

Blockchain & Money



Class 20

November 27, 2018

Class 20 Overview

- Readings and Study Questions
- Investor Protection and Howey Test
- Initial Coin Offerings – Some Realities
- SEC Enforcement Actions
- SEC Exempt Offerings
- ICOs – Path Forward
- Conclusions

Class 20 (11/27): Study Questions

- How ICOs mix economic attributes of both consumption and investment. How ICO tokens' design features - their risks, expectation of profits, manner of marketing, exchange trading, limited supply and capital formation – are similar to investments schemes.
- Why is the ICO market rife with scams and fraud?
- What is the U.S. Securities and Exchange Commission's current approach to ICOs? What are the options for completing a compliant ICO?

Class 20 (11/27): Readings

- *'Digital Asset Transactions: When Howey Met Gary (Plastic)'* Hinman
- *'Initial Coin Offerings: Can Regulators Curb the Risks? How Many ICOs Are Scams?'* ValueWalk
- *'ICO Quality: Development & Trading'* Satis Group
- *'Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud'* Wall Street Journal
- *'ICOs Are Setting Capital Free. That's Revolutionary'* CoinDesk

Investor Protection - Going beyond Consumer Protection

- Investors get Full & Fair Disclosure from Issuers
- Fraud & Deceptive Sales Practices Prohibited
- Transparency & Anti-Manipulation Promoting Market Integrity
- Advisors' Conflicts of Interest Disclosed and Minimized

U.S. Securities Law

- The Howey Test (1946):

- Is it an investment of money or assets?
- Is the investment in a common enterprise?
- Is there a reasonable expectation of profits?
- Is it reliant on the efforts of a promoter or others?



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The Duck Test



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“When I see a bird that walks like a duck and swims like a duck and quacks like a duck, I call that bird a duck.”

James Whitcomb Riley, poet

Initial Coin Offerings

- Proceeds used to build networks
- Purchasers anticipate profits through appreciation
- Tokens usually issued prior to being functional
- Development, while open source, is largely centralized
- Promoters allocate themselves 'premined' tokens
- Tokens are fungible & transferable
- Scarcity is fostered with preset 'Monetary policy'

Development Stage of ICO Projects



Large Token Sales Yet to Launch Network

• Telegram	\$1.7 Billion	2/18	1Q 2019
• Filecoin	\$257 Million	9/17	2Q 2019
• Dfinity	\$102 - 195 Million	8/18	1Q 2019
• Polkadot	\$144 Million	10/17	3Q 2019
• tZero	\$134 Million	8/18	TBD

Ernst & Young ICO Study: 'The Class of 2017 – one year later'

Top 141 2017 ICO Projects as of September 30, 2018

- 86 % Trading below Listing Price
- 30% Lost Substantially all Value
- Portfolio Down 66%
- Only 13% have Working Products
- Another 16% have Prototypes

Note: Scams reported in readings range from 25% (Catalini & Gans) to 81% (Statis Group)

Ethereum: DApps & Average Daily Volume

• Exchanges	179	25875
• Gambling	488	17735
• Games	466	15660
• Finance	228	2665
• Property	62	2575
• Storage	55	1745
• Social	228	520
• Media	111	380
• Wallet	71	370
• Development	142	320
• Other	218	275

(Governance, Identity, Security, Energy, Insurance & Health)

SEC ICO Enforcement Actions

- DAO Report – July 2017
- REcoin Complaint – September 2017
- Munchee Order – December 2017
- AriseBank Asset Freeze - January 2018
- Centra Tech Complaint – April 2018
- Longfin Asset Freeze – April 2018
- Titanium Asset Freeze - May 2018
- Tomahawk Settlement – August 2018
- Blockvest Emergency Court Order – October 2018
- Airfox and Paragon Orders – November 2018

Exempt Securities Offerings

- Regulation D – Restricted Offerings
 - 506(c) – Accredited Investors Only
 - 506(b) – Accredited Investors + 35 Sophisticated – no General Solicitations
 - 504 - < \$5 million
- Regulation A – Offering Statement with Financials
 - Tier 1 - \$20 million – Any Investors & must file with State Securities Regulator
 - Tier 2 - \$50 million – Subject to ongoing reporting requirements & Limits on non-accredited investors
- Regulation CF - Crowdfunding
 - \$1.07 million through SEC Registered Platform, Information Disclosure and limits on Investors

Rule 506/Section 4(a)(6)/Regulation A comparison

Rule 506(b) offerings (traditional Regulation D)	Regulation D New Rule 506(c) offerings	Regulation CF Section 4(a)(6) crowdfunding	Regulation A Tier 1 (old Reg A as changed)	Regulation A Tier 2 (new)
Solicitation: Limited marketing directly to known investors without “general solicitation”; no internet solicitation (although online intermediaries may be used)	No limitations on solicitation, can be marketed over the internet; TV, advertisements and solicitation on social media permitted	Marketed over the internet, but primary solicitation and disclosure happens on “funding portal”; publicity anywhere else (including social media) is restricted	Public offering; can be marketed anywhere	Public offering; can be marketed anywhere
Eligible issuers: Both SEC-registered and private companies can use exemption (U.S. and foreign)	Both SEC-registered and private companies can use exemption (U.S. and foreign)	Only U.S. companies not registered with the SEC can issue; no investment companies; restrictions on investment companies and blank check companies	U.S. and Canadian; no SEC-registered companies; no blank check companies; companies that have failed to make previous required filings excluded	U.S. and Canadian; no SEC-registered companies; no blank check companies; companies that have failed to make previous required filings excluded
Offering size: No dollar limit on offering size	No dollar limit on offering size	\$1m limit on offering size but contemporaneous Rule 506 offerings permitted	\$20 million annual limit (can include \$6 m by selling shareholders)	\$50 million annual limit (can include \$15m by selling shareholders)
Eligible investors: Up to 35 non-accredited investors permitted; no limits on accredited investors	Only accredited investors may buy	No restrictions on type of investors but they must show they understand their investment and are limited in dollar amount	All investors © CrowdCheck. All rights reserved. This content is excluded from our Creative Commons license. For more information, see https://ocw.mit.edu/help/faq-fair-use/	All investors

ICOs – Path Forward

- Continued High Failure Rates
- Likely Further Decline in Funding Totals

- Increased Numbers of Enforcement Cases and Private Litigation
- Regulators & Courts Bring Added Clarity to ICO Security Definition
- More ICOs brought into Compliance

- Early Tokens Tested as Some Platforms become Functional
- Markets Better Differentiate Viability of ICO Use Cases

Class 21 (11/29): Study Questions

- What are the opportunities of blockchain technology to lower costs and counterparty risks in the clearing, settlement and processing of financial transactions?
- Why have the applications proposed to date almost exclusively been focused on permissioned or private distributed ledger technology?
- What lessons might be drawn from the ongoing projects – ASX for equities, ISDA for swaps, others?

Class 21 (11/29): Readings

- 'Blockchain could save investment banks up to \$12 billion a year: Accenture' Reuters
- *'ISDA Publishes Digital Iteration of the Common Domain Model'* ISDA
- *'ASX's Proposed Distributed Ledger and the Future of Clearing and Settlement'* Leung, Medium

Optional

- 'Distributed ledger technology in payments, clearing, and settlement' Mills

Conclusions

- Initial Coin Offerings are a New Means of Crowdfunding
- Benefits of Tokens Economics are still Uncertain
- A Majority of ICOs have Failed, Many have been Scams, Many More have been Non-Compliant with Securities Laws
- ICO Markets will only Prosper with Use Cases are Truly Viable and Issuance is Compliant with Investor Protection Frameworks

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