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Gerald S. (Gerry) Sachs
Partner
T +1 (202) 344 4269
gsachs@venable.com

Christopher L. Boone
Associate
T +1 (202) 344 4248
clboone@venable.com

Venable LLP
600 Massachusetts Avenue, NW
Washington, DC 20001
www.venable.com

Blockchain, Tokenization, & ICOs: What's the Hype?

What exactly is an Initial Coin Offering (ICO), and why is everyone talking about them? Are they even legal, and what is the risk? This article explains the ICO phenomenon, the risks involved, and the current legal landscape. Initial Coin Offerings, or ICOs for short, come in different flavors, but one common characteristic is the presence of a digital token or "coin" built on a blockchain network (or the promise of one in the future).

But what is blockchain?

At its most basic, blockchain is like a massive spreadsheet or ledger distributed to the public that updates itself with every transaction on its network in real time. This distributed, digital ledger is composed of transactions (or other records) linked and secured using cryptography. Through the use of blockchain technology, developers can create unique and innovative digital assets and platforms with various characteristics.

What are digital tokens or "coins," and where do they come from?

A token is a digital asset that can be transferred almost instantaneously between two parties over the internet without involving a third party. However, not all tokens are the same. Tokens, such as Bitcoin, Ethereum, Litecoin, XRP, or Stellar Lumens, can serve as a replacement for traditional currency. They can be designed to provide the right to a future good or service or even be used to set up and execute smart contracts. Alternatively, tokens can be backed by a particular type of asset, such as gold, silver, or other collateral.

ICOs have raised over $2 Billion in 2017, with some ICOs raising as much as $200 million. Filecoin, for example, raised $257 million over a month of activity. Filecoin aims to provide a decentralized network for digital storage through which users can effectively rent out their spare capacity. In return, those users receive Filecoins as payment.

Another example is Golem, which presents itself as a global, decentralized supercomputer that anyone can access. It is comprised of the combined power of each participating user's machines, from personal computers to data centers. Users who rent out their computing power are compensated with Golem Network Tokens.

The hype: Is it a security or not? It depends . . .

The United States Security and Exchange Commission (SEC), which regulates securities, has warned that, depending on the facts and circumstances of any particular ICO, the offering may involve the sale of securities and, therefore, may be subject to SEC (and

Gerald S. (Gerry) Sachs
Partner
T +1 (202) 344 4269
gsachs@venable.com

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Associate
T +1 (202) 344 4248
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state) regulation. Assuming an offering of such tokens is not a sale of securities just because it involves a blockchain token is fraught with peril. The facts and circumstances that determine whether an ICO is offering a so-called "utility" token or a security are not clear. However, the SEC has reiterated its historical position, that it considers the substance of a transaction over form.

To date, we have four examples from the SEC to work with. The DAO ICO, PlexCoin ICO, MUN ICO, and the AriseBank ICO were each deemed "investment contracts" under securities law.

Just because an ICO is considered a security, however, does not make it illegal. It only means that the ICO must comply with the applicable securities laws. Registration with the SEC and compliance with the applicable regulations, while potentially expensive and time- consuming, may prevent a tremendous headache later on.

What laws should I consider?

At a minimum, you should consider all federal consumer protection and securities laws, including but not limited to the Dodd-Frank Wall Street Reform and Consumer Protection Act's prohibition against unfair, deceptive, and abusive acts, and the Securities Acts of 1933 and 1934, and their implementing regulations (Regulation A, A+ S-K, S-X, Rule 10b-5). In addition, if an ICO should be classified as a security pursuant to federal law, it would likely be necessary to consider all relevant state securities or "Blue Sky" laws.

Looking ahead

Blockchain, tokenization, and ICO are upon us, and businesses would be well served to keep abreast of the risks, rewards, and legal landscape of these burgeoning phenomena.

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