

## Crypto 'IEOs' Grow Globally Despite US Legal Obstacles

By Tom Zanki

*Law360 (July 19, 2019, 11:46 AM EDT)* -- Initial exchange offerings, a fast-rising global phenomenon where cryptocurrency exchanges administer token sales on behalf of blockchain startups, stand little chance of taking off in the U.S. because of legal risks tied to this novel form of capital raising, lawyers say.

Given regulatory obstacles to U.S. investors, market participants in the nascent crypto industry are conducting IEOs mostly abroad, where they are finding receptive audiences. Mid-year data from cryptocurrency database Inwara show IEOs raised \$1.6 billion globally through June, compared with \$30 million in the first half of 2018.

Accounting giant PricewaterhouseCoopers LLP also noted in a recent report that IEO activity has “accelerated significantly” since early 2019, showing that “fundraising via cryptocurrencies is becoming more established and striving for greater institutionalization and credibility.”

IEOs, the latest iteration in an evolving field of crypto financing, may appeal to investors because the trading platforms that manage the token sales vet the startups that are seeking funding. This could comfort investors who fear being burned after so many earlier forms of crypto-funding campaigns known as “initial coin offerings” — where issuers marketed their sales directly to the public without an intermediary — went bust because of fraud or business failure.

“The theory is that investors are looking for some kind of stamp of approval on these offerings, given the level of fraud that has been publicized,” Baker Botts LLP partner Sam Dibble said.

While IEOs may address some concerns for token buyers, they don’t appear to solve regulatory problems that have dogged token offerings since their inception — at least when viewed from a U.S. perspective. Many trading platforms that run IEOs instead operate overseas in jurisdictions that are considered softer on cryptocurrency regulation. Binance, a leading IEO provider, is based in Malta, while platforms Kucoin and Huobi operate in Singapore.

Lawyers say IEOs won't pass muster in the U.S. because the Securities and Exchange Commission largely views the underlying tokens sold in crypto-funding schemes as securities, which makes any intermediaries involved in such transactions subject to securities laws.

The SEC established this view after it began policing ICOs, citing the likelihood that such tokens were being marketed to investors on their potential for profit, thus bearing the hallmarks of securities. As such, any trading platforms that help arrange similar offerings would be required to register with U.S. regulators and comply with laws governing broker-dealers and exchanges.

Morgan Lewis & Bockius LLP counsel Albert Lung said "most IEOs out there are probably illegal" from a U.S. securities law perspective.

"It doesn't matter if you are doing an ICO or an IEO," Lung said. "If the underlying token is a security, you still have to comply with securities regulations."

Inwara recently reported that 11 IEOs have taken place in the U.S., which ranks a distant second to Singapore in activity. The SEC appears to be monitoring trends for U.S. involvement in IEOs.

Valerie Szczepanik, the SEC's senior advisor for digital assets and innovation, reportedly told a Coindesk conference in May that cryptocurrency trading platforms that seek to list tokens for compensation, or bring buyers to the table for issuers, "are probably engaging in broker-dealer activity."

If such platforms are not registered, Szczepanik said, "they will find themselves in trouble in the U.S., if they have a U.S. issuer or U.S. buyers, if they are operating on the U.S. market."

The SEC did not respond to a request for comment. The agency has not mentioned any specific platforms that it is watching.

U.S. broker-dealers come under strict custody requirements, which are intended to ensure that customer assets are properly safeguarded. The SEC is still grappling with how to apply traditional custody rules to newer concepts like digital assets in order to combat loss or theft.

Given the likelihood of unlicensed broker-dealers handling the custody of digital assets, Dibble said "the IEO model couldn't fly more squarely in the face of what the SEC is worried about."

That said, Dibble is concerned that market participants in the blockchain sector are looking abroad for friendlier regulations. Blockchain is the technology that powers digital currencies, which are designed to enable financial transactions between peers without banks or middlemen.

"The downside is places like Malta and less regulated locations, to the extent that they get comfortable with some of these new concepts, are kind of eating the U.S.'s lunch on these trading markets and approaches to raising capital," Dibble said.

Speed and liquidity are perceived benefits of IEOs. By entrusting a trading platform to market their offering, provide due diligence, customer screening and other services, a startup can theoretically focus more attention on developing its business. Also, a company raising funds may be able to tap investors more quickly with an IEO, since a trading platform already has enlisted users. Those users in turn can then buy and sell their tokens on the existing platform.

“The buyer has some comfort that there is a market to resell,” said Fenwick & West LLP counsel Dan Freidberg. “In connection with an IEO, the exchange typically lists that security or that token on their platform, so there will be a ready secondary market.”

Companies typically give a listing fee and a percentage of their proceeds to the trading platform. However, Inwara recently cautioned that “everything ain’t sunshine and rainbows” with IEOs, noting that platforms have a monetary incentive to launch these offerings, which could cause conflicts.

The fact that startups are relying on intermediaries can also be seen as contrary to the ethos of crypto advocates, which seek to eliminate middlemen. But one expert argues that the additional verification that comes from third-party reviews is needed to help the crypto industry mature.

“In order for this universe of coins and crypto and blockchain to continue to evolve and be successful, it must have trust,” said Hal Crawford, a managing director at financial industry consultant Alvarez & Marsal. “When we see the evolution of going from an individual offering to a platform or exchange offering, you are introducing additional parties. By adding those additional parties, we are adding levels of due diligence, compliance and trust.”

Most IEOs to date have been modest in size, with the exception of a \$1 billion IEO by Hong Kong-based Bitfinex in May. Many platforms also tout their ability to quickly raise funds.

Binance Launchpad, the IEO platform for Binance, raised more than \$7 million for peer-to-peer file-sharing service BitTorrent in January in less than 15 minutes, according to its website. Inwara reports that the average sale time for an IEO is as low as 5.5 days while the average sale time for an ICO is as high as 97.2 days.

Traditional capital raises, such as initial public offerings, are often far longer in the U.S., given disclosures and other rules meant to protect investors. U.S. companies can raise funds quicker through private offerings that require less disclosure, but such offerings must be limited to wealthier investors.

Besides an IPO, the only way a company can sell a legal token offering to the broad public in the U.S., is through a so-called Reg A+ offering. This avenue, often called a “mini-IPO” is considered a less costly alternative to a full-blown IPO that comes with fewer rules.

More than a year after companies began submitting applications for Reg A+ token sales, this avenue could be making headway in the U.S.

The SEC this month cleared its first two offerings under its Reg A+ exemption for blockchain company Blockstack and video streamer YouNow.

Stradling Yocca Carlson & Rauth PC shareholder Amit Singh said the developments were “definitely encouraging” but noted that Reg A+ is still not an easy path, pointing out that Blockstack paid \$2 million in legal fees and spent several months seeking regulatory approval.

Singh acknowledged that the process could improve as the SEC gets more comfortable with Reg A+ offerings, which allow companies to raise up to \$50 million in a year. Until then, blockchain-based startups selling to investors outside the U.S. could be lured to IEOs.

“For now, however, the IEO path is much more straightforward and quicker,” Singh said. “I think a Reg A+ STO [security token offering] will make more sense as a second step after raising funds through other sources, whether through a private offering or an IEO.”

It’s not clear whether IEOs will have staying power given the early track record. When reporting on the decline of ICOs last year, PwC noted that ICOs were partly suffering because few business projects funded under these offering structures had produced any viable products.

ICOs, given the SEC’s view that they are likely securities sales, also fizzled because of regulatory crackdown. Lung doesn’t expect U.S. regulators to view IEOs any more favorably.

“If anything, it makes it a lot more difficult to argue that this is not a securities offering,” Lung said.

--Editing by Alyssa Miller.