2017), https://hbr.org/2017/04/who-controls-the-blockchain.

[17] *Id.*

[18] *Id.*

Decentralization: Instead of relying on a centralized server to store information, blockchain technology distributes an identical ledger to all connected computers (or nodes), creating a decentralized storage system.[19] Unlike conventional banks, there is no central bookkeeper. All of the code in a public blockchain is distributed amongst all users and blockchain maintenance (recording and validating new transactions) is performed globally using a process called mining.[20] While a blockchain's original creators may fashion the code to maintain some control over the system's functions, new nodes in a public blockchain have the same copy of the electronic ledger as the creators, and everyone is bound by the code's rules.[21]

Immutability: Put simply, it is very difficult to mess with a blockchain's recorded data. Blockchains can only be altered with permission from multiple connected nodes.[22] Immutability and consensus help ensure that a single bad actor cannot alter the ledger's content. When a new transaction is verified by a set number of nodes, it is encrypted and added to a block of other transactions. The block is then attached to the chain of unalterable public transactions[23]—hence the name "blockchain." Some have suggested that the immutability of the decentralized ledger makes blockchain transactions "trustless" because bad actors can be corrected by reference to the public ledger.[24] However, large scale hacks have

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[19] *See* Nolan Bauerle, *What is Blockchain Technology?*, COINDESK, https://www.coindesk.com/information/what-is-blockchain-technology/ (last visited Oct. 7, 2018) ("In the case of blockchain, every node in the network is . . . updating the record independently . . . .").

[20] *Proof of Work vs Proof of Stake: Basic Mining Guide*, BLOCKGEEKS, https://blockgeeks.com/guides/proof-of-work-vs-proof-of-stake/ (last visited Oct. 7, 2018).

[21] *See* Murck, *supra* note 16 ("[Y]ou don't have to trust your counterpart to perform their obligations or properly record transactional data, since these processes are standardized and automated, but you do have to trust that the code and the network will function as you expect.").

[22] *See* Bauerle, *supra* note 19 ("Authorizing transactions is a result of the entire network applying the rules upon which it was designed (the blockchain's protocol).").

[23] *See* Murck, *supra* note 16 (describing the process by which transactions are distributed to independent ledgers).

[24] *See* Aleksander Bulkin, *Explaining blockchain—how proof of work enables trustless consensus*, KEEPING STOCK (May 3, 2016), https://keepingstock.net/explaining-blockchain-how-proof-of-work-enables-trustless-consensus-2abed27f0845 ("When we talk about trustless systems, we mean that our ability to trust it does not depend on the intentions of any party, which could be arbitrarily malicious.").

shown that while distributed ledgers may be theoretically unchangeable, blockchain systems are not incorruptible.[25]

Anonymity: Some blockchains, like Bitcoin, are designed so that, while the general public can view bitcoin transactions on a public blockchain, the transacting parties use an encrypted pseudonym.[26] Users looking at the ledger cannot identify who is trading with whom.[27] Instead, those looking at the blockchain can only see the parties' pseudonyms, the amounts transferred, and times of the transactions.[28] It does not take much to imagine the difficulty in regulating a large market of unidentifiable persons, and the anonymity facet of a blockchain poses particular difficulty for the SEC.

Blockchain is still in its infancy. While originally developed to create cryptocurrencies like Bitcoin, coders have experimented and created new blockchains with more complex uses.[29] Ethereum, for instance, is a blockchain currency that began in 2014.[30] Its internal code promotes development of new applications, and startup companies have developed various apps on top of Ethereum.[31]

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[25] *See* Alexandra Harney & Steve Stecklow, *Twice Burned – How MT Gox's bitcoin customers could lose again*, REUTERS (Nov. 16, 2017, 1:15 PM), https://www.reuters.com/investigates/special-report/bitcoin-gox/ ("When Mt. Gox, the world's largest bitcoin trading exchange, collapsed in early 2014, more than 24,000 customers around the world lost access to hundreds of millions of dollars' worth of cryptocurrency and cash.").

[26] *See* Iyke Aru, *Blockchain Transaction Anonymity is Necessary Evil*, COINTELEGRAPH (Apr. 18, 2017), https://cointelegraph.com/news/blockchain-transaction-anonymity-is-necessary-evil (discussing anonymity of blockchain transactions).

[27] *See* Zulfikar Ramzan, *Bitcoin: Overview*, KHAN ACADEMY, 3:29–5:00, https://www.khanacademy.org/economics-finance-domain/core-finance/money-and-banking/bitcoin/v/bitcoin-overview (last visited Aug. 30, 2018) (describing how users cannot identify other traders).

[28] *Id.*

[29] *See* Joel Monegro, *Fat Protocols*, USV (Aug. 8, 2016), https://www.usv.com/blog/fat-protocols (last visited Dec. 4, 2017) (discussing how "early adopters, perhaps financed in part by the profits of getting in at the start, build products and services around the protocol, recognizing that its success would further increase the value of their tokens").

[30] Nathan Schneider, *Code your own utopia: Meet Ethereum, bitcoin's most ambitious successor*, AL JAZEERA AMERICA (April 7, 2014, 5:00 AM), http://america.aljazeera.com/articles/2014/4/7/code-your-own-utopiameetethereumbitcoinasmostambitioussuccessor.html .

[31] Ethereum tokens are called "ether" and coders create new projects on top of the protocol code, much like new apps for an iphone. *See id.* ("These tools would be able to interact with one another and conduct transactions with a common currency called ether."). Ethereum raised $18 million in its own 2014 ICO. *ICOs – Initial Coin Offerings – Infographic*, BLOCKCHAINHUB (July 18, 2017), https://blockchainhub.net/blog/infographics/initial-coin-offerings/.

Consumers can access these apps by spending their "ether," Ethereum's token, to purchase other application's 'app tokens.'[32] App tokens are not physical tokens at all; they are crypto-assets that grant access to a corresponding blockchain app.[33] App tokens can be bought outright from current owners, and their price reflects the market valuation.[34]

B. HOW ICOS WORK

When app developers use online publicity to sell their app tokens and generate capital, these sales are called Initial Coin Offerings (ICOs).[35] While ICOs are still in their infancy, typical ICOs so far have involved a blockchain tech developer who wants to fund a new blockchain app or to support an existing app.[36] To do this, the developer promotes their project online and sells app tokens in a scheduled offering, giving the consumer ownership or access rights to the new application.[37]

It may be helpful to imagine Ethereum as a virtual fairground. The fairground land is promising, but there isn't much to do on empty, open land. However, applications made on Ethereum's

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[32] Also called "appcoins" or "dApps," app tokens represent membership access or rights to function within an application. *See* Will Warren, *The difference between App Coins and Protocol Tokens*, 0X PROTOCOL (Feb. 1, 2017), https://blog.0xproject.com/the-difference-between-app-coins-and-protocol-tokens-7281a428348c (noting that token sales "are being used to drive network effects around specific applications (dApps) rather than the common building blocks (protocols) that make applications possible").

[33] *See Cryptographic Tokens*, BLOCKCHAINHUB, https://blockchainhub.net/tokens/ (last visited Oct. 7, 2018) (describing the difference between work and usage app tokens in a blockchain protocol).

[34] For the most part, app token prices are comparable to those of stocks and rely on the classic semi-strong market efficiency assumption. *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (outlining the basic assumptions of the efficient markets theory). Whether the 'efficient markets' assumption is correct in this context, considering the instability of crypto-markets, is beyond the focus of this Note.

[35] Antonio Madeira, *How does an ICO work*, CRYPTOCOMPARE (July 30, 2018), https://www.cryptocompare.com/coins/guides/how-does-an-ico-work/ (collecting and describing several notable ICOs).

[36] *See id*. (detailing the structures and results of six ICOs, including the token distribution).

[37] *See* Jeff John Roberts, *Why Tech Investors Love ICOs–and Lawyers Don't*, FORTUNE (June 26, 2017) http://fortune.com/2017/06/26/ico-initial-coin-offering-investing/ (discussing the Brave ICO, which distributed tokens to give "buyers early access to its technology . . . [while raising] money without ceding any control to private investors or venture capitalists").

blockchain are like new rides popping up on the fairground. If you want to enter the fairground, first you have to exchange U.S. dollars for ether. Ether, Ethereum's token, will act as your entry ticket, but most of the rides require their own tokens to ride. To get on a ride, you have to exchange some of your ether for that ride's app tokens.

ICOs would then be the dramatic pre-openings of blockchain app rides on the fairground. First, the founders advertise what their application will do and how people can get involved. [38] Then, once the community is excited about the product, the founders sell app tokens, using the profits to build the application that they advertised. At the Ethereum fair, your newly purchased app tokens can grant you access to the new ride, could give you some ownership of the ride, or can be held as an investment and sold to other people at the fair. If a ride becomes especially popular, like the DAO application did before its collapse, the app tokens for that ride will rise dramatically in price. Conversely, if the fairgoers begin to doubt the ride's prospects for completion or if a different ride becomes the fair's biggest attraction, app tokens may precipitously decline in price.

C. THE PRE-2017 "WILD WEST"

Despite dramatic price fluctuations,[39] and hype surrounding around new apps that turned out to be speculative or fraudulent, the regulatory presence around ICOs before 2017 was largely nonexistent. [40] ICOs were "a Wild West with few rules, and no policemen, where investors could bypass Wall Street's analysts and brokers to buy young companies that have undergone little due diligence."[41] The investment potential and lack of regulatory

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[38] Smith + Crown maintains a curated list of current and upcoming ICOs. *See ICOs / Token Sales*, SMITH + CROWN, https://www.smithandcrown.com/sale/ (last visited Oct. 7, 2018).

[39] *See ICO Tracker*, COINDESK, https://www.coindesk.com/ico-tracker/ (last visited Oct. 7, 2017) (tracking ICO size, number, and monthly funding).

[40] *See* Roberts, *supra* note 37 (noting that in a traditional IPO a company must register with the SEC, but in 2017 "[f]or ICOs there [we]re no such requirements yet").

[41] Lawrence Carrel, *SEC Bulletin May Bring Order To Wild West ICO Market*, INV'RS BUS. DAILY (Aug. 26, 2017), http://www.investors.com/etfs-and-funds/personal-finance/sec-bulletin-may-bring-order-to-wild-west-ico-market/.

overhead provided a haven for startups without access to conventional venture capital or that could not afford an IPO.[42]

Further, ICOs were still novel, misunderstood by people uninterested in cryptocurrencies, and not profitable enough to garner much attention. But they quickly became too profitable to ignore. While ICOs raised only an aggregate $300 million between 2014 and year-end 2016, they raised over $14 billion thus far in 2018.[43] The most successful ICO in 2013, Mastercoin ICO, raised $500 thousand in bitcoin in 2013.[44] Contrastingly, the DAO's 2016 ICO raised $150 million.[45] The Waves ICO raised $16 million; the Gnosis ICO raised $13 million; the Status ICO raised $100 million; and the Bancor ICO raised $156 million, all in the last four years.[46] The Tezos ICO that ended in July 2017 raised $232 million.[47] And most recently, the EOS ICO raised $4.2 billion.[48] By 2017, ICOs surpassed traditional venture capital in fundraising for blockchain ventures.[49]

Additionally, cryptocurrencies themselves dramatically rose in value. At Bitcoin's launch in 2009, one bitcoin traded for $0.0076.[50] At the start of 2017, one bitcoin traded for $908.09.[51] By December 2017, one bitcoin traded for over $17 thousand.[52] Similarly, Ethereum, the second most valuable cryptocurrency, grew 2,367%

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[42] Not only are the due diligence and filing requirements for a conventional IPO expensive, but underwriters also traditionally take a percentage of every share sold, decreasing investment returns. Jay Ritter, *Why Is Going Public So Costly*, FORBES (June 19, 2014, 4:09 PM), https://www.forbes.com/sites/jayritter/2014/06/19/why-is-going-public-so-costly/#1023ed864ff0.

[43] *ICO Tracker*, COINDESK, https://www.coindesk.com/ico-tracker/ (last visited Oct. 27, 2018).

[44] Sherman Voshmgir & Valentin Kalinov, *ICOs- Initial Coin Offerings- Infographics*, BLOCKCHAINHUB (July 18, 2017), https://blockchainhub.net/blog/infographics/initial-coin-offerings/.

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] Arjun Kharpal, *Initial coin offerings have raised $1.2 billion and now surpass early stage VC funding*, CNBC.COM (Aug. 9, 2017, 7:13 AM), https://www.cnbc.com/2017/08/09/initial-coin-offerings-surpass-early-stage-venture-capital-funding.html.

[50] *History of Bitcoin Infographic*, http://historyofbitcoin.org/ (last visited Oct. 7, 2018).

[51] *Bitcoin Price Tracker*, COINBASE, https://www.coinbase.com/charts?locale=en;%20CoinDesk,%20Bitcoin%20Price%20Index%20Chart,%20http://www.coindesk.com/price/ (last visited Oct. 27, 2018).

[52] *Id.* Bitcoin prices can fluctuate dramatically. In October 2018, bitcoin traded at approximately $6,400. *Id.*

in value in 2017.[53] Ether traded at $8.24 on January 1, 2017.[54] By October 6, 2017, ether traded at $3,001.[55] Cryptocurrencies' meteoric rise has been attributed to Chinese investment,[56] unreliable hype and publicity,[57] and general crypto-market development.[58] Regardless of the reason for the surge, these value gains increased the capital-raising potential of ICOs.

However, because they are built on cryptocurrency base codes, app tokens share many of the same weaknesses in security and volatility that are inherent in cryptocurrencies.[59] Stereotypes connecting cryptocurrencies with cyber-crime and illegal trade have been reinforced by highly publicized incidents like Ross Ulbricht's Silk Road trial[60] and ransomware attacks.[61] Further, anonymity,

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[53] Arjun Kharpal, *Bitcoin may have doubled this year, but rival Ethereum is up 2,000 percent. Here's why*, CNBC.COM (May 24, 2017, 7:55 AM), https://www.cnbc.com/2017/05/24/ethereum-price-bitcoin-rally.html.

[54] *Ethereum Charts*, WORLDCOININDEX, https://www.worldcoinindex.com/coin/ethereum (last visited Oct. 7, 2018).

[55] *Id.* Like bitcoin, the price of ether has also fluctuated. In October 2018, ether traded at approximately $200. *Id.*

[56] *See* Bryan Rich, *Who's Behind The Spike In Bitcoin?*, FORBES (May 24, 2017, 10:11 PM), https://www.forbes.com/sites/bryanrich/2017/05/24/whos-behind-the-spike-in-bitcoin/#9c2512f47d42 (attributing increasing bitcoin demand to the fact that "Chinese money is going into bitcoin").

[57] *See* Jeff John Roberts, *3 Reasons Why Bitcoin Broke $2,000*, FORTUNE (May 21, 2017), http://fortune.com/2017/05/21/bitcoin-2000/ (waving off the surge in bitcoin price by stating that it "sure feels like we are in the midst of a hype cycle now").

[58] *See* Matthew J. Belvedere, *Coinbase: Bitcoin's spike into the stratosphere is unlikely due to firms buying to pay cyber ransoms*, CNBC.COM (May 26, 2017, 9:37 AM), https://www.cnbc.com/2017/05/26/coinbase-bitcoins-spike-into-the-stratosphere-is-unlikely-due-to-firms-buying-to-pay-cyber-ransoms.html. Adam White, heading Coinbase's crypto-exchange, attributed bitcoin's rise to "continued growth in the fundamentals of the network." *Id.*

[59] *See* Roberts, *supra* note 37 ("Jeff Garzik, a leading figure in the blockchain community who runs a consultancy called Bloq, sees ICOs as 'transformative' but remains wary. 'Ninety-nine percent of these ICOs will be garbage,' he says. 'It's like penny stocks but with less regulation.'").

[60] United States v. Ulbricht, 858 F.3d 71, 82–83 (2d Cir. 2017) ("Silk Road users principally bought and sold drugs, false identification documents, and computer hacking software. Transactions on Silk Road exclusively used Bitcoins, an anonymous but traceable digital currency.")

[61] Nicole Perlroth et al., *Cyberattack Hits Ukraine Then Spreads Internationally*, NEW YORK TIMES (June 27, 2017) https://www.nytimes.com/2017/06/27/technology/ransomware-hackers.html; Roy Strom, *Ransomware Attack on DLA Piper Puts Firms, Clients on Red Alert*, THE AMERICAN LAWYER (June 27, 2017, 4:54 PM), http://www.americanlawyer.com/id=1202791614770/Ransomware-Attack-on-DLA-Piper-Puts-Law-Firms-Clients-on-Red-Alert?slreturn=20170910154831

decentralization, and lack of regulation all buttressed the negative cryptocurrency bias by creating an intensely speculative ICO environment. For example, an ICO for a token called Dogecoin was based on a popular dog meme and was originally meant as a joke, but it generated enough online publicity to balloon to $400 million in value.[62] Regulators frequently warned investors that some ICOs were ponzi schemes and that tokens could be illiquid.[63]

III. SEC INVOLVEMENT

A. THE DAO REPORT

The Decentralized Autonomous Organization (DAO) was a tech project built with smart contracts on the Ethereum protocol.[64] The concept was to have a decentralized venture capital fund that would operate without any centralized leadership and fund projects that token-holders would find attractive.[65]

The DAO conducted its ICO in April 2016 and raised $150 million from 11,000 investors.[66] However, within two months of the offering's close, a token holder manipulated an insecurity in the DAO's code to siphon off $50 million in ether into a private account.[67] Because 14% of all existing ether was invested in the DAO, the $50 million loss was akin to losing around 5% of the entire

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[62] Kevin Roose, *Is There a Cryptocurrency Bubble? Just Ask Doge*, NEW YORK TIMES (Sept. 15, 2017), https://www.nytimes.com/2017/09/15/business/cryptocurrency-bubble-doge.html.

[63] *See, e.g.*, SEC. & EXCH. COMM'N, INVESTOR BULLETIN: INITIAL COIN OFFERINGS (July 25, 2017) https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings ("[V]irtual tokens or coins may be susceptible to fraud, technical glitches, hacks, or malware."); SEC. & EXCH. COMM'N, OFFICE OF INV. EDUC. & ADVOCACY, PONZI SCHEMES USING VIRTUAL CURRENCIES (2017), https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf ("We are concerned that the rising use of virtual currencies in the global marketplace may entice fraudsters to lure investors into Ponzi and other schemes in which these currencies are used to facilitate fraudulent, or simply fabricated, investments or transactions.").

[64] Antonio Madeira, *The DAO, The Hack, The Soft Fork and The Hard Fork*, CRYPTOCOMPARE, https://www.cryptocompare.com/coins/guides/the-dao-the-hack-the-soft-fork-and-the-hard-fork/ (last updated Oct. 4, 2018).

[65] *Id.*

[66] Andrew Tar, *SEC Ruling on the DAO and ICO, Explained*, COINTELEGRAPH (July 27, 2017), https://cointelegraph.com/explained/sec-ruling-on-the-dao-and-ico-explained.

[67] Rob Price, *Digital currency Ethereum is cratering because of a $50 million hack*, BUSINESS INSIDER (June 17, 2016, 5:34 AM), http://www.businessinsider.com/dao-hacked-ethereum-crashing-in-value-tens-of-millions-allegedly-stolen-2016-6.

currency.[68] The hack sent Ethereum's price into a tailspin; within hours, ether's value dropped from $21.50 to $15 per token.[69]

The fallout from the DAO's collapse also caught the SEC's attention. On July 25, 2017, the SEC issued an investigation report on the DAO ICO.[70] The report concluded that "DAO tokens are securities under the Securities Act of 1933 . . . and the Securities Exchange Act of 1934."[71] The SEC's DAO report was its first declaration of jurisdiction over any ICO.

Token holders invested ether into the DAO expecting to derive profits exclusively from the efforts of the DAO's creators and curators. Because they met the requirements of the *Howey* Test, [72] the SEC held that DAO tokens were securities and that the DAO was subject to SEC filing requirements.[73] The report further stated that "[t]he Commission has determined not to pursue an enforcement action in this matter," but implied that future ICOs should consider themselves on notice.[74] Essentially, moving forward, ICOs should expect to fall under U.S. securities law if their tokens resemble securities.[75]

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[68] Klint Finley, *A $50 Million Hack Just Showed that the DAO is All Too Human*, WIRED (June 18, 2016, 4:30 AM), https://www.wired.com/2016/06/50-million-hack-just-showed-dao-human/.

[69] *Id.*

[70] *See* DAO 21(A) REP., *supra* note 7.

[71] *Id.* at 1.

[72] The traditional test to determine whether something is an "investment contract" within the definition of the 1933 Act, and therefore regulated as a security, is derived from *SEC v. Howey*, 328 U.S. 293, 298–99 (1946) ("[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.").

[73] *See* DAO 21(A) REPORT, *supra* note 7, at 11–13.

[74] *Id.* at 1.

[75] The SEC's subsequent actions have shown that they were not posing an empty threat; since the DAO Report, the agency has filed charges against Maksim Zaslavskiy for two unregistered fraudulent ICOs. SEC. AND EXCH. COMM'N, *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds*, Release No. 2017-185 (Sep. 29, 2017), https://www.sec.gov/news/press-release/2017-185-0. The SEC also halted the $15 million PlexCoin ICO and filed charges against its CEO Dominic Lacroix both for fraud and for failing to register the offering. SEC. AND EXCH. COMM'N, *SEC Emergency Action Halts ICO Scam*, Release No. 2017-219 (Dec. 4, 2017) https://www.sec.gov/news/press-release/2017-219?utm_content=bufferc34ce&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer.

B. BANNING U.S. INVESTORS

The DAO Report was the first time that the SEC formally recognized that app tokens were securities and that ICOs were securities offerings. Industry reactions covered a spectrum. Ethereum's trading price, which had recovered from the DAO hack, fell 10% immediately following the report's publication.[76] Roger Ver, a prominent bitcoin investor, denounced the SEC action as government oppression, calling the regulators "[a] bunch of strangers in a far off land threatening peaceful people all over the world with violence if they don't obey."[77]

Others who had grown suspicious of fraudulent ICO activity viewed the SEC intervention as a positive move toward legitimizing crypto-markets. Brad Garlinghouse, CEO of Ripple, stated that "[r]egulators aren't going away–and shouldn't. For generations, they have protected people from fraud (some is happening w[ith] the ICO market)[.]"[78] But, on the whole, blockchain startups were subject to heightened anxiety after the report, with many feeling that "[t]he writing [was] on the wall for many recent I.C.O.s: The S.E.C. is coming."[79]

In response to the DAO report, some ICO projects sought to exclude U.S. investors. Without U.S. persons involved, startups reasoned that the SEC would have no jurisdiction and their ICO would be exempt from SEC filing requirements. Monaco VISA took this path.[80] The startup, which sought to create an alternative to conventional credit cards, conducted an ICO from May to June 2017, but put a measure in place to prevent contributions from U.S. persons.[81] Investors looking to donate to Monaco VISA's ICO were uniformly directed to a click-wrap page asking: "Are you a citizen of

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[76] Jeff John Roberts, *The SEC's Big Digital Coin Ruling: What It Means*, FORTUNE (July 26, 2017), http://fortune.com/2017/07/26/sec-icos/.

[77] *See* Tar, *supra* note 66.

[78] *Id*. Ripple is a cryptocurrency supported by blockchain. *Our Company*, RIPPLE, https://ripple.com/company/ (last visited Oct. 15, 2018).

[79] *See* Roberts, *supra* note 71 (quoting attorney Brian Klien to the *New York Times*).

[80] MONACO VISA, https://crypto.com//en/cards.html (last visited Oct. 7, 2018).

[81] Dana Edwards, *ICOs are not for US Citizens? Should ICOs reject self proclaimed US Citizens as a way to reduce legal and regulatory risk?*, STEEMIT (May 2017), https://steemit.com/icos/@dana-edwards/icos-are-not-for-us-citizens-should-icos-reject-self-proclaimed-us-citizens-as-a-way-to-reduce-legal-and-regulatory-risk (via archive.org).

the United States?"[82] There were two options to select from: "Y or N." Should the investor select 'yes,' they were directed to a message stating, "sorry, your citizenship excludes you from participation in this ICO due to excessive regulatory risk from your SEC."[83]

Other ICOs have since adopted similar click-wrap U.S. resident blocks. Moeda, an ICO that aims to help female business development, excluded US investors.[84] As did PAquarium, an Estonian startup intending to use ICO funding to build the world's largest aquarium.[85] The research director of Smith + Crown, a cryptocurrency analysis group, stated that "[m]any token sales are barring U.S. persons from participating because of concerns around the U.S. SEC . . . . The potential of SEC enforcement understandably makes both the entrepreneurs wary and their off-chain backers uncomfortable."[86]

IV. ICOS AND REGULATION S COMPATIBILITY

A. THE JURISDICTION QUESTION

To protect U.S. consumers and investors, the SEC requires companies to file and disclose financial information about securities offerings affecting U.S. persons.[87] Under the Securities Act of 1933, however, Regulation S provides a filing safe harbor for securities offerings "outside the United States."[88] Under this safe harbor, American and foreign companies can offer securities to foreign markets without filing as long as the offering does not extend to the U.S. and there is little danger that the securities will reenter American markets.[89]

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[82] *Id.*

[83] *Id.*

[84] Andrew Ramonas, *No U.S. Investors Need Apply for Some Digital Coin Offerings*, BLOOMBERG LAW (Aug. 31, 2017) https://www.bna.com/no-us-investors-n73014463997/.

[85] *Id.*

[86] *Id.*

[87] SEC. & EXCH. COMM'N, WHAT WE DO, https://www.sec.gov/Article/whatwedo.html (last updated June 10, 2013) ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.").

[88] 17 C.F.R. §§ 230.901 (2007).

[89] *Id.*

By refusing to sell to U.S. investors, ICOs have created a new issue for the SEC. The Regulation S exemption has never before applied to crypto-assets. But because the SEC determined that the 1933 and 1934 acts apply to ICOs selling securities,[90] it follows that the exemptions in those Acts (including Regulation S) also apply to ICOs. And while blockchain's inherent anonymity and decentralization complicate the application of securities law to ICOs, the Regulation S framework can be interpreted in a way that satisfies the exemption's statutory intent.

It is increasingly important to determine how the foreign offering exemption applies to ICOs. The SEC has already come up against this issue in practice. In late 2017, the SEC filed suit against Dominic LaCroix, a recidivist Canadian securities law violator, and halted his company's $15 million ICO.[91] The SEC asserted that the ICO for PlexCoin failed to file with the SEC and fraudulently assured investors that their return on investment would be between 200% and 1,354%.[92] The Eastern District of New York asserted both subject matter and personal jurisdiction over the defendant.[93]

However, in January 2018, LaCroix's lawyer revealed plans to file a motion to dismiss based on lack of personal jurisdiction.[94] LaCroix's attorney asserted that "while the SEC claims many U.S. investors bought into the PlexCoin ICO, the defendants specifically took steps to exclude U.S. persons from the offering, noting that in order to participate in a PlexCoin transaction, would-be purchasers had to confirm that they were not a U.S. citizen, and were not purchasing on behalf of a U.S. person."[95]

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[90] *See* DAO 21(A) REPORT, *supra* note 7, at 18 (concluding that anyone "who offer[s] and sell[s] securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption").

[91] SEC v. PlexCorps, No. 17 Civ. 7007, 2017 WL 6398722, at *2–4 (E.D.N.Y. Dec. 14, 2017) (granting a preliminary order and asset freeze against Dominic LaCroix and his owned entities for likely violation of securities laws).

[92] Complaint at 2, 14, SEC v. PlexCorps, No. 17 Civ. 7007, 2017 WL 5988934 (E.D.N.Y. Dec. 1, 2017) (stating that there was no registration filing or exemption and that the Plexcoin website promised returns of 200%, 332%, 629%, or 1,354% depending on when investors purchased tokens).

[93] *PlexCorps*, 2017 WL 6398722, at *2 ("The Court likely has subject-matter jurisdiction over the instant action and personal jurisdiction over the Entity Defendant.").

[94] Stewart Bishop, *Digital Coin Offeror Says SEC Can't Sue in US Over $15M ICO*, LAW360 (January 9, 2018), https://www.law360.com/articles/1000467/digital-coin-offerer-says-sec-can-t-sue-in-us-over-15m-ico.

[95] *Id.*

This dispute illustrates the need to clarify the foreign offering exemption. If LaCroix did exclude U.S. investors in such a way that his ICO is out of the SEC's reach, then the SEC will be forced to dismiss the charges and un-freeze LaCroix's assets. This could mean that the "many U.S. investors" that LaCroix defrauded would be without recourse.[96] Alternatively, if the court asserts jurisdiction when LaCroix genuinely believed he was conducting an exclusively foreign offering, the result will heighten the uncertainty that ICOs face. By clarifying the scope of the Regulation S safe harbor, this Note will provide a framework that could serve to preempt needless litigation and promote efficiency during the crypto-regulator courtship.

B. THE REGULATION S FRAMEWORK

While its application can be cumbersome, Regulation S is not an overly complex securities exemption. To be considered "outside the U.S." and satisfy the filing safe harbor under Regulation S, a securities offering must (1) be made in an "offshore transaction," (2) not use "directed selling efforts" that target the U.S., and (3) comply with the "additional conditions" imposed based on the likelihood that securities will flow back into the U.S. market.[97] All three elements must be satisfied to fall within the safe harbor and make an offeror exempt from filing.[98]

1. Offshore Transaction

Under Regulation S, an offer, sale, or resale of securities is part of an "offshore transaction" if "[t]he offer is not made to a person in the United States," and if "[a]t the time the buy order is originated, the buyer is outside the United States, or the seller and any person acting on its behalf *reasonably believe* that the buyer is outside the United States."[99] Additionally, "offers and sales of securities to

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[96] *Id.*

[97] 17 C.F.R. §§ 230.901–905 (2007).

[98] *Id.* at § 230.903(a) (requiring all three elements to classify an offer or sale of securities as occurring outside the United States).

[99] *Id.* at § 230.902(h)(1) (emphasis added). *See also* § 230.902(k)(1) (defining "U.S. person" to include "natural person resident[s]," trusts, and other entities created by natural person residents or for their benefit).

persons excluded from the definition of 'U.S. person' . . . shall be deemed to be made in 'offshore transactions.'"[100]

In layman's terms, to meet the initial requirement of conducting an "offshore transaction," ICOs must ensure that the buyer is not (1) located in the United States, or (2) a "U.S. person."[101] But because cryptocurrency transactions are pseudonymous and conducted on a distributed network, it is practically impossible to delineate an ICO investor's physical location.[102] Therefore, the most workable method to ensure an offshore transaction is to exclude all "U.S. persons" from the ICO.

Offerors do not need to ensure with absolute certainty that investors are not American to exclude U.S. persons. Instead, the SEC applies a deferential standard. When promulgating Regulation S, "the Commission noted that *sellers should determine* the reasonable steps necessary to confirm the offshore location of the buyer and the non-U.S. person status of the beneficial holder."[103] By not mandating specific practices to prove an absence of U.S. investment, the SEC ensured that "'[t]he offshore transaction requirement would thus impose a positive obligation on sellers and their agents to ensure (*by whatever means they consider satisfactory*)'" that the buyer was not a U.S. person.[104]

Following the SEC's reasoning, to conduct an "offshore transaction," ICOs are only required to take measures that they find appropriate and make a good faith effort to exclude U.S. persons. While there may be multiple ways to meet this standard, the most obvious way to satisfy the "offshore transaction" element is to use a conspicuous click-wrap notice.[105] Basically, ICOs need a pop-up

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[100] *Id.* at § 230.902(h)(3).

[101] *Id.* at § 230.902(h)(1).

[102] *See supra* Part I.A (describing decentralization and anonymity as primary features of a blockchain).

[103] SEC. & EXCH. COMM'N, RESPONSE LETTER: ON-MARKET BOOKBUILDS PTY LTD (2014), https://www.sec.gov/divisions/corpfin/cf-noaction/2014/on-market-bookbuilds-reg-s-111314.htm (emphasis added).

[104] *Id.* (citing Offshore Offers and Sales, Securities Act Release No. 33-6779, 53 Fed. Reg. 22661 (June 17, 1988)) (emphasis in original).

[105] Additionally, the SEC has since clarified that issuers may use "electronic procedures" to obtain "certifications and agreements" from investors. SEC. & EXCH. COMM'N, COMPLIANCE AND DISCLOSURE INTERPRETATIONS, SECTION 277: RULE 903, 277.05 (Nov. 6, 2017), https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#277.05.

screen that requires investors to verify that their ICO contributions are not made on behalf of a "U.S. person."

For example, a startup called Atlant launched an ICO in September 2017.[106] When eager investors tried to purchase app tokens from the Atlant ICO website, a click-wrap notification popped up:

> I confirm hereby that I am not U.S. citizen/permanent resident/representing U.S. company or citizen/permanent resident/representing company of any jurisdiction where purchase of ATL tokens is illegal, restricted or requires special accreditation.[107]

To invest cryptocurrency in Atlant and receive app tokens, investors had to certify that they were not a U.S. citizen or entity.[108] And while it may be unartfully drafted, the click-wrap language does preclude U.S. persons from contributing without notice.[109] Because Atlant decided that click-wrap was a reasonable measure to exclude U.S. persons, Atlant would satisfy the deferential first prong of Regulation S.

However, it is worth noting that a click-wrap notification like Atlant's is likely the lowest standard of notification that the SEC will consider a good faith means to exclude U.S. investors. While an issuer may select the means of exclusion that they "consider satisfactory," there are limits to that discretion.[110] For instance, the SEC's guidance explicitly states that "if the disclaimer [barring U.S. persons] is not on the same screen as the offering material, or is not

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[106] *ATLANT announces Successful Initial Coin Offering (ICO)*, ATLANT BLOG, https://blog.atlant.io/antlant-announces-successful-initial-coin-offering-ico-85cee4b69b82 (Nov. 7, 2017) (announcing the completion of the Atlant ICO on October 31, 2017).

[107] Screenshot of Atlant ICO Website, https://atlant.io/?utm_source=runcpa&utm_medium=banner&utm_campaign=ICOStarted&track_id=212350129 (last visited Jan 13, 2018) (screenshot on file with author).

[108] *Id.*

[109] This tactic is similar to the one that Dominic LaCroix claims to have used, *supra* note 92, and Monaco Visa did use, *supra* note 82. But keep in mind that click-wrap notice only serves to satisfy the "offshore transaction" prong of Regulation S.

[110] *See supra* note 105 at 277.04 (stating that the "'safe harbor protection would not be available where offers and sales were made nominally to non-U.S. persons to evade the restrictions.'" (citing Securities Act Release No. 6863 (April 24, 1990)).

on a screen that must be viewed before a person can view the offering materials, it would not be meaningful."[111]

An interested investor in the above-described "browse-wrap" situation could navigate to an ICO's website and invest without ever seeing or being aware that terms and conditions exist that might prohibit U.S. investment. Also, because the terms are not prominently featured in a browse-wrap scenario, investors may assume that any existing terms are boilerplate and that such terms would not preclude their contribution.[112] For these reasons, anything less than a clear and conspicuous click-wrap notification should be deemed insufficient to put U.S. persons on notice that they are excluded from an ICO.

On the other hand, this baseline requirement does not preclude ICOs from taking further precautions beyond click-wrap notice. The Datum ICO (seeking to create a data commodities market)[113] and Mercury Protocol ICO (an Ethereum-based communication platform)[114] required investing parties to register and undergo third-party due diligence with Whitelist[115] to ensure that investors were not U.S. persons. Likewise, the EOS ICO website[116] employed

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[111] Statement Regarding Use of Internet Web Sites To Offer Securities, Release No. 33-7516, 63 Fed. Reg. 14806, at 14808, n.21 (March 23, 1998) https://www.sec.gov/rules/interp/33-7516.htm#foot21; *see also id.* ("Because of the global reach of the Internet, a disclaimer that simply states, 'The offer is not being made in any jurisdiction in which the offer would or could be illegal,' however, would not be meaningful").

[112] For similar reasons, browse-wrap conditions have long been invalidated in contract law for not providing consumers with constructive notice. *See, e.g.*, Nguyen v. Barnes & Noble, Inc., 763 F.3d 1171, 1179 (9th Cir. 2014) (invalidating an arbitration mandate in online terms-of-use where "a website makes its terms of use available via a conspicuous hyperlink on every page of the website but otherwise provides no notice to users nor prompts them to take any affirmative action to demonstrate assent"); Specht v. Netscape Commc'ns Corp., 306 F.3d 17, 32 (2nd Cir. 2002) (holding that "a reference to the existence of license terms on a submerged screen is not sufficient to place consumers on inquiry or constructive notice of those terms").

[113] DATUM, https://gettingstarted.datum.org/docs/introduction/html (last visited Oct. 7, 2018) ("Datum provides . . . access to a data marketplace to monetize your data.").

[114] MERCURY PROTOCOL, https://www.mercuryprotocol.com/ (last visited Aug. 30, 2018) ("Our technology, products and vision aim to bring people together in a trusted way to build relationships, conduct commerce, and thrive online.").

[115] ICO WHITELIST, https://www.icowhitelist.com/about (last visited Aug. 30, 2018) ("By analyzing deals and conducting due diligence ICO Whitelist uncovers deals at an early stage.").

[116] EOS is an ICO-funded project similar to Ethereum that seeks to develop "an operating system-like construct upon which applications can be built." EOS, *Frequently Asked Questions*, https://eos.io/faq (last visited Oct. 7, 2018).

click-wrap notification and automatically excluded U.S. IP addresses from contributing.[117] These additional measures are more burdensome than the click-wrap requirement but are certainly recommendable as extra precautions.

Lastly, despite an offeror's best efforts, the SEC recognizes that "U.S. persons may respond falsely to residence questions, disguise their country of residence by using non-resident addresses, or use other devices, such as offshore nominees, in order to participate in offshore offerings of securities or investment services," even in the face of reasonable safeguards.[118] But an ICO offeror is not liable for fraud perpetrated by investors. Instead, an ICO must only show that it took "reasonable steps" to ensure that U.S. persons were excluded to meet the "offshore transaction" requirement.[119] In the near-anonymous cryptocurrency environment, a click-wrap notification is reasonable for meeting that requirement under Regulation S.

2. Directed Selling Efforts

Foreign offering issuers seeking safe harbor from SEC filing must also refrain from "directed selling efforts."[120] Assuming that an ICO fulfills the "offshore transaction" notice requirements, it will satisfy the no "directed selling efforts" requirement if the ICO abstains from marketing in any media that specifically targets U.S. audiences. Under Regulation S, "[d]irected selling efforts" are defined as "any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S."[121]

Overall, the SEC's practical focus when identifying "directed selling efforts" has been to weed out activity that has "the effect of . . . conditioning the [United States] market."[122] For instance, the

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[117] Screenshot of EOS, https://eos.io/ (last visited Dec. 24, 2017) (on file with author).

[118] *See supra* note 111, at 14808.

[119] *Id.* at 14808–09 ("[I]f a U.S. person purchases securities or investment services notwithstanding adequate procedures reasonably designed to prevent the purchase, we would not view the Internet offer after the fact as having been targeted at the United States, absent indications that would put the issuer on notice that the purchaser was a U.S. person.").

[120] 17 C.F.R. § 230.903(a)(2) (2007).

[121] *Id.* at § 230.902(c).

[122] *Id.* at § 230.902(c)(1).

regulation submits that an ad in a publication with "an average circulation in the United States of 15,000 or more copies per issue" is an example of market conditioning that the SEC would deem "directed selling efforts."[123]

But in the era of internet marketing, ICOs have no need to advertise in print media. Instead, social media enables blockchain entrepreneurs to bypass traditional marketing means and spread excitement about their ICOs online.[124] In the absence of any accredited rating service, cryptocurrency investors turn toward social media outlets like Twitter[125] and Reddit[126] to discuss ICOs and discern good investments from empty schemes.

Fortunately, the SEC has published guidance on internet advertisement.[127] In most cases under Regulation S, the SEC "generally would not consider an offshore Internet offer made by a non-U.S. offeror as targeted at the United States ."[128] However, each case will receive an independent analysis and prudent issuers should ensure that (1) "[t]he Web site includes a prominent disclaimer" that U.S. investors are prohibited, and (2) "[t]he Web site offeror implements procedures that are reasonably designed to guard against sales to U.S. persons in the offshore offering."[129]

Taken as a whole, the SEC's internet guidance suggests that foreign ICOs can generally advertise on third-party cites like Reddit or Instagram as long as their offering portal includes the click-wrap

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[123] *Id*. at § 230.902(c)(2)(i).

[124] SEC. AND EXCH. COMM'N, INVESTOR ALERT: SOCIAL MEDIA AND INVESTING- AVOIDING FRAUD, 3 (Jan. 2012), https://www.sec.gov/investor/alerts/socialmediaandfraud.pdf (highlighting the dangers of fraud through the internet and stating that "[p]ump-and-dump schemes often occur on the Internet where it is common to see messages posted that urge readers to buy a stock quickly or to sell before the price goes down . . .").

[125] Laura Shin, *ICO Communities Look Past Regulations and Attempt to Evaluate Tokens and Set Standards*, FORBES (Aug. 11, 2017, 8:03 PM), https://www.forbes.com/sites/laurashin/2017/08/11/ico-communities-look-past-regulations-and-attempt-to-evaluate-tokens-and-set-standards/ ("One band of crypto insiders formed via Twitter has begun a series of salons on token ethics for issuers.")

[126] A vibrant cryptocurrency community has developed on Reddit. *See*, *e.g.*, *r/bitcoin*, REDDIT, https://www.reddit.com/r/Bitcoin/ (last visited Aug. 30, 2018) (a reddit forum focused on Bitcoin); *r/cryptocurrency*, REDDIT, https://www.reddit.com/r/CryptoCurrency/ (last visited Aug. 30, 2018) (discussing cryptocurrency); *r/ethereum*, REDDIT, https://www.reddit.com/r/ethereum/ (last visited Aug. 30, 2018) (discussing Ethereum and ICOs).

[127] *See supra* note 111, at 14806.

[128] *Id*. at 14808.

[129] *Id*.

disclaimer required under the "offshore transaction" prong.[130] Additionally, offerors are normally given some leeway because the internet pervades modern culture. For instance, the SEC guidance offers as an example: "the fact that an Internet offeror posts offering materials in English even though it is based in a non-English speaking country will not, by itself, demonstrate that the offer is targeted at the United States."[131]

However, one growing trend that the SEC will deem "direct selling efforts" is the recruitment of U.S.-based celebrities to promote ICOs. In 2017 alone, celebrities like DJ Khaled, Floyd Mayweather, and Paris Hilton all promoted ICO launches on their Instagram accounts.[132] Cobinhood, a blockchain project promising a "zero trading fee cryptocurrency exchange,"[133] recruited actor/musician Jamie Foxx to promote their ICO.[134] And since all of these celebrities are primarily popular in the United States, their endorsements would reasonably and (perhaps) purposefully "have the effect of . . . conditioning the [United States] market" and thus generate U.S. excitement around the ICOs.[135]

The SEC has since openly criticized and warned about such endorsements. The agency published a statement insisting that "[a]ny celebrity or other individual who promotes a virtual token or coin that is a security must disclose the nature, scope, and amount of compensation received in exchange for the promotion."[136] Further, the SEC held that celebrities "making these endorsements may also be liable for potential violations of the anti-fraud provisions of the federal securities laws, for participating in an unregistered offer and sale of securities, and for acting as

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[130] *See supra* Part III.B.1. To be sure, the "directed selling efforts" prong requires the same click-wrap notification backstops that are already required by the previous prong. But the doctrinal overlap of reinforcing investor notice actually promotes the SEC's disclosure mission and creates no additional burdens on ICO offerors.

[131] *See supra* note 111, at 14808 n.22.

[132] Rachel O'Leary, *DJ Khaled Is the Latest Celebrity to Promote an ICO*, COINDESK (Sept. 29, 2017, 12:45 AM), https://www.coindesk.com/dj-khaled-is-the-latest-celebrity-to-promote-an-ico/.

[133] COBINHOOD, https://cobinhood.com/ (last visited Oct. 7, 2018).

[134] Eugene Kim, *Cryptocurrency investors worry about a bubble as Jamie Foxx and other celebrities jump on board*, CNBC (Sept. 19, 2017, 2:28 PM), https://www.cnbc.com/2017/09/19/jamie-foxx-ico-investors-worried.html.

[135] 17 C.F.R. § 230.902(c)(1) (2007).

[136] SEC STATEMENT URGING CAUTION AROUND CELEBRITY BACKED ICOS (Nov. 1, 2017), https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos.

unregistered brokers."[137] Essentially, the SEC will not tolerate unregistered ICOs using U.S. celebrity endorsements.

But as long as ICOs meet the requirements necessary to satisfy an "offshore transaction"[138] and avoid advertisements specifically targeted toward American consumers (like paying for social media endorsements from U.S. celebrities), they should satisfy the "no directed selling efforts" analysis of the Regulation S safe harbor.

3. Flowback and Additional Conditions

Because protecting U.S. investors is its primary mission, the SEC promulgated Regulation S to further the policy that the SEC should not regulate offerings that do not affect U.S. markets.[139] But even when foreign securities are initially offered only to non-U.S. persons, there is still no guarantee that those securities will not reenter the U.S. after their initial sale either through secondary markets or personal transfer.[140] To address dangers stemming from unregistered securities entering the U.S. from abroad and affecting home markets (a phenomenon known "flowback"), Regulation S imposes additional conditions on issuers whose unregistered securities are likely to reenter U.S. markets.[141]

i. Flowback Categories

Under Regulation S, foreign offerings are traditionally categorized into either Category 1, Category 2, or Category 3, based on the projected likelihood that the unregistered securities will

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[137] *Id.*

[138] *See supra* Part III.B.1.

[139] SEC. AND EXCH. COMM'N, OFFSHORE OFFERS AND SALES, RELEASE NO. 122, at 1, 5 (1990) ("The Commission, however, historically has recognized that registration of offerings with only incidental jurisdictional contacts should not be required.").

[140] Clinton Culpepper, *Establishing an Executive Agreement to Permit Regulation S Securities and Avoid the Fraudulent Activities Associated with their Secondary Transfer*, 31 REV. LITIG. 661, 674–75 (2012) ("Because the unregulated securities can be sold at the market price of the registered securities, the companies make a profit on the difference between the prices of the unregistered Regulation S securities and registered domestic securities that are trading in U.S. financial markets.").

[141] *See* OFFSHORE OFFERS AND SALES, RELEASE NO. 122, *supra* note 139, at 12 ("The criteria used to divide securities into three groups, such as nationality and reporting status of the issuer and the degree of U.S. market interest in the issuer's securities, were chosen because they reflect the likelihood of flowback into the United States and the degree of information available to U.S. investors regarding such securities.").

reenter the United States.[142] Securities presenting the least danger of flowback fall into Category 1 and need only meet the "offshore transaction" and "no directed selling efforts" obligations.[143]

Securities presenting intermediate danger of flowback are Category 2 offerings and must satisfy both the Category 1 requirements and meet "additional conditions."[144] Chief among these conditions, a Category 2 offeror must (1) mark their securities as "restricted" from U.S. purchase and (2) impose a "40-day distribution compliance period" during which issuers and purchasers are barred from selling the securities to U.S. persons or entities.[145]

Finally, unregistered offerings that present the greatest likelihood of flowback receive Category 3 additional conditions.[146] Category 3 offerors must satisfy the restrictions placed on Category 1 and 2 offerings and must ensure that their securities are subject to a year-long "distribution compliance period"—a longer wait than Category 2's forty days.[147] Additionally, Category 3 offerors must affirmatively certify that any security purchaser is a non-U.S. person, and that any subsequent sales during the "distribution compliance period" (even those secondary sales not from the issuer) contain a notice that the securities must not be sold to a U.S. person.[148]

ii. Substantial U.S. Market Interest

To determine the likelihood of flowback for the purpose of assigning Category 1, 2, or 3 burdens, the SEC looks to whether there is a "substantial U.S. market interest" in the foreign securities.[149] Traditionally, the SEC has used "securities exchanges and inter-dealer quotation systems" or has analyzed where the majority of an offeror's outstanding debt securities have settled to discern whether the U.S. market interest is substantial.[150] Based on

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142 *See id.* at 4.
143 17 C.F.R. § 230.903(a)–(b)(1) (2007).
144 *Id.* at § 230.903(a)-(b)(2).
145 *Id* at § 230.903(b)(2).
146 *See id.* at § 230.903(b)(3) (imposing the greatest number of conditions on offerings).
147 *Id.* at § 230.903(a), (b)(3).
148 *Id.*
149 *Id* at § 230.903(b)(1)(i)(A).
150 *Id.* at § 230.902(j).

the agency's findings under those metrics, an offering would have to meet requirements under the corresponding category.[151]

However, there is no translatable inter-dealer system in the blockchain market to help discern a national market interest for ICOs. Because ICOs use anonymous globalized cryptocurrencies and there are no nationally-based authoritative quotation systems, there is currently no workable metric by which we might assign an ICO a specific score of U.S. interest, or even determine if purchasers are American.[152] The most comparable metric would be to rely on the internet traffic found on Reddit, Twitter, and other sites. However, that standard would be arbitrary and unreliable.

C. CATEGORY 3 ADDITIONAL CONDITIONS SHOULD APPLY TO ICOS

Since the metric traditionally used to ascertain the "U.S. market interest" and categorize Regulation S offerings cannot be feasibly applied to ICOs, the SEC should err on the side of caution and interpret Regulation S to impose the Category 3 conditions to all unregistered ICOs.[153] Considering the SEC's demonstrated interest in protecting U.S. investors from exposure to dangerous investments without adequate disclosures, there is significant need for the SEC to approach ICO fundraising with caution.[154] Should the SEC be overly deferential to blockchain startups using ICOs, there is greater likelihood that both pervasive fraud and inadequate diligence[155] will harm American investors.

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[151] *Id.* at § 230.903(a)–(b)(1).

[152] Timothy Lee, *How Private Are Bitcoin Transactions?*, FORBES (Jul. 14, 2011, 9:31 AM), https://www.forbes.com/sites/timothylee/2011/07/14/how-private-are-bitcoin-transactions/ ("[Bitcoin] hasn't built the kind of surveillance infrastructure the government has for tracking dollar-denominated transactions.")

[153] Those categories appear at 17 C.F.R. § 230.903(b)(3) (2007).

[154] The SEC has already begun enforcement actions against Maksim Zaslavskiy for launching two entirely fraudulent ICOs that raised around $300,000. *See* Release No. 2017–185, *supra* note 75.

[155] For example, Tezos completed its 2017 ICO without any SEC filing. *See infra* note 162. It has since devolved into an internal power struggle, leaving investors with near-worthless tokens and without any of the promised network benefits. *See* Paul Vigna, *Tezos Raised $232 Million in a Hot Coin Offering, Then a Fight Broke Out*, WALL ST. J. (Oct. 19, 2017, 12:07 AM), https://www.wsj.com/articles/tezos-raised-232-million-in-a-hot-coin-offering-then-a-fight-broke-out-1508354704 (describing the Tezos founders' power struggle).

1. Alternative Classifications are Insufficient

Because there is no workable metric to determine U.S. market interest and categorize ICO projects, the SEC must forgo merit-based classification until a suitable system develops. Until such time, the SEC has four distinct options: (1) assert that ICOs cannot rely on Regulation S at all and must file under Section 5 if they are offering security tokens to U.S. investors; (2) apply the most deferential Category 1 restrictions to all ICOs in the absence of affirmative proof of market interest; (3) apply the mid-level Category 2 additional conditions to all ICOs; or (4) apply the most stringent Category 3 additional conditions to all ICOs in the absence of evidence that there is no U.S. market interest.

The first option is undesirable because not allowing ICOs to use Regulation S is contrary to SEC policy.[156] Requiring all ICOs to register would rope in foreign ICOs who are issuing securities solely in limited foreign markets. The SEC does not wish to exert global jurisdiction on all securities offerings.[157] Such an interpretation would directly contradict the SEC's limited jurisdictional reach and violate the "longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States."[158]

In contrast, applying Category 1 additional conditions to unregistered ICOs would be under-inclusive. Though the SEC is deferential in the application of the "offshore transactions" requirement, "additional conditions" are protections added to protect against securities that present a heightened risk of flowback.[159] Just because the SEC cannot gauge the public interest in a specific security does not mean that flowback does not present a danger to U.S. investors.

Finally, applying Category 2 additional conditions would be an unprincipled middle-ground measure that would neither satisfy blockchain entrepreneurs nor substantially protect U.S. markets from restricted securities. Companies launching ICOs would still need to label their securities as restricted, but the label would expire

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156 *See supra* note 139.

157 *Id.*

158 Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2877 (2010) (citing EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 248 (1991)) (internal quotations omitted).

159 17 C.F.R. § 230.903(b)(3) (2007).

after a mere forty days.[160] Those restrictions are insufficient. Tezos, for instance, finished its ICO in July of 2017, but as of October the development team expressed doubts that the network could launch before February 2018.[161] If Category 2 conditions applied, U.S. persons could have unwittingly traded unregistered Tezos tokens for five months after the forty-day period before the promised network was even active. Allowing unregistered tokens (like Tezos) to enter the U.S. market without disclosure after only forty days exposes investors to the speculative trading volatility that still exists well after that period.[162] A one-year holding period may not entirely quash speculation, but it would better attract investors that actually believed in the young company and ensure that investors are not solely participating to engage in pump-and-dump behavior.

2. Text, Policy, and Intent All Support Category 3 Conditions

The language in Regulation S supports the application of Category 3's "additional conditions" to ICOs. Category 3 applies "to securities that are not eligible for Category 1 or 2."[163] Category 1 only applies when "[t]here is no substantial U.S. market interest,"[164] and Category 2 is generally reserved for reporting issuers and foreign debt offerings.[165] Because there is no way to divine an ICO's market interest for purposes of Category 1, and ICO companies are mostly unreported and are not debt offerings under Category 2, the default language of Category 3 should control.

Further, applying Category 3 "additional conditions" to ICOs is necessary to serve the policy animating Regulation S. Since its

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[160] *See id.* § 230.903(b)(2)(ii).

[161] *See* Josiah Wilmoth, *Tezos Derivatives Crashes Amid Management Infighting after $232 Million ICO*, CRYPTOCOINS NEWS (Oct. 20, 2017, 8:25 PM), https://www.ccn.com/tezos-derivatives-crash-amid-management-infighting-and-stalled-development/ (describing the delayed launch date).

[162] Tezos now faces litigation and regulatory risk for securities violations, highlighting the dangers ICOs face. *See* Jon Buck, *Tezos ICO Class Action Lawsuit in Works as Value Tumbles*, COINTELEGRAPH (Oct. 21, 2017), https://cointelegraph.com/news/tezos-ico-class-action-lawsuit-in-works-as-value-tumbles (noting that a San Diego-based law firm asserted that Tezos founders "have violated U.S. securities laws in conducting the ICO . . . [h]ere, it is clear that the tokens were never registered.").

[163] 17 C.F.R. § 230.903(b)(3) (2007).

[164] *Id.* at § 230.903(b)(1)(i)(A).

[165] *See id.* at § 230.903(b)(2) ("Category 2. The following conditions apply to securities that are not eligible for Category 1 . . . of this section and that are equity securities of a reporting foreign issuer, or debt securities of a reporting issuer or of a non-reporting foreign issuer.").

promulgation, the SEC has consistently maintained that the Regulation S exemption "does not apply to transactions that, though in technical compliance, are designed to evade the registration requirement."[166] Already, ICOs conducted under the guise of excluding U.S. persons are trading freely on secondary exchanges without any restrictions on U.S. purchases.[167]

Demonstrating the danger of secondary markets, EOS (the ICO previously mentioned for using IP detection to exclude American investors) is already openly trading on secondary markets like Kraken and Bitfinex, which are available to both U.S. and foreign persons.[168] While the EOS group disclaims any involvement with secondary trading, they concede that "it is possible that EOS tokens could be transferred on a peer-to-peer basis or on platforms operated by 3rd parties."[169]

So, while EOS knows that secondary markets trade its unregistered tokens to U.S. persons, EOS has no reason to care. As it currently stands, U.S. persons can visit a U.S.-based exchange and purchase unregistered crypto-tokens without receiving any disclosure or notice that the tokens are unregistered. Additionally, the rising cryptocurrency prices and public awareness[170] will likely only drive more eager U.S. investors into these fluid, anonymous markets.

The SEC can actively disincentivize the EOS group's apathy by applying Category 3 additional conditions. If Category 3 conditions were in place, EOS tokens would be subject to a one year "distribution compliance period" wherein the issuer must certify

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166 Geiger v. SEC, 363 F.3d 481, 488 (D.C. Cir. 2004) (citing Offshore Offers and Sales, Release No. 6863, 55 Fed. Reg. 18,306 (May 2, 1990));*see also* SEC v. Luna, No. 2:10–CV–2166–PMP–CWH, 2014 WL 794202 (D. Nev. Feb. 26, 2014); SEC v. Boock, No. 09 Civ. 8261(DLC), 2011 WL 3792819 (S.D.N.Y. Aug. 25, 2011).

167 A San Francisco-based secondary market called Kraken allows global users to exchange "Bitcoin(XBT), Ethereum (ETH), Bitcoin Cash (BCH), Monero (XMR), Dash (DASH), Litecoin (LTC), Ripple (XRP), Stellar/Lumens (XLM), Ethereum Classic (ETC), Augur REP tokens (REP), ICONOMI (ICN), Melon (MLN), Zcash (ZEC), Dogecoin (XDG), Tether (USDT), Gnosis (GNO), and EOS (EOS)." *Frequently Asked Questions*, KRAKEN, https://www.kraken.com/help/faq (last visited Dec. 26, 2017).

168 *See Kraken Launches EOS Trading*, KRAKEN (July 1, 2017), https://blog.kraken.com/post/1112/kraken-launches-eos-trading/ ("Kraken is pleased to announce support for EOS trading!"); BITFINEX WEBSITE, https://www.bitfinex.com/ (trading EOS as of Dec. 26, 2017).

169 *Frequently Asked Questions*, EOS, https://eos.io/faq (last visited Oct. 7, 2018).

170 *See supra* Part I.C (discussing how cryptocurrencies dramatically rose in value).

that any purchasers are non-U.S. persons.[171] Additionally, EOS tokens would need an attached disclaimer[172] that contractually obligates any subsequent purchasers and sellers to refuse sale to any U.S. persons during the one-year period.[173] If these conditions were in place, they would better protect the market from illiquid tokens and guarantee that U.S. investors at least receive notice before purchasing unregistered tokens during the one-year period.[174]

And finally, Regulation S's legislative history supports the application of Category 3's "additional conditions." One of the primary concerns that the SEC had with the initial version of Regulation S was that "[a]lthough the regulation ha[d] proved successful for many types of offerings . . . Regulation S [was] used as a means of perpetrating fraudulent and manipulative schemes."[175] In 1998, responding to concerns stoked by microcap securities, the SEC took steps to strengthen Regulation S's restrictions and extended the "distribution compliance period" to one year for domestic issuers.[176]

The SEC has never loosened restrictions applied by Regulation S, and the 1998 move toward tightening restrictions demonstrates that the Commission's attitude errs on the side of adding additional

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[171] See 17 C.F.R. § 230.903(b)(3) (2007) ("The purchaser of the securities (other than a distributer) certifies that it is not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person . . . .").

[172] This ledger need not be a physical agreement, and in fact could be ingrained in the crypto token itself. EOS actually boasts as a feature that within each token that "enables blockchains to establish a peer-to-peer terms of service agreement or a binding contract among those users who sign it, referred to as a 'constitution.'" *EOS.IO Technical White Paper v2*, GITHUB (Mar. 16, 2018), https://github.com/EOSIO/Documentation/blob/master/TechnicalWhitePaper.md#constitution.

[173] 17 § 230.903(b)(3) (2007). It should be noted that the "restricted security" requirement, while conventionally applied only to domestic issuers in a foreign offering, could also be applied to foreign issuers of crypto-tokens. Applying the "restricted security" requirement to foreign issuers would further protect investors from ICO risks and would not harm the statutory interpretation of Regulation S.

[174] *See* Use of Internet Web Sites To Offer Securities, *supra* note 111 ("In our view, if a U.S. person purchases securities or investment services notwithstanding adequate procedures reasonably designed to prevent the purchase, we would not view the Internet offer after the fact as having been targeted at the United States, absent indications that would put the issuer on notice that the purchaser was a U.S. person.").

[175] SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: OFFSHORE OFFERS AND SALES (REGULATION S) (Feb. 18, 1998), https://www.sec.gov/rules/final/33-7505.htm#body14.

[176] *See id*. ("The distribution compliance period for these securities will be lengthened from 40 days to one year . . . .").

precautions. If the SEC were to apply less than Category 3 "additional conditions," the move would directly contradict the protectionist purposes that motivated the 1998 revision and would weaken Regulation S's application.

V. CONCLUSION

Initial Coin Offerings present a new way for tech companies to garner fast capital investment. And for a couple of years, they operated without any regulatory oversight. But those days are now over. The SEC's DAO report and subsequent enforcement actions signal an end to the wild-west ICO days. By stepping into the crypto-environment, the SEC demonstrated that it will apply the 1933 and 1934 Security Acts to ICOs that it deems to be selling securities. Moving forward, foreign ICOs seeking an exemption from SEC filing by excluding U.S. investors should be on notice that they will need to turn to Regulation S.

For an ICO to comply with Regulation S and be exempt from securities registration, the ICO must first ensure it has met the "offshore transaction" requirement by (at least) installing a click-wrap U.S. exclusion notice. Next, the project must refrain from any "directed selling efforts"—efforts that target U.S. investors. While general internet advertisements will not count as targeted advertising, enlisting U.S.-based celebrity endorsements likely will count.

Lastly, since the "substantial U.S. market interest" test does not translate to the crypo-market context, deciding which "additional conditions" ICOs should meet under Regulation S is the most burdensome statutory adjustment. However, the text, the sound policy of protecting U.S. investors from risk, and Regulation S's history all support utilizing the Category 3 "additional conditions."

Regulation S provides a flexible and appropriate structure whereby issuers can ensure compliance and avoid securities filing. Simultaneously, under Regulation S, regulators can protect U.S. investors from potentially disastrous risk. At some point, ICOs and blockchain may evolve to the point where a new regulatory doctrine is required to properly serve the SEC's charge. But as ICOs stand today, the existing Regulation S framework is authoritative, workable, and adaptable. This Note suggests the optimal

interpretive scheme to apply that framework and tame the crypto-wild west.