

BLOCKCHAIN PRACTICE GROUP

How to Launch a Token Sale Legally in the U.S.

**Myths & Realities of Launching ICOs
in the United States**

ABOUT US

DILENDORF
KHURDAYAN

Blockchain, Real Estate & Private Client

Dilendorf Khurdayan is a New York-based law firm that serves the international blockchain community.

Among our clients are blockchain startups, established blockchain developers, FinTech firms, private funds and others in the process of developing, marketing and launching new cryptocurrency funds and virtual tokens.

Our lawyers are experienced in working closely with domestic and foreign clients and their advisers to help them understand, plan for, and comply with U.S. state and federal laws regulating cryptocurrency funds and virtual tokens.

[DILENDORF.COM](https://www.dilendorf.com)

TOPICS

- **Myths & realities** surrounding token sales in the U.S.
 - **How to launch** a token sale in the U.S. within 3 weeks **without registering with the SEC** under **Regulation D** and **Regulation S**
 - **Broker-Dealer** issues in ICOs
-

TOPICS

- **Myths & realities** surrounding token sales in the U.S.
- **How to launch** a token sale in the U.S. within 3 weeks **without registering with the SEC** under **Regulation D** and **Regulation S**
- **Broker-Dealer** issues in ICOs

MYTHS

1. “We have a utility token.”
 2. If I don’t sell to U.S. investors, I don’t need to do AML/KYC.
 3. I can ask investors to certify that they are not Americans.
 4. I can only sell to professional/institutional investors in the U.S.
 5. If I use a SAFT, (a) I don’t need to worry about securities regulations, and (b) the tokens I issue under the SAFT will not be securities.
 6. I need to register with the SEC in order to sell tokens in the U.S.
-

1. UTILITY vs. SECURITY TOKENS

- **Myth:** “Our token serves a function on our platform, which is already live. Therefore, it is a utility token and not a security.”
 - **Reality:** It doesn't matter what you call your token, whether it serves a function on your platform, or whether your platform is already live — **if it meets the test for a security, it's a security.**
 - SEC Chairman Jay Clayton to Congress: “**Every ICO I've seen is a security.**”
-

A SECURITY BY ANY OTHER NAME...

➤ What's the difference?

- A **utility token** is a token that serves some function on the sponsor's platform—maybe it lets users buy or sell services, for example.
- A **security token** looks more like a traditional security—it lets users vote or entitles them to share in the sponsor's profits, e.g.

➤ U.S. law defines “security” broadly. Typically the SEC and U.S. courts use the *Howey* Test to define a security as **any contract, transaction, or scheme** whereby:

- A person **invests money** or anything else of value
- In a **common enterprise** (which different courts define differently)
- And is led to **expect profits**
- Predominantly from **the efforts of others (central management)**.

➤ **Bottom Line:** If you have a utility token with security-like features, or if it otherwise meets the *Howey* test, **you have to treat it like a security.**

... WOULD STILL BREAK THE LAW

- **Security Tokens: The DAO Token**
 - **Not surprising:** Looks like a classic equity interest in a business entity.
 - **Utility Tokens: Munchee and MUN Tokens**
 - **MUN Tokens were utility tokens:** Customers could pay for meals at participating restaurants, and restaurants could buy advertising, using MUN Tokens in the Munchee iPhone app.
 - **All of the Above and SAFTs**
 - **February 2018 Subpoenas**
-

2. AML/KYC AND U.S. INVESTORS

- **Myth:** “If I don’t sell to U.S. investors, I don’t need to do AML/KYC.”
 - **Reality:** AML/KYC requirements are **separate from securities regulations**, dealing with money laundering issues (and governed by FinCen, not the SEC). Plus, how do you know you are not selling to U.S. investors if you don’t do AML/KYC?
 - Remember, selling unregistered securities to US investors is a **strict liability offense**.
-

3. CERTIFYING NON-U.S. STATUS

- **Myth:** “I can just make investors certify that they are not Americans.”
 - **Reality:** It is illegal to sell unregistered securities in the United States, **regardless of whether you know your buyer is American or intend to sell to Americans. Issuers are strictly liable.**
-

4. ACCREDITED ≠ PROFESSIONAL

- **Myth:** “I can only sell to professional or institutional investors in the U.S.”
- **Reality:** Accredited investors **do not** have to be professional or institutional investors.

U.S. Accredited Investors

- An “**accredited investor**” includes a **natural person who**:
 - **Earned income that exceeded \$200,000** (or \$300,000 together with a spouse) **in each of the prior two years**, and reasonably expects the same for the current year; **or**
 - **Has a net worth over \$1 million**, either alone or together with a spouse (excluding the value of the person’s primary residence)
- An “accredited investor” may also be an entity such as a bank, partnership, corporation, nonprofit, or trust, when the entity satisfies certain criteria.

5. USE OF SAFTs

- **Myth A:** “If I use a SAFT, I don’t need to worry about securities regulations.”
- **Reality:** Everyone agrees that **the SAFT itself is a security**, and **the tokens may be securities, too.**

MORE SAFT MYTHS

- **Myth B:** “If I use a SAFT, the tokens I issue under the SAFT will not be securities.”
- **Reality:** Tokens may be securities **regardless of whether a SAFT is used.**
- **The Reality for Related Myths:**
 - Using a SAFT **doesn't transform a security into a non-security.**
 - There is **no bright-line rule of functionality.**
 - The **timing of others' efforts makes no difference.**

6. SEC Registration

- **Myth:** “I need to register with the SEC to sell tokens in the U.S.”
 - **Reality:** Even if a token is a security, it may qualify for **an exemption from registration.**
 - As a practical matter, **there is usually no need to register** because you can almost always structure an ICO to qualify for an exemption.
-

TOPICS

- Myths & realities surrounding token sales in the U.S.
- **How to launch** a token sale in the U.S. within 3 weeks **without registering with the SEC** under **Regulation D** and **Regulation S**
- Broker-Dealer issues in ICOs

SEC POSITION

- SEC Chairman Jay Clayton: “**Every ICO I’ve seen is a security.**”
 - U.S. law defines “security” broadly.
 - Not empty threats: Remember The DAO, Munchee, and this year’s subpoenas.
 - **General Rule:** You must register a security with the SEC before you can offer or sell it.
 - **Consequence of selling unregistered securities:**
Strict liability.
-

EXEMPTIONS FROM REGISTRATION

- **BUT** there are exemptions from the registration requirement.
 - If your security qualifies for an exemption, **you don't need to register it.**
- **Examples:**
 - 3(a)(10) – Regulation D: Rule 504 – Regulation A+
 - 3(a)(11) – Regulation D: Rule 506(b) – Regulation CF
 - 4(a)(2) – Regulation D: Rule 506(c) – Regulation S

Regulation A+, Regulation D, Regulation S, Regulation CF... Aspirin Please!



GOOD FOR ICO?

ONLY 506(c) under Regulation D, Regulation S
and **MAYBE** Regulation A+

REGULATION D – 506(c)

➤ Overview of Rule 506(c)

- No restrictions on advertising—**general solicitation** is permitted
- **No prospectus required** (although issuers generally release a private-placement memorandum)
- Only **accredited investors** may participate in the sale
- Issuers can raise an **unlimited amount of funds**
- **Form D must be filed** with the SEC after the sale (but doesn't need SEC approval)
- State securities laws are **pre-empted** (no need to seek registration or exemption on a state level)
- Purchasers **cannot transfer their securities for one year** (subject to certain exceptions)
- **No financial reporting requirements** for the issuer

CONCURRENT REGULATION D + S

- Although not as well-known as Regulation D, token sponsors should structure a **concurrent offering under Regulation S** for non-U.S. investors.
 - **Advantage:** Non-U.S. investors under Regulation S do not have to undergo the same accreditation process as U.S. investors under Regulation D.
 - If you don't use Regulation S for foreigners, **you must accredit all your investors** under Regulation D—not just U.S. investors.
 - **Advantage:** Non-U.S. investors who are not **distributors or affiliates** of the issuer or its distributors can **resell immediately** to other non-U.S. investors.
-

REGULATION S?!



REGULATION S

➤ Overview

- Rule 901 says that “offers and sales that **occur outside the United States**” don’t have to be registered.
 - **BEWARE:** The SEC has never clearly explained when an offer and sale occur outside the United States, so you shouldn’t rely on Rule 901 alone.
- Fortunately, Rule 903 provides a **safe harbor**—if an offer and sale satisfy the following requirements, they are deemed to occur outside the United States:
 - Offer and sale made in an **offshore transaction**;
 - No **directed selling efforts** are made in the United States; and
 - **Certain other requirements** described in 903(b) are satisfied.

EXAMPLE: CONCURRENT REG D + S

- Telegram's Pre-Sale was conducted as concurrent offerings under Regulations D and S:

13. Offering and Sales Amounts

Total Offering Amount \$850,000,000 USD or Indefinite

Total Amount Sold \$850,000,000 USD

Total Remaining to be Sold \$0 USD or Indefinite

Clarification of Response (if Necessary):

This \$850,000,000 offering was made under a claim of federal exemption under Rule 506(c) and/or Regulation S under the Securities Act of 1933.

Source: https://www.sec.gov/Archives/edgar/data/1729650/000095017218000030/xslFormDX01/primary_doc.xml

BUT - INTEGRATION DOCTRINE

- **What is it?** The SEC can treat multiple offerings under different exemptions as a single offering. In other words, **using one exemption might destroy your ability to use another, and both offerings might fail.**
 - **Example:** Rule 506(c) (Regulation D) says you can openly advertise your security in the United States, but Rule 903 (Regulation S) says you can't make "directed selling efforts" in the U.S. **These rules present a potential conflict between Regulation D and Regulation S.**
 - Although the SEC has said concurrent offerings are OK, it hasn't provided clear guidance on that conflict, or what sorts of activities might cross the line and require integration of the offerings.
 - How to avoid integration goes beyond the scope of this presentation—just remember you need to take certain steps to ensure you properly run concurrent offerings.
-

COMPLIANT SALE UNDER REG D + S

- **How long does it take? 3 – 4 weeks.**
 - **What's involved? At a minimum:**
 - Determination of the appropriate sales structure
 - Preparation of a private-placement memorandum
 - Preparation of a purchase agreement
 - Preparation of necessary investor questionnaires
 - AML/KYC checks and investor verifications
 - Filing Form D with the SEC
 - **Anything else? Additional tasks may include:**
 - Review of advisory and marketing arrangements
 - Referral and bounty programs advice
 - Arrangements with ICO platforms
 - Broker-dealer licensing
-

TOPICS

- Myths & realities surrounding token sales in the U.S.
- How to launch a token sale in the U.S. within 3 weeks without registering with the SEC under Regulation D and Regulation S
- **Broker-Dealer** issues in ICOs

BROKER-DEALER ISSUES IN ICOs

➤ What is a broker-dealer?

- Under U.S. law, **any person who receives compensation for marketing a security may be a broker-dealer.**
- To determine if someone is a broker-dealer, the SEC looks at the unique **facts and circumstances** of each case—**there is no bright-line rule.**
- **Factors considered include:**
 - Does the person participate in important parts of a securities transaction, such as solicitation, negotiation, or execution?
 - Is the person's compensation dependent upon or related to the outcome of the transaction?
 - Does the person otherwise engage in the business of effecting or facilitating securities transactions?
 - Does the person handle the securities or funds of others in connection with securities transactions?

➤ Why does it matter?

- Broker-dealers **must be registered with the SEC.**
- **The SEC can shut down an offering if even one person acting as a broker-dealer is not registered.**

POTENTIAL BROKER-DEALERS IN ICOs

➤ **Advisors and Consultants**

- **ICO advisors and consultants** who help market the token sale or introduce investors to the sponsors may be broker-dealers.

➤ **ICO Platforms**

- **ICO platforms** help market and process a token sale, conduct AML/KYC and accreditation checks, find investors for the sale, and collect a percentage of the purchase price.

➤ **Bounty Program Participants**

- **Bounty programs** offer rewards to users who complete specific tasks, such as marketing the token sale on social media.

➤ **Referral Program Participants**

- **Referral programs** reward users who refer investors to the token sale.
-

SUMMARY

- **Myths & realities** surrounding token sales in the U.S.
- **How to launch** a token sale in the U.S. within 3 weeks **without registering with the SEC** under **Regulation D** and **Regulation S**
- **Broker-Dealer** issues in ICOs

DISCLAIMER

This presentation outline and the presentation itself are for *general* educational purposes only and are not intended to provide *specific* guidance or legal advice about what to do or not to do in any particular case.

You should not rely on this general information and should seek the assistance of an attorney to help you resolve any issues.

Thank you.

THANK YOU!



Rika Khurdayan, Esq.
rk@dilendorf.com

Partner

Dilendorf Khurdayan PLLC
60 Broad Street, 24th Floor
New York, NY 10017

t. +1 212-457-9797
TG @dklaw



Max Dilendorf, Esq.
md@dilendorf.com

Partner