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The rise of tokens: critical considerations for VC firms

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The year 2017 saw the rise of a new form of financing for technology startups: the initial coin offering.

The *Wall Street Journal* recently reported that companies raised $6 billion in ICOs last year, and with $1.8 billion going toward ICOs in the first two months

of 2018, that growth appears to be accelerating.

Many of these ICOs represented the very first round of capital raising for the companies involved, and for companies that would have never been able to raise from traditional venture investors using conventional capital structures.

Given the increasing volume and role that tokens are playing in the startup market, VC investors are increasingly considering ICOs for non-dilutive financing for their portfolio companies.

These token offerings have been described as "reverse ICOs," but we believe that a more appropriate name is "hybrid token offerings."

Legal Uncertainty

The legal status of tokens remains uncertain, with an alphabet soup of federal and state regulators claiming jurisdiction over token sales, from the **CFTC** to the **FTC** to the **OCC** to the **SEC** to their counterparts among state regulators.

Companies selling tokens as part of ICOs in the first part of 2017 often presumed that the tokens they sold were not securities, referring to them as "utility tokens" akin to **Kickstarter** projects. They thus presumed that the token sales were not subject to federal or state securities laws.

In July 2017, the SEC issued a report after investigating tokens offered and sold by a "virtual" organization known as the "decentralized autonomous organization," or DAO.

The SEC found that the DAO's tokens were securities and subject to federal securities law. In the DAO enforcement action, the SEC stated clearly that tokens in such ICOs would need to be registered with the SEC, absent a valid exemption applicable to the offer and sale of the tokens being distributed in the ICO.

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Since the DAO decision, the SEC has issued a plethora of additional enforcement actions, including the termination of a token offering by **Munchee Inc**, a restaurant-review platform. In Munchee, the ICO was designed to fund the "tokenization" of its existing restaurant-review application.

In recent days, the SEC has been reported to be undertaking a broad investigation of ICOs, their investors, sponsors, advisers and vendors.

Given the legal ambiguities associated with selling tokens, many companies in the last months of 2017 structured their fundraising via Simple Agreements for Future Tokens, or SAFTs. These SAFTs were made available only to accredited investors and essentially are an option to receive tokens in the future. This defers the distribution of underlying tokens until the blockchain-based network is launched and is functional. Thus, once the network is launched, the tokens have commercial utility ("utility tokens") and would not be considered securities as defined under the securities law.
The theory is that while the initial sale of SAFTs are as securities; once the SAFT is converted into tokens upon network launch, the tokens would have sufficient commercial "utility" that they would not be considered securities. However, this approach has not been approved by any securities regulator.

Critical Issues for VC Investors

Given these developments, venture investors should consider the following issues:

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1. Hybrid token offering approval. The approval for a hybrid token offering under traditional venture-financing documents is uncertain, particularly the requirement for preapproval by preferred-stock investors. The **National Venture Capital Association** has recognized this ambiguity and has included new "protective provisions" in the latest versions of its forms of standard VC-transaction documents published in February 2018. Venture investors should include protective provisions in future financings.
2. Application of blockchain technology to portfolio companies. VC investors should work with their portfolio companies to assess whether they can use blockchain technology and the business goals that blockchain can enable. A hybrid token offering requires the use of blockchain technology. One issue such offerings may solve is the cold-start problem, the challenge of creating a business based on a network that must attract large numbers of users, or a critical mass, to bring a product to market.
3. Terms of the hybrid token offering. The board of a portfolio company should approve the critical terms of the hybrid token offerings.
4. Identity of the issuer. Portfolio companies are considering jurisdictions with favorable tax regimes, such as the Cayman Islands, British Virgin Islands, Gibraltar and Puerto Rico. Portfolio companies are also considering the use of independent foundations to manage the development of open-source blockchain projects. This structure is like many traditional open-source projects, such as the **OpenStack Foundation** and HyperLedger Project, hosted by the **Linux Foundation**.
5. Tokenomics. Tokenomics refers to the terms of the token offering: the role, features and purpose of tokens. Allocation of tokens among the community, including the management of the portfolio company, is a critical issue and depends on the business model for the specific blockchain project.
6. Control of the blockchain project in the portfolio company's exit. The blockchain project may be a significant asset of the portfolio company. Venture investors and portfolio-company boards should be mindful that the blockchain project or "control" of the blockchain project may be critical for a successful exit.

Although these issues are still evolving, tokens and cryptosecurities are vehicles that demand study and consideration. We expect 2018 will see the venture capital industry working to develop a set of industry norms for conducting hybrid token offerings.

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