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CROWDFUNDING CAPITAL IN THE AGE OF BLOCKCHAIN-BASED TOKENS

PATRICIA H. LEE[†]

INTRODUCTION

Less than three years ago, the Securities and Exchange Commission (“SEC”) adopted investment crowdfunding regulations (“Reg. CF”) to facilitate small companies’ efforts to raise capital and jumpstart employment.¹ Reg. CF provides companies² with potentially one of the most disruptive transformations in capital markets.³ Its potential has been lauded as a possible vehicle to democratize capital formation and

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¹ See generally 17 C.F.R. §§ 200, 227, 232, et al. (2018) [hereinafter SEC Crowdfunding Act]; adopted pursuant to the Jumpstart Our Business Companies Act, Pub. L. No. 112-106, §§ 301–05, Title III, 126 Stat. 306 (2012) [hereinafter JOBS Act].

² The term “company” represents small companies that provide notice filings under Reg. CF, notwithstanding the actual entity classification, e.g. limited liability company or partnership.

³ William Hinman, Director, Division of Corporate Finance, SEC, Remarks at the Yahoo Finance All Markets Summit: Crypto: Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018) (“Some people believe that this technology will transform e-commerce as we know it.”); Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOS*, 2015 U. ILL. L. REV. 217, 220 (2015). See also Howard Marks, *How Crowdfunding is Disrupting VCs*, FORBES (June 10, 2018, 8:45 AM), <https://www.forbes.com/sites/howardmarks/2018/06/10/how-crowdfunding-is-disrupting-vcs/#4a105f174823>.

to decentralize investments by way of the Internet.⁴ This method of companies crowdfunding securities through intermediaries (“broker dealers” or “funding portals”) and offering the securities for sale to the general public is referred to as “investment crowdfunding.”⁵

Scholars have raised numerous questions about the companies, the investments, and the costs of offerings before and after adoption of Reg. CF.⁶ Various questions and concerns raised include whether: (1) companies would refrain from using this newly crafted exemption in light of the regulatory complexity

⁴ Seth C. Oranburg, *Democratizing Startups*, 68 RUTGERS L. REV. 1013, 1065–66 (2016) (recommending a resale exemption to avoid subjecting small stockholders to the risk of fraud-on-the-market and to limit disclosure requirements). *See also* Lenore Palladino, *Democratizing Investment* (May 15, 2018) (unpublished paper) (on file with Franklin & Eleanor Roosevelt Institute, Smith College), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3194693# (arguing that “[i]f portals act as connectors rather than thick intermediaries, small investors could, in theory, gain more of the wealth flowing from private companies”).

⁵ *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, U.S. SEC. AND EXCH. COMM’N (last updated Apr. 5, 2017), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#_ftn1. In order to act as an intermediary in a transaction involving the offer or sale of securities in reliance on § 4(a)(6) of the Securities Act, an organization is required to register—either as a broker-dealer under § 15(b) of the Exchange Act or as a funding portal pursuant to § 4A(a)(1) of the Securities Act. These funding portals can register with the SEC on Form Funding Portal and can be a sole proprietorship, partnership, corporation, limited liability company, or other organized entity acting as an intermediary in crowdfunding transactions. *Id.* The funding portal must also become a member of FINRA. *See Funding Portals We Regulate*, FINRA, <https://www.finra.org/about/funding-portals-we-regulate> (last visited Feb. 26, 2019); *see also Forms List*, U.S. SEC. AND EXCH. COMM’N, <http://www.sec.gov/forms> (last visited Feb. 16, 2019) (additional information for registration, amendments, and withdrawal are set out in *Instructions for Forms*, available at <http://www.sec.gov/forms> and in text of the rules).

⁶ Reza Dibadj, *Crowdfunding Delusions*, 12 HASTINGS BUS. L.J. 15, 27–29, 39 (2015) (arguing that crowdfunding at these costs is a “dismal idea”). *See also* Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV. 543, 551 (2017) (discussing inherent risks of crowdfunding investments, including “inherent uncertainty and high likelihood of failure of early-stage start-up companies,” sophistication of ordinary investors; and fraud running rampant); Lynnise E. Phillips Pantin, *The Wealth Gap and the Racial Disparities in the Startup Ecosystem*, 62 ST. LOUIS U. L.J. 419, 447 (2018) (“[C]urrent capital raising schemes available to entrepreneurs may not be enough to meaningfully narrow the racial wealth divide”); David Groshoff, *Equity Crowdfunding as Economic Development?*, 38 CAMPBELL L. REV. 317, 337 (2016) (the SEC’s inability to protect investors from investment fraud); Garry A. Gabison, *Equity Crowdfunding: All Regulated but Not Equal*, 13 DEPAUL BUS. & COM. L.J. 359, 362 (2015) (concerns about fraud and incompetence).

and exorbitant costs;⁷ (2) the investment offering quality would jeopardize the offerings or keep investors away; (3) investors would fall prey to purchasing inappropriate securities;⁸ (4) Reg. CF might become the “go to” exemption for companies with poor credit ratings;⁹ and, (5) alternative financing would render Reg. CF of little effect.¹⁰ Before the regulations were adopted, Christine Hurt further asked the question: “which types of entrepreneurs and funding models will survive and thrive under a new crowdfunding regime?”¹¹

As the lion’s share of securities offered are under public offerings or other safe harbor exemptions, the outcomes and impacts of Reg. CF small business offerings are not studied, monitored or amplified to the same extent as larger offerings. The line of inquiry in this Article is the scope of Reg. CF, including questions about the level of company participation, the types of businesses seeking capital formation, and the quality of the investments offered. Furthermore, to what extent has Reg. CF investment crowdfunding facilitated company capital formation and provided a means for investors to purchase suitable investments? Towards that end, the author retrieved data from SEC Form C notice filings and other SEC filings completed by companies beginning with Reg. CF’s adoption date through June 30, 2018.¹² Additionally, company websites were

⁷ Dibadj argues that offerings in excess of \$500,000 were less discouraging, and predicts that “crowdfunding will have precious little impact.” Dibadj, *supra* note 6, at 41. See also Patricia H. Lee, *Access to Capital or Just More Blues? Issuer Decision-making Post SEC Crowdfunding Regulation*, 18 TENN. J. BUS. L. 19, 68–69 (2016) (suggesting that high regulatory costs, liability and public disclosure compliance requirements may deter some companies from seeking capital through Reg. CF financing methods).

⁸ Dibadj, *supra* note 6, at 40–41.

⁹ Lee, *supra* note 7, at 70.

¹⁰ *Id.* at 64–67.

¹¹ Hurt, *supra* note 3, at 221.

¹² *Edgar Company Filings*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/edgar/searchedgar/companysearch.html> (last visited Feb. 16, 2019) (company Form C, C/A, C-U, C-W filings and registrations were retrieved and reviewed here); *Form C*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/files/formc.pdf>, (last visited Feb. 16, 2019). With respect to company Reg. CF offerings: Form C/A is the method to amend an offering; Form C-U is the filing to announce the success or failure of an offering after the closing date; Form C-W is the form to withdraw the filing before the closing date. These forms encompassed the dataset utilized. See also Constance Z. Wagner, *Securities Fraud in Cyberspace: Reaching the Outer Limits of the Federal Securities Laws*, 80 NEB. L. REV. 920, 924 (2001) (explaining that the SEC has allowed Edgar Filings since 1984 to permit companies to electronically file disclosure documents under the 1933, 1934 Act and the Investment Company Act of 1940).

reviewed to compare and contrast the data filed with the SEC, primarily for updates.

Two clarifications about the usage of the term “investment crowdfunding” should be noted. First, scholars refer to this type of financing method in several other ways: equity crowdfunding,¹³ securities crowdfunding,¹⁴ investor crowdfunding,¹⁵ and securities crowdsourcing.¹⁶ As the focus of this Article is on both a company’s attempt to formulate capital and the suitability of securities for investors, the term investment crowdfunding seems most appropriate in this context. Second, investment crowdfunding could also be used to refer to crowdfunding campaigns that are offered under other 1933 Act exemptions or to international campaigns.¹⁷ In this Article, the term investment crowdfunding is primarily used to discuss Reg. CF exemption campaigns hosted in the United States.

In light of the research, the Article makes several assertions. First, the progress of investment crowdfunding is neither dismal, nor a resounding success. Rather, the change is more a mix of positive and troubling developments. The data reviewed and retrieved provides positives regarding participation, funding portal expansion, and the fact that some companies raised capital. Furthermore, there has been growth in the

¹³ Joan MacLeod Heminway, *Selling Crowdfunded Equity: A New Frontier*, 70 OKLA. L. REV. 189, 194 (2017). However, Professor Heminway further points out “that, not every crowdfunded offering of a profit-sharing instrument or interest is equity crowdfunding.” *Id.* at 194. See also Gabison, *supra* note 6, at 362 (equity crowdfunding); Groshoff, *supra* note 6, at 334.

¹⁴ Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L. REV. 885, 889 (2018). The terminology “securities crowdfunding” is a good descriptor, except that the term, gives focus to the securities and not the whole transaction, which conceivably is an investment from a shareholder’s perspective. The use of the term “equity crowdfunding” appears limiting as companies can seek debt, convertible or equity financing. The opposite concern surrounds using the term “securities crowdsourcing,” which implies a broader context but is narrowed by putting “securities” in front of the broader term crowdsourcing.

¹⁵ Hurt, *supra* note 3, at 234 (“Both equity crowdfunding and debt crowdfunding with an expectation of interest offer a return on a backer’s investment above and beyond a thank you card or DVD . . .”).

¹⁶ Richard A. Epstein, *The Political Economy of Crowdsourcing: Markets for Labor, Rewards, and Securities*, 82 U. CHI. L. REV. DIALOGUE 35, 47 (2015).

¹⁷ See Schwartz, *supra* note 14, at 889 (“Securities crowdfunding, while born in the United States, has become a worldwide phenomenon, with New Zealand leading the charge.”); Anton Didenko, *Regulating FinTech: Lessons from Africa*, 19 SAN DIEGO INT’L L.J. 311, 313 (2018) (discussing crowdfunding in Kenya and South Africa); KIM WALES, PEER-TO-PEER LENDING AND EQUITY CROWDFUNDING: A GUIDE TO THE NEW CAPITAL MARKETS FOR JOB CREATORS, INVESTORS, AND ENTREPRENEURS 218 (2018).

crowdfunding of Reg. CF securities, and in the sale of digital tokens based on blockchain technology (also known as “distributed ledger technology,” or “DLT”).¹⁸

At the same time, the Article notes some troubling inferences about investment crowdfunding company offerings generally, and digital token offerings, more specifically. For example, the expansion of securities (i.e. digital tokens and coins) offered to investors may present risks for both investors and the companies.¹⁹ Reg. CF digital token offerings reliant on the blockchain are complex, uncertain, and speculative securities, which raise doubts about the likelihood of an investor’s return on an investment. Some companies have not been successful with their digital token offerings, with cancelled offerings rather than capital raised. Although funding portals are growing, the downside is that funding portals are typically located in limited parts of the country and have limited liability. Many areas of the country are not participating in Reg. CF capital formation. Thus, unless a company in such an area utilizes an alternative means of financing, they may not have access to capital for their emerging enterprise. The foregoing suggests that we are not yet close to fulfilling the goals of capital formation, let alone job creation under the current regulatory scheme.

Insights from the research suggest that this topic is more nuanced than initially apparent, because the larger market of initial coin offerings (“ICO”) is represented by well-publicized ICOs which have the greatest volume of transactions when compared to Reg. CF digital tokens.²⁰ That being said, ICOs are being closely monitored by the SEC, the Commodity Futures Trading Commission (“CFTC”), and the Federal Trade Commission (“FTC”).²¹ However, Reg. CF blockchain-based offerings are not monitored in the same way since companies file the required and periodic notices with the SEC including

¹⁸ See KEVIN WERBACH, *THE BLOCKCHAIN AND THE NEW ARCHITECTURE OF TRUST* 49 (2018) (“Cryptocurrency enthusiasts envision digital tokens as being widely accepted for all sorts of financial payments by people around the world, as credit cards are.”). See also, Jay G. Baris & Joshua Ashley Klayman, *Blockchain Basics for Investment Managers: A Token of Appreciation*, 51 REV. SEC. AND COMMODITIES REG. 67, 68 (2018).

¹⁹ See *infra* Part I.C.

²⁰ See *infra* Part I.A.

²¹ See Jonathan Rohr & Aaron Wright, *Blockchain-Based Token Sales, Initial Coin Offerings, and the Democratization of Public Capital Markets*, 70 HASTINGS L.J. 463, 465 (2019) (“[T]he Securities Exchange Commission (“SEC”) and its counterparts in other jurisdictions have turned their attention to token sales.”).

disclosure documents that include the predictions of risk affiliated with the offerings.

To illustrate the findings, this Article proceeds like so. Part I provides a brief history of the Reg. CF exemption law and the research findings about investment crowdfunding, generally, and digital tokens, more specifically. Next, Part II provides insights on the current state of offering blockchain-based digital tokens to unsophisticated investors and the silver linings in the data. Finally, Part III provides recommendations for a path forward in Reg. CF. First, the SEC should re-evaluate its regulatory policy in light of the proliferation of blockchain-based token offerings and gaps in funding portals, and provide additional warnings to unsophisticated investors who may be taking on enhanced investment risk. The uncertainty and risk of digital tokens reliant on blockchain technology foretells a troubling high risk of investment loss, which may supplement the expected high risk of loss for startup tech companies. Second, companies, particularly idealistic tech startups, that are considering the offer of digital tokens, should thoughtfully consider alternatives to these offerings. There remains a level of uncertainty and risk in these offerings, which could result in greater risk and liability than the alternative financing available to them. Lastly, economic development organizations should consider developing their role in attracting, designing, and implementing funding portals to provide the support that tech and other startup companies need to raise capital for their business.

I. REG. CF LAW AND DIGITAL TOKENS

A. *Capital Formation*

Historically, raising capital was a pathway for large, well-established enterprises. One way larger enterprises raised large amounts of capital was through traditional public offerings of securities under the 1933 Act. Prior to Reg. CF, companies that sought to offer securities had several options. First, they could register securities pursuant to the 1933 Act, which provides a statutory framework for the federal regulation of securities offerings. Registration would be cost prohibitive for smaller companies.²² Second, companies could seek one of several safe harbor exemptions discussed further in this Section. The other

²² See Lee, *supra* note 7, at 67.

traditional way of raising capital is pursuant to various exemptions under the 1933 Act, discussed herein. Third, the company could avoid offering securities and consider a host of other funding alternatives.²³

“Crowdfunding is the use of the Internet or other means to raise money . . . in small amounts from a large number of contributors to support a wide range of ideas and ventures.”²⁴ Investment crowdfunding is the younger sibling of the crowdfunding of ideas, goods, and services offered to the public. Investment crowdfunding started with Title III of the Crowdfund Act. This Act amended the 1933 Act and allowed companies²⁵ to offer and sell up to \$1 million of unregistered equity securities in a twelve-month period, without registering them.²⁶ The SEC raised the cap on exempted transactions to allow companies to raise \$1.07 million in 2017.²⁷ The normative goal of the Crowdfund Act was to encourage small business growth and promote employment, specifically to “help entrepreneurs raise the capital they need to put Americans back to work and create an economy that’s built to last.”²⁸ The Crowdfund Act aimed to lower regulatory hurdles for companies trying to go public and to allow firms to have more private shareholders.²⁹ The Crowdfund Act further promised to provide issuers the ability to

²³ See generally WALES, *supra* note 17; see also Lee, *supra* note 7, at 50–66.

²⁴ RICHARD A. MANN & BARRY S. ROBERTS, *ESSENTIALS OF BUSINESS LAW AND THE LEGAL ENVIRONMENT* 799 (Cengage, 13th ed., 2017); see also Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 283 (2014) (describing crowdfunding as a “financing method used primarily by startups and small businesses to raise small amounts of capital from a large number of people over the Internet”); Joan MacLeod Heminway, *Crowdfunding and the Public/Private Divide in U.S. Securities Regulation*, 83 U. CIN. L. REV. 477, 477 n.1 (2014).

²⁵ The Crowdfund Act would allow eligible, domestic, nonpublic issuers to raise up to \$1.07 million as of 2017 (a figure that would be periodically adjusted for inflation). *Investor Bulletin: Crowdfunding Investment Limits Increase*, U.S. SEC. AND EXCH. COMM’N (May 5, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_crowdfundingincrease.

²⁶ JOBS Act, *supra* note 1, § 302.

²⁷ In the first year, the SEC capped the investments at \$1 million and raised the cap to \$1.07 million in 2017. 17 C.F.R. § 227.100(a)(1) (2018).

²⁸ Press Release, The White House, Office of the Press Sec’y, President Obama to Sign Jumpstart Our Business Companies (JOBS) Act (Apr. 5, 2012), <https://obamawhitehouse.archives.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act>; see also Oranburg, *supra* note 4, at 1030 (discussing the goals of the Crowdfund Act).

²⁹ *Regulation A+ (REG A+)*, NYSE, <https://www.nyse.com/regulation-a> (last visited Feb. 17, 2019).

access investors via the Internet with the aid of funding portals. Schwartz described the goals as a quest for efficiency, on the one hand, and a quest for inclusiveness on the other.³⁰

Registering securities or offering securities under a safe harbor exemption would be necessary to avoid violating § 5 of the 1933 Act.³¹ Sections 5(a) and 5(c) of the 1933 Act generally prohibit any person, including broker-dealers, from using the mails or interstate means to sell or offer to sell, either directly or indirectly, any security unless a registration statement is in effect or has been filed with the Commission as to the offer and sale of such security, or an exemption from the registration provisions applies.³² For this reason, companies seeking to avoid complications under the securities laws must register or find an allowable safe harbor exemption. The next Section provides a brief overview of the SEC's adoption of Reg. CF and the differences between the legal and economic requirements of Reg. CF filings and other 1933 Act safe harbor exemptions.³³

1. What is Reg. CF?

The idea of offering securities in small amounts to a large number of participants is not only novel, but is also becoming a disruptive financial and technological innovation. This disruption is precipitated, in part, by the SEC's implementation of the Crowdfund Act and, in part, due to a variety of external factors. In a very nascent way, Reg. CF was a positive step towards democratizing investment markets and decentralizing access to capital.³⁴ In light of the intersection of e-commerce and

³⁰ See Schwartz, *supra* note 14, at 893.

³¹ See Securities Act of 1933, 15 U.S.C. § 77e (2012); *Responses to Frequently Asked Questions About a Broker-Dealer's Duties When Relying on the Securities Act Section 4(a)(4) Exemption to Execute Customer Orders*, U.S. SEC. AND EXCH. COMM'N (Oct. 9, 2014), <https://www.sec.gov/divisions/marketreg/faq-broker-dealer-duty-section4.htm> ("Section 5 of the Securities Act requires all offers and sales of securities in interstate commerce to be registered, unless an exemption from registration is available."). For cases establishing a *prima facie* case, see SEC v. Cavanagh, 445 F.3d 105, 121 n.13 (2d Cir. 2006), SEC v. Calvo, 378 F.3d 1211, 1215 (11th Cir. 2004), SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).

³² See Securities Act of 1933, 15 U.S.C. § 77e(a),(c).

³³ This research does not include a discussion on intrastate offerings of securities.

³⁴ Society's ability to democratize and to decentralize access to capital is a question that scholars will research in the upcoming years.

social media, scholars have considered such crowdfunding moves to represent “populist, Internet-based business finance.”³⁵

Reg. CF allows small, undercapitalized companies to engage in crowdfunding capital formation. To that end, Reg. CF set forth structures, compliance requirements, restrictions, responsibilities, and costs, to allow for smaller equity investments. Reg. CF facilitates the raising of capital from the general public through the sale of securities,³⁶ provides opportunities for companies³⁷ to utilize internet funding portals, and helps to locate members of the public willing to invest.³⁸ The Crowdfund Act and the Reg. CF exemption brought the promise of “a new, unregistered, wide-reaching brand of securities offering . . . that, together with other changes in U.S. securities regulation, may become a new gateway to public securities markets.”³⁹

Through Reg. CF, U.S. companies that are not already Exchange Act reporting companies are allowed to raise up to \$1.07 million in a twelve-month period, allow the solicitation of their shares, and exempt the offering from SEC and state securities law registration.⁴⁰ Such measures have joined a host of other developments that have collectively opened the floodgates of crowdfunding investment. For example, Congress has allowed companies to raise money and offer shares to the general public, not just to accredited or sophisticated investors.

In addition to Reg. CF, Congress also enacted Reg. A+ in the JOBS Act.⁴¹ In furtherance of legislative goals, Reg. CF, Reg. A, and the amended Reg. A+, provided new opportunities for small

³⁵ See Heminway, *supra* note 13, at 193; see also Alma Pekmezovic & Gordon Walker, *The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital*, 7 WM. & MARY BUS. L. REV. 347, 357, 366 (2016) (“The rise of websites such as Facebook, Twitter, and LinkedIn—websites generally associated with the emergence of Web 2.0—as well as the popular payment services site PayPal, enabled crowdfunding to gain greater visibility.”).

³⁶ See, e.g., 17 C.F.R. § 200.30-3 (2018); Parsont, *supra* note 24, at 282.

³⁷ Of the 1,112 companies that filed Form C’s to register securities, four had principal offices outside of the United States and those locations included: Armenia, Spain, Kenya and the United Kingdom. See *infra* Part I.C and accompanying data.

³⁸ See *infra* Part I.C.

³⁹ See Heminway, *supra* note 13, at 205; see also Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1458 (2013) (“Securities crowdfunding is a new idea, modeled on the recently introduced and highly successful concept of ‘reward’ crowdfunding, which is practiced on Kickstarter, IndieGoGo, and other websites.”).

⁴⁰ *Regulation Crowdfunding*, *supra* note 5.

⁴¹ 17 C.F.R. § 230.251 (2018) (explaining the scope of the exemption).

businesses to attract the financing they needed to run their businesses.⁴² The basic details about each regulation are briefly set forth below. Under the regulatory regimes, the definition of “security” is based on the broadly worded provision of § 2(a)(1) of the 1933 Act, which states:

any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.⁴³

Effective June 2015, the SEC amended Reg. A and authorized Reg. A+ to allow a U.S. or Canadian company two types of greater funding opportunities, set forth as either Tier 1 or Tier 2 offerings.⁴⁴ For Tier 1 offerings, companies can raise up to \$20 million in a twelve-month period, with no more than \$6 million in offers by selling to security-holders that are affiliates.⁴⁵ For Tier 2, companies are allowed to raise up to \$50 million in a twelve-month period using a public solicitation of their shares, with no more than \$15 million to affiliates, and to exempt the offering from SEC and state securities law registration.⁴⁶

There are also basic requirements applicable to both Tier 1 and Tier 2 offerings, including, among others, company eligibility requirements, bad actor disqualification provisions, and disclosure requirements. Additional requirements apply to Tier

⁴² Anzhela Knyazeva, *Regulation A+: What Do We Know So Far?*, 2–7 (Nov. 2016), https://www.sec.gov/files/Knyazeva_RegulationA%20.pdf.

⁴³ Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012).

⁴⁴ See Knyazeva, *supra* note 42, at 1–3 (Regulation A, amended June 19, 2015, provides an exemption from registration for certain small issues).

⁴⁵ See 17 C.F.R. § 230.251(a)(1).

⁴⁶ See *id.* § 230.251(a)(2); see also Knyazeva, *supra* note 42, at 3 n.10.

2 offerings, including limitations on the amount of money a non-accredited investor may invest in a Tier 2 offering, requirements for audited financial statements, and the filing of ongoing reports.⁴⁷ Issuers of Tier 2 offerings are not required to register or qualify their offerings with state securities regulators. However, “resales of securities purchased in a Tier 2 offering that do not meet the condition of one of the exemptions from state registration must be registered with state securities regulators.”⁴⁸

2. How Reg. CF Differs from Other Exempt and Nonexempt Offerings

a. 1933 Act Offerings⁴⁹

Reg. CF filings and 1933 Act offerings differ significantly. Other than involving the same three discernable players—a company, a funding portal, and an investor—there is not much similarity between these methods of offering securities. Differences include transaction structure and size, investment research availability, liquidity, market share, exchange systems, and the types of securities offered. First and foremost is the cost. In a 1933 Act public offering, the costs start at \$4.2 million in offering costs directly attributable to the IPO, plus underwriter fees equal to 4% to 7% of gross proceeds.⁵⁰

Pursuant to Reg. CF, for the first time, small investors are allowed to buy small dollar amounts of unregistered securities from companies. The SEC’s threshold bifurcates investors into

⁴⁷ Knyazeva, *supra* note 42, at 3 n.8.

⁴⁸ *Id.* at 26 n.59 (citing *Securities Act Rules, Questions and Answers of General Applicability, Question 182.10*, U.S. SEC. AND EXCH. COMM’N, <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm> (last updated Nov. 6, 2017)).

⁴⁹ Registration under the 1933 Act includes registering a set of documents, including a prospectus, which are filed with the SEC before an entity goes public and quarterly and annual reports after the entity goes public. See *Registration Under the Securities Act of 1933*, U.S. SEC. AND EXCH. COMM’N (last updated Sept. 2, 2011), <https://www.sec.gov/fast-answers/answersregis33htm.html>. See also Alexander F. Cohen, *Financial Statement Requirements in US Securities Offerings*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 5, 2017), <https://corpgov.law.harvard.edu/2017/02/05/financial-statement-requirements-in-us-securities-offerings/>.

⁵⁰ *Considering an IPO to fuel your company’s future?*, PWC, <https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html> (last visited Feb. 17, 2019); see also Jay Preston, Note, *Initial Coin Offerings: Innovation, Democratization and the SEC*, 16 DUKE L. & TECH. REV. 318, 328 (2018) (estimating between \$4 and \$28 million).

two categories: those who have more than \$100,000 in income and those with less than \$100,000. The SEC further clarified that if both an investor's income and net worth are less than \$100,000, then the amount invested could not exceed \$2,000 or 5% of their net worth—whichever is greater.⁵¹ However, there is no floor to the income and net worth, with issuers relying on their funding portals to assess investor limits and qualifications.⁵² The securities offered continue to be of high risk with provisions that seemingly protect companies more than the investors.

Reg. CF investors have a one-year restriction on the resale of Reg. CF and other restricted stock purchased from other safe harbor transactions. The reasonableness of these resale restrictions continues to be debated. Legal scholars have argued that allowing companies to sell stock through crowdfunding and mini-IPOs is not enough—securities regulations must allow investors to resell that stock.⁵³ Oranburg makes three arguments to support the view that more liquidity is fundamental to meet the normative goals of crowdfunding. First, investors are discouraged from investing because they do not have a way to liquidate their stock easily in a resale market.⁵⁴ Second, capital continues to be consolidated in more mature companies instead of young organizations.⁵⁵ Third, wealthy and influential investors can resell large blocks of stock and can do so in secret trading environments.⁵⁶ The liquidity is also problematic for investors, as there may not be a ready and available market for their newly purchased security. Oranburg's solution is to call for a "144B" venture-exchange safe harbor, in

⁵¹ See Dibadj, *supra* note 6, at 23 (noting that the SEC "bifurcates investors into two categories: those whose annual income or net worth is less than \$100,000 and those whose annual income or net worth is at or above that amount").

⁵² See Dibadj, *supra* note 6, at 24 (noting that the issuer may rely on the intermediary to assess these limits).

⁵³ See Oranburg, *supra* note 4, at 1015–16. See also, Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2399 (1998).

⁵⁴ See Oranburg, *supra* note 4, at 1015–1016.

⁵⁵ See *id.*

⁵⁶ See *id.* Oranburg defines dark-pool markets as trading markets available and known to very few investors and further notes that these dark-pool markets are "private stock markets that are not accessible by the general investing public." See *id.* at 1047.

addition to the “144A” safe harbor for venture transactions on the over-the-counter markets.⁵⁷

Also, a resale exchange for Reg. CF investment crowdfunding transactions does not currently exist. For example, an investor holding less than \$100 can buy publicly offered 1933 Act securities and then trade publicly traded stock freely on their own or through a registered broker/dealer.⁵⁸ Securities can also be bought under Reg. CF, but resale is not readily available. To solve the resale and liquidity problems, lawmakers have presented two promising bills that passed the U.S. House of Representatives. The first bill is the Main Street Growth Act.⁵⁹ The Main Street Growth Act amends the Securities Exchange Act of 1934 to allow for the registration of venture exchanges with the SEC to provide a venue that is tailored to the needs of small and emerging companies and offers qualifying companies one venue in which their securities can trade.⁶⁰ The second bill is the Crowdfunding Amendments Act. This bill would allow crowdfunding investors to pool their money together into a fund that is advised by a registered investment advisor.⁶¹

In 1933 Act offerings, traditional offerings have included common stock, preferred stock, and debt instruments. However, in Reg. CF offerings, securities offerings can include standard equity, debt, revenue participations, and a variety of investment

⁵⁷ See *id.* at 1055–57 (noting curiosity surrounding why “the SEC has not already acted to create a domestic venture exchange”).

⁵⁸ For members of the public, stocks on NYSE and NASDAQ can be purchased at small dollar amounts with brokerage fees as low as \$5.95. *Online Broker Partners*, NASDAQ, <https://www.nasdaq.com/investing/online-brokers/> (last visited Feb. 17, 2019); see also *NYSE Exchange Fees*, INTERACTIVE BROKERS, <https://www.interactivebrokers.com/en/index.php?f=934> (last visited Feb. 17, 2019); *Pricing*, TD AMERITRADE, <https://www.tdameritrade.com/pricing.page> (last visited Feb. 17, 2019) (stock trades at \$6.95 over the internet).

⁵⁹ Main Street Growth Act is sponsored by Rep. Tom Emmer (R-MN). Main Street Growth Act, H.R. 5877, 115th Congress (2017-2018). H.R. 5877 was introduced on May 18, 2018 and passed the House on July 10, 2018. *Id.* On July 11, 2018, the bill was received in the Senate and read twice and referred to the Committee on Banking, Housing, and Urban Affairs. *Id.* It would allow for the registration of venture exchanges with the SEC to provide a venue that is tailored to the needs of small and emerging companies and offers qualifying companies one venue in which their securities can trade. *Id.*

⁶⁰ *Id.*

⁶¹ Crowdfunding Amendments Act, H.R. 6380, 115th Congress (2017-2018). H.R. 6380 was introduced in the House on July 16, 2018 and referred to the House Committee on Financial Services on July 16, 2018. *Id.*

contracts,⁶² that funding portals have developed and promoted for a company's use.⁶³ Companies have begun to offer more complex investment contracts, such as SAFE—simple agreements for future equity, KISS—keep it simple securities, and contractual revenue sharing agreements.⁶⁴ The SAFEs are not debt instruments, but rather future equity instruments, whereby shareholders have no voting or shareholder rights, and no lender rights or priorities.⁶⁵ A KISS, on the other hand, is a debt instrument that offers convertible securities (equity or debt) with favorable terms, like significant investor rights, protections, and preferences upon conversion into equity.⁶⁶ The research findings demonstrate the continuation of SAFE investment contract security offerings.⁶⁷

Under Reg. CF, there has been a growth in the number of investment contracts known as the simple agreement for future token ("SAFT")—an investment contract between a purchaser and seller that promises the delivery of digital tokens or other equity/debt instruments in the future,⁶⁸ conditionally or unconditionally.⁶⁹ SAFT and its corollary future digital tokens expanded in Reg. CF offerings between November of 2017

⁶² Wroldsen, *supra* note 6, at 589. Wroldsen identified two new forms of simplified contracts, "SAFE" and "KISS," securities, specially tailored for crowdfunding investment offerings with high-growth potential. These securities hold great promise, though not without drawbacks. Wroldsen developed an understanding of the taxonomy, terms, and variations in crowdfunding investment contracts, illustrating a baseline, standardized investment contract, as well as the emerging SAFE and KISS. *Id.* See also Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-So-Safe Safe*, 102 VA. L. REV. ONLINE 168, 170–75 (2016).

⁶³ Wroldsen, *supra* note 6, at 546.

⁶⁴ *Id.* at 582; see also Giorgia Coltella, *SAFE vs. KISS, The Evolution of the Convertible Note*, MEDIUM (Sept. 19, 2017), <https://medium.com/centrally/safe-vs-kiss-the-evolution-of-the-convertible-note-4859d42a867d>.

⁶⁵ Wroldsen, *supra* note 6, at 573.

⁶⁶ *Id.* at 570–71.

⁶⁷ As of June 2018, outside of common stock transactions, SAFEs were the number one type of security offered by two of the top five largest funding portals.

⁶⁸ Pete Martin, *What the Cardozo Report Gets Right and Wrong About SAFT's Approach to ICO Self-regulation*, MEDIUM (Dec. 1, 2017), <https://medium.com/votem/what-the-cardozo-report-gets-right-and-wrong-about-safts-approach-to-ico-self-regulation-3bf7fbcc7be5> (citing NOT SO FAST—RISKS RELATED TO THE USE OF A "SAFT" FOR TOKEN SALES (Cardozo Blockchain Project Research Reprt #1 Nov. 21, 2017)). See also Averie Brookes, *U.S. Regulation of Blockchain Currencies: A Policy Overview*, 9 AM. U. INTELL. PROP. BRIEF 75, 102 (2018) (noting a company's use of a SAFT to launch its token sale and later development of a working model for self-regulation).

⁶⁹ See *infra* Part I.C.

through June 30, 2018.⁷⁰ “The distinctive feature of SAFT is that it splits the promise of future tokens from the distribution of operational tokens.”⁷¹

In 2016, Joseph Green evaluated investment contracts offered under Reg. CF and found that SAFEs were not so “safe” or appropriate investments, as many of the companies would not actually be able to raise venture capital funding.⁷² At this time, the typical SAFE was a security developed by a Silicon Valley company accelerator named Y Combinator for companies expecting to raise institutional venture capital funding at a later date.⁷³ Time will tell whether they will be suitable investments for investors. Reg. CF offerings are occurring within a broader context of advancements in distributed ledger technology,⁷⁴ which present new opportunities and challenges for companies in their quest to raise capital, and offer complexity for the investing public and regulators.⁷⁵

Reg. CF offerings and 1933 Act offerings are similar in that both have notice requirements and companies are subject to liability under Reg. CF investment crowdfunding. Securities may be sold to any member of the public in small amounts, but with a smaller cap of \$1.07 million for Reg. CF companies, compared to offerings in other safe harbor exemptions. Second, neither purchase requires that the investor be sophisticated or accredited like other exempt filings require. Third, investors can lose their money from buying shares and other investment

⁷⁰ See *infra* Part I.C.

⁷¹ See WERBACH, *supra* note 18, at 207 (noting that the initial transaction is typically handled under SEC Regulation D or Regulation Crowdfunding, two of the exceptions to the registration requirements for securities offerings).

⁷² See Green & Coyle, *supra* note 62, at 170, 174 (warning that “the nomenclature ‘SAFE’ may actually be somewhat misleading” and that “[t]he safety implied by the clever acronym ‘SAFE’ actually points to the instrument’s safety for the issuing company—which is able to avoid the maturity dates associated with convertible notes—rather than any safety for the investor.”).

⁷³ See *id.* at 171.

⁷⁴ The technological phase relates to the new cryptocurrency heights that have recently been accomplished. First, there has been success in raising small dollar amounts via Reg. CF to serve as a first step before a second round of funding. Second, there have been successful ICOs, Reg. D and Reg A+ are raising significant dollars in cryptocurrency, despite recent legal travails, fraud, and hacking. Third, the development of blockchain and complimentary exchanges tie in to the future trading of Reg. CF tokens.

⁷⁵ See Wroldsen, *supra* note 6, at 551 (discussing inherent risks of crowdfunding investments, including inherent uncertainty and high likelihood of failure of early-stage startup companies; sophistication of ordinary investors; and fraud running rampant).

instruments from a company registered under the 1933 Act, possibly as easily as they might under Reg. CF. This means that for both 1933 Act publicly offered securities and investment crowdfunding: (1) securities are available publicly; (2) investors need not be sophisticated or accredited investors before purchase; and, (3) investors can risk the loss of their investment. Both offerings must be mindful not to violate § 10(b) of the Exchange Act.⁷⁶

Section 10(b) of the Exchange Act makes it unlawful to “use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.”⁷⁷ Rule 10b-5 makes it unlawful “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,” as well as to engage in other manipulative and deceptive activities.⁷⁸

b. Exempt Offerings

From the perspectives of both companies and investors, complying with securities laws is wrought with complexity. For a company, after the entity has decided to raise capital, it must determine whether it wants to issue common or preferred stock, debt, or possibly an investment contract. Once that decision is made, there is a need to determine which exemption is best to proceed with if they do want to sell a security. Not discussed in this Article is the possibility of filing an intrastate security offering. Many states have passed their own state-level crowdfunding exemptions, which exempt small business intrastate crowdfunding from federal securities registration.⁷⁹ As

⁷⁶ Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2012).

⁷⁷ *Id.* In *Morris v. Overstock.com*, the company was sued under Section 10(b) and Rule 10b-5 for misrepresentations or omissions made to shareholders on their intent to engage in an ICO. Class Action Complaint for Violations of Federal Securities Laws at 2–3, *Morris v. Overstock.com*, (D. Utah Mar. 29, 2018) (No.2:18-cv-00271-PMW).

⁷⁸ 17 C.F.R § 240.10b-5(b) (2019).

⁷⁹ Evan Glustrom, Note, *Intrastate Crowdfunding in Alaska: Is There Security In Following The Crowd?*, 34 ALASKA L. REV. 293, 308 (2017) (“[t]hese state-level regulations completely exempt intrastate crowdfunding from SEC regulation so long as the issuer is organized in the state and all investors reside in the state”).

of 2016, the majority of intrastate crowdfunding provisions required a notice filing with a state regulator.⁸⁰ However, there are unrealistic limitations of selling only to in-state investors. While there may be a variety of exemptions available, there may be only one viable choice.

There are many differences between Reg. CF offerings and other exempt filings.⁸¹ For example, Reg. D offerings under the 1933 Act allow two exemptions from § 5 registration requirements under Rules 504⁸² and 506.⁸³ These offerings are considered private and have different restrictions than a public offering. Reg. D offerings, which can only be made to accredited sophisticated investors, can be resold under Rules 144 and 144A with volume restrictions.⁸⁴ But, resale restrictions continue for non-accredited investors.⁸⁵

There are additional restrictions and limitations on Reg. D safe harbor exemptions. In Rule 504 offerings, issuers are limited to offering up to \$5 million in securities in a twelve-month period, provided that the offerings are consistent with the public interest, and certain bad actors are disqualified from participation.⁸⁶

Rule 504 currently permits the resale of securities issued in Rule 504 offerings that involve general solicitation or advertising where either the offering is registered in one or more states and one or more states require the dissemination of a state-approved disclosure document or the offering is exempt but sales are only made to accredited investors.⁸⁷

⁸⁰ See Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 33-10238 (Oct. 26, 2016). *E.g.*, Alabama, Arizona, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Iowa, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, New Mexico, North Carolina, Oregon, South Carolina, Tennessee, Texas, Vermont, Washington, West Virginia, Wisconsin, Wyoming and the District of Columbia. Other states have pending legislation that would require notice filings for intrastate crowdfunded offerings, *e.g.*, California, Hawaii, Missouri, Nevada, and New Hampshire.

⁸¹ The Commission amended Rule 504, effective January 20, 2017. *Id.* at 76–82. It also repealed Rule 50, effective May 22, 2017. *Id.* at 82–86. Finally, the Commission adopted new rule 147A as a safe harbor to the Section 3(a)(11) exemption, effective April 20, 2017. *Id.* at 16.

⁸² 17 C.F.R. § 230.504(a) (2018).

⁸³ *Id.* § 230.506(a).

⁸⁴ See Oranburg, *supra* note 4, at 1026–27.

⁸⁵ *Id.* at 1025.

⁸⁶ See Rohr & Wright, *supra* note 21, at 75.

⁸⁷ Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 33-10238 (Oct. 26, 2016).

“Rule 506(b) prohibits general solicitation and limits sales to no more than 35 non-accredited investors” whereas Rule 506(c) allows general solicitation to an unlimited number of accredited investors.⁸⁸ Under 506(c), companies may sell to an unlimited number of accredited investors, but cannot solicit investors.⁸⁹ In the next Section, some additional background is provided about the emergence of crowdfunding and other available exemptions and safe harbors operative during the new investment crowdfunding era.

Outside of the costs and limitations trading, theoretically, there is no reason that Reg. CF offerings could not succeed and serve as an extremely positive force. Positive outcomes include the democratization of company offerings,⁹⁰ lower crowdfunding transaction costs,⁹¹ increasing shareholder choice, and funding portal inclusivity and efficiency.⁹² However, a flood of speculative, risky, and uncertain securities may hinder positive outcomes. The worst case is that the macro benefits of this particular safe harbor are hijacked. Hijacking may be a strong term to use, but it may be appropriate to the extent that a flood of largely unregulated and potentially volatile securities,⁹³ securities fraud risk,⁹⁴ or unfettered exuberance may

⁸⁸ *Id.* at 86; *see also* 17 C.F.R. § 230.506(b)(2)(ii) (“Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment . . .”).

⁸⁹ *See* Preston, *supra* note 50, at 326.

⁹⁰ *See* Pekmezovic & Walker, *supra* note 35, at 347 (arguing that equity crowdfunding “enhances access to capital for SMEs globally while simultaneously democratizing access to investments for ordinary citizens”); *see also* Oranburg, *supra* note 4, at 1029–31 (discussing the JOBS Act’s potential to achieve purported goals of democratizing access to capital, creating jobs, and growing the innovation economy).

⁹¹ *See* Lee, *supra* note 7, at 68–69 and accompanying text.

⁹² *See* Schwartz, *supra* note 14, at 912 (theorizing that securities crowdfunding campaigns have a tension between inclusiveness and efficiency: “[t]he SEC concluded, again, probably correctly, that some level of exclusivity is needed for crowdfunding to work; total inclusivity is simply too inefficient to function”).

⁹³ Dirk A. Zetzsche et al., *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation*, 23 *FORDHAM J. CORP. & FIN. L.* 31, 35 (2017) (advocating four approaches regarding how to properly regulate FinTech, which include: “doing nothing,” “cautious permissiveness through flexibility and forbearance,” “restricted experimentation,” “and regulatory development”).

⁹⁴ In the midst of the SEC’s adoption of Reg. CF, scholars wrote about investor protection, securities fraud, and finding ways to balance what was perceived as an opening for widespread theft of investors’ contributions. *See* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 *MINN. L. REV.* 561, 606–07 (2015); Dibadj, *supra* note 6, at 31, 39–44; Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78

thwart the goals of the Crowdfund Act and hinder them from being realized.

3. Reg. CF Offerings and the Sale of Digital Tokens

The issuance of digital tokens reliant on blockchain technology is an explosive development in capital fundraising campaigns.⁹⁵ Most of this activity is happening in the IPO markets, but some of the activity is occurring in Reg. CF offerings. This development has skeptics and proponents. On the one hand, billionaire investor Warren Buffett says “[s]tay away from it. It’s a mirage.”⁹⁶ Meanwhile, former U.S. CFTC Chairman, Gary Gensler, states that “blockchain technology . . . underlying bitcoin has a real chance to be a catalyst for change in the world of finance, and that’s because it moves data and it also applies [] computer code across a decentralized network.”⁹⁷

To understand these assets and securities, the terms tokens, crypto tokens, cryptocurrency, and blockchain ledger technology are briefly described below. The definition of the word token has recently been revised to: “a piece resembling a coin issued for use . . . by a particular group on specified terms,” “issued as money by some person or body other than a de jure government,” or “a unit of cryptocurrency.”⁹⁸ Historically, the word token represented a tangible item, such as a bus token or a game token. Practitioners and scholars classify tokens as “digital tokens,” with a unit of value tied to a blockchain ledger.⁹⁹ The token’s

TENN. L. REV. 879, 881 (2011); Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439–40 (2012).

⁹⁵ See Rohr & Wright, *supra* note 21, at 463.

⁹⁶ Mitch Tuchman, *Heed Warren Buffett’s Warning: Bitcoin is Pure FOMO*, MARKETWATCH (February 10, 2018), <https://www.marketwatch.com/story/heed-warren-buffetts-warning-bitcoin-is-pure-fomo-2017-12-26> (“[t]he idea that it has some huge intrinsic value is just a joke, in my view”).

⁹⁷ Dave Liedtka, *Most Tokens From ICOs Are Securities, Former CFTC Head Says*, BLOOMBERG (October 15, 2018), <https://www.bloomberg.com/news/articles/2018-10-15/most-tokens-from-icos-are-securities-former-cftc-head-says>.

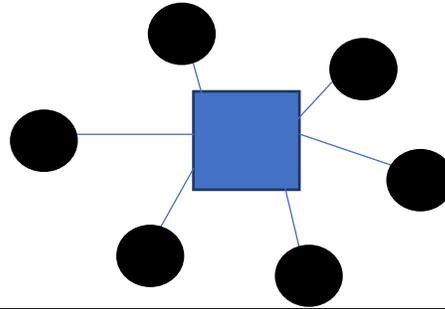
⁹⁸ *Token*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/token> (last visited Feb. 18, 2019). Cryptocurrency is defined as “any form of currency that only exists digitally, that usually has no central issuing or regulating authority but instead uses a decentralized system to record transactions and manage the issuance of new units, and that relies on cryptography to prevent counterfeiting and fraudulent transactions.” *Cryptocurrency*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/cryptocurrency> (last visited Feb. 18, 2019).

⁹⁹ Baris & Klayman, *supra* note 18, at 70 (describing digital tokens as representing a unit of value, which may make them look more like commodities,

“virtual” or “digitized” characteristic evokes the colloquial term “crypto token,” a term used by the tech industry to describe virtual currencies or digital assets tied to the blockchain,¹⁰⁰ and recently by courts and the SEC as “cryptocurrency ‘tokens’ or ‘coins.’”¹⁰¹ Digital tokens can be a reward, combining functional and consumptive elements, and also can be fundamental to a blockchain network.¹⁰² Tokens can be purchased either with cash or by using other coins.¹⁰³ Tokens are also potentially tradeable and transferable through an exchange for another coin or an item of value.¹⁰⁴ Recently, the Internal Revenue Service (“IRS”) has ruled that digital tokens will be treated as property for federal income tax purposes.¹⁰⁵

The SEC mandates that funding portals host a company’s offering to investors. To visualize the role of the funding portal, using Werbach’s square surrounded by six circles is helpful. An intermediary is a central player in the offering and provides a role between the company and the investor, as follows:

*Graphic of an Intermediary’s Role*¹⁰⁶



stating: “There is tremendous flexibility in how to structure digital tokens and what those digital tokens may represent.”). Nathan Dudgeon & Gareth Malna, *Distributed Ledger Technology: From Blockchain to ICOs*, 37 BANKING & FIN. SERVICES POLY REP. 4, 4 (February 2018) (“A blockchain facilitates online transactions by acting as a secure, digitized, decentralized, public ledger.”).

¹⁰⁰ Michael Patterson, *Crypto’s 80% Plunge is Now Worse Than the Dot-Com Crash*, BLOOMBERG (Sept. 12, 2018), <https://www.bloomberg.com/news/articles/2018-09-12/crypto-s-crash-just-surpassed-dot-com-levels-as-losses-reach-80>.

¹⁰¹ *United States v. Zaslavskiy*, No. 17 CR 647 (RJD), 2018 WL 4346339, at *2 (E.D.N.Y. 2018).

¹⁰² Baris & Klayman, *supra* note 18, at 75 n.47.

¹⁰³ *See Zaslavskiy*, 2018 WL 4346339, at *5 (noting the type of currency, such as Bitcoin or ether, that can purchase an app token); *see also infra* Part I.C.

¹⁰⁴ *See infra* Part I.C.

¹⁰⁵ I.R.S. Notice 2014-21, I.R.B. 2014-16 (Apr. 14, 2014).

¹⁰⁶ *See WERBACH*, *supra* note 18, at 25–27. Werbach describes an “intermediary” as one connoted by the box as a “trust architecture,” with the intermediary taking “the place of social norms and government-issued laws to structure transactions.” *Id.* at 27.

Examples of large enterprises utilizing intermediary models are Amazon, eBay, Uber, and Airbnb, where the consumer goes to their respective platform selling the items of a third party business.¹⁰⁷ This intermediary model for funding portals was adopted by the SEC, but it may provide a false sense of security for investors. The funding portal has limited liability and the funding portal isn't designing the disclosure language included in the offering by the companies. What is more ironic about centralizing the intermediary funding portal function, is that for digital tokens, what is offered would be a different type of securities model because the security is reliant on the development of the blockchain network.

Werbach illustrates how a blockchain network operates, which he describes as one where “nothing is assumed to be trustworthy . . . except the output of the network itself . . . [and] defines th[is] landscape for the blockchain's interactions with law, regulation, and governance.”¹⁰⁸

It may be a minor point, but it is unclear what the real value of the funding portals is, outside of centralizing an activity that will inevitably become decentralized.

Why would a company use these blockchain-based digital tokens? This method allows a business to create its own digital assets for sale to the public—similar to an initial public offering.¹⁰⁹ These digital tokens are developed to reside on an issuing company's own blockchain and can represent an asset or a utility,¹¹⁰ a right to services and other goods, as well as a variety of other uses.¹¹¹ Some companies are offering digital tokens because they seek to become a dominant competitive player in this developing innovation. Furthermore, blockchain-

¹⁰⁷ *Id.* at 28.

¹⁰⁸ *See id.* at 29.

¹⁰⁹ *See* Dudgeon & Malna, *supra* note 99, at 6 (providing a definition and an explanation why ICOs are so popular globally).

¹¹⁰ *See infra* Part I.C.

¹¹¹ *See* Rohr & Wright, *supra* note 21. The authors provide distinctions between different types of tokens reliant on blockchain technology: e.g., *utility tokens*, “which have both consumptive and speculative characteristics;” protocol tokens, which are tokens used “to compensate parties for participation in some activity that contributes to the maintenance of the blockchain and its network” e.g., a token to the person(s) that validate cryptographic hash for a block; and *app tokens* which are “created by deploying a smart contract program on the Ethereum network[.]” *Id.* at 468, 470, 474.

based token offerings sold to Reg. CF investors are occasionally a testing ground for future ICOs.¹¹²

4. Digital Token Regulatory Controversy

Scholars argue that there are three categories of regulatory controversy: illegality, validity, and classification regarding the broader category called “cryptocurrency.”¹¹³ There are overlapping jurisdictions among federal regulators regarding the regulation of digital tokens, from the CFTC, the SEC, the Treasury Department, the Department of Justice, and the IRS.¹¹⁴ One court has stated that the CFTC has concurrent jurisdiction with the SEC over the future of digital currencies.¹¹⁵ Recently, the SEC found that cryptocurrencies issued for the purpose of raising funds are securities and thus subject to securities laws.¹¹⁶ The SEC has also set up a new Cyber Unit which is issuing alerts for investors of coin offerings.¹¹⁷ The IRS continues with its

¹¹² Michael R. Meadows, Note, *The Evolution of Crowdfunding: Reconciling Regulation Crowdfunding with Initial Coin Offerings*, 30 LOY. CONSUMER L. REV. 272, 273 (2018) (Meadows’ article focused principally on ICOs as a method of crowdfunding, noting that “[w]hile ICOs serve as an effective method of raising capital, crypto-crowdfunding may repackage traditional crowdfunding models that would otherwise trigger federal securities laws.”). In their own right, ICOs are a crowdfunding method used by companies to raise capital selling digital assets (e.g. digital token) that utilize blockchain technology.

¹¹³ WERBACH, *supra* note 18, at 178.

¹¹⁴ Jai R. Massari et al., *The Fragmented Regulatory Landscape for Digital Tokens*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 26, 2018), <https://corpgov.law.harvard.edu/2018/03/26/the-fragmented-regulatory-landscape-for-digital-tokens/>; *see also* Commodity Futures Trading Commission v. McDonnell, 287 F. Supp. 3d 213, 230 (E.D.N.Y. 2018) (entering a Preliminary Injunction Order against Defendants Patrick K. McDonnell and CabbageTech, Corp. d/b/a Coin Drop Markets and affirming the CFTC’s January 18, 2018 complaint charging defendants with fraud and misappropriation in connection with purchases and trading of the virtual currencies Bitcoin and Litecoin).

¹¹⁵ *McDonnell*, 287 F. Supp. 3d at 230 (affirming that CFTC has standing to exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce and granting a preliminary injunction in favor of the CFTC).

¹¹⁶ Edmund Mokhtarian & Alexander Lindgren, *Rise of the Crypto Hedge Fund: Operational Issues and Best Practices for an Emergent Investment Industry*, 23 STAN. J.L. BUS. & FIN. 112, 116 n.10 (2018); *see also* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81027 (July 25, 2017) [hereinafter DAO Report].

¹¹⁷ Press Release, Sec. Exch. Comm’n, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), <https://www.sec.gov/news/press-release/2017-176>. *See also Investor Alert: Public Companies Making ICO-Related Claims*, INVESTOR.GOV (Aug. 28, 2017), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making-ico-related> (last visited on Feb. 18, 2019). The SEC’s

exclusive jurisdiction over taxation of tokens, and to the extent that a crime has been committed, the Department of Justice may intervene. Thus, to better understand the legality of the various jurisdictional questions, companies need to be counseled wisely about various agency considerations.

With respect to classification, the current regulatory framework for digital tokens and cryptocurrencies has been described as a “fragmented, overlapping, and complex regulatory landscape,”¹¹⁸ including its treatment as property for federal income tax purposes.¹¹⁹ Some argue that the use of SAFTs for the purchase of “pre-functional” tokens delivers a “functional” token that ultimately is not a security.¹²⁰ Others argue the use of a SAFT likely muddies the analysis of whether a utility token is a security for purposes of U.S. federal securities law.¹²¹

According to a recent SEC report pursuant to Section 21(a), the SEC applied longstanding securities law principles to demonstrate that a token constituted an investment contract, and therefore, was a security under U.S. federal securities laws.¹²² The SEC concluded that this DAO digital token offering represented an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.¹²³ It also noted that “merely calling a token a utility token or structuring it to provide some utility does not prevent the token from being a security.”¹²⁴ Applying the *Howey* test,¹²⁵ the SEC’s arguments

Office of Investor Education and Advocacy issued an Investor Alert in August 2017 warning investors about scams of companies claiming to be engaging in ICOs.

¹¹⁸ Massari et al., *supra* note 114; *see also* Meadows, *supra* note 112, at 272–73. Meadows’ article focuses principally on ICOs as a method of crowdfunding. However, Meadows notes the “unique issues crypto-crowdfunding poses to participating consumers and regulatory authorities” as well as issues “with the emergence of blockchain technology, which adds an additional layer of complexity in determining whether federal securities laws apply to a crowdfunding campaign.” *Id.* at 273.

¹¹⁹ I.R.S. Notice 2014-21, I.R.B. 2014-16 (Apr. 14, 2014).

¹²⁰ Baris & Klayman, *supra* note 18, at 76.

¹²¹ *Id.* at 76.

¹²² DAO Report, *supra* note 116, at 15. *See also* Preston, *supra* note 50, at 322 (stating that the *Howey* test can be refined to four factors to consider an investment contract a security: (1) “[i]t is an investment of money; (2) [t]he investment of money is in a common enterprise; (3) [a]ny profit comes from the efforts of a promotor or third party; and (4) [t]here is an expectation of profits from the investment.”).

¹²³ DAO Report, *supra* note 116, at 15.

¹²⁴ Press Release, Sec. Exch. Comm’n, Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

¹²⁵ SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

would seemingly apply to tokens and other offerings would be securities. These tokens incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others which are hallmarks of a security under U.S. law.¹²⁶

However, while companies issue digital tokens under the applicable safe harbors, the SEC's ability to regulate in this market is not settled. Former SEC Chair Mary Jo White distinguished virtual currencies as not necessarily being securities; she also stated that interest and returns could be subject to securities regulation. Well-publicized ICO offerings make up a much greater portion of ICOs than do Reg. CF digital tokens.¹²⁷ That being said, ICOs are being closely monitored by the SEC, the CFTC, and the FTC.¹²⁸ Reg. CF blockchain-based offerings on the other hand, are not monitored in the same way because companies file the required and periodic notices with the SEC, including disclosure documents that include the predictions of risk affiliated with the offerings.

The method by which digital tokens are offered and sold to investors varies in that the offerings "can take many different forms, and the rights and interests a coin is purported to provide the holder can vary."¹²⁹ Digital tokens can be offered to purchasers outside of the United States under Reg. S as long as the tokens do not flow back to the United States.¹³⁰ The digital tokens can be registered, offered, and sold to shareholders under Rule 144¹³¹ of the 1933 Act or under a safe harbor exemption (e.g. Reg. A, Reg. A+, Reg. D), as long as the company complies with the requirements of these alternatives.

¹²⁶ Press Release, Statement on Cryptocurrencies, *supra* note 124 ("On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities. I urge you to be guided by the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.").

¹²⁷ See *infra* Part I.C.

¹²⁸ See Rohr & Wright, *supra* note 21, at 465 (noting that "the Securities Exchange Commission ('SEC') and its counterparts in other jurisdictions have turned their attention to token sales").

¹²⁹ Press Release, Statement on Cryptocurrencies, *supra* note 124.

¹³⁰ See Rohr & Wright, *supra* note 21, at 508 n.226 (referencing Reg. S, 17 C.F.R. § 230.904 for offshore filings).

¹³¹ 17 C.F.R. § 230.144 (2018).

Since Reg. CF's inception, over 1,100 companies have offered over \$600 million of securities to investors under Reg. CF.¹³² These amounts represent a sizable expansion in investment crowdfunding under these agency rules and rebuts the notion that few would use the exemption.¹³³ A part of that growth is attributed to the surprising development of Reg. CF "digital token" or "blockchain-based token" offerings, which represent a newer type of investment contract, distinguishable and seemingly more complex than prior investment contracts offered under Reg. CF. These type of token offerings are proliferating and being sold to investors, growing at a greater pace than traditional investment crowdfunding securities offerings. If growth continues at this pace, these Reg. CF digital tokens will expand the type and quality of securities historically offered to investors.

Digital tokens are being offered and sold through both investment contracts under Reg. CF¹³⁴ and through registered ICOs.¹³⁵ ICOs represent a significant number of the tokens sold outside of Reg. CF digital tokens. However, digital tokens are also being offered and sold without registration, a method subject to enhanced scrutiny by the SEC and other state securities enforcement agencies.¹³⁶

¹³² Details about the companies and total amounts raised in investment crowdfunding campaigns are discussed *infra* Part I.C. The total offerings do not include any amounts offered or raised in ICOs nor any amounts raised under other available securities exemptions, such as Reg. A+ or Reg. D. Also, this figure does not represent success or failure in amounts actually raised under the campaign.

¹³³ Of the 1,112 filings, several duplications were removed from the data.

¹³⁴ See *infra* Part I.C.

¹³⁵ Not to be confused with registered ICOs, digital tokens offered under Reg. CF are offered and sold in transactions exempt from federal securities laws governing the registration of securities offerings. There are a variety of securities laws that still apply to Reg. CF filings, including disclosures about the companies, insider trading, and limitations on the transactions allowed (e.g., amount offered by the issuer is under \$1.07 million in any twelve-month period and small dollar amounts sold to investors). *Regulation Crowdfunding*, *supra* note 5. This Article seeks to address the scope and effect of token offering campaigns on companies and their investors and to provide recommendations as to how regulators may want to rethink Reg. CF investment crowdfunding in light of developments in Reg. CF token offerings.

¹³⁶ Brian Fung, *State Regulators Unveil Nationwide Crackdown On Suspicious Cryptocurrency Investment Schemes*, WASH. POST (May 21, 2018), https://www.washingtonpost.com/news/the-switch/wp/2018/05/21/state-regulators-unveil-nationwide-crackdown-on-suspicious-cryptocurrency-investment-schemes/?utm_term=.e342d426441b ("Securities regulators across the United States and Canada announced dozens of investigations . . . into potentially deceitful cryptocurrency investment products, the largest coordinated crackdown to date by state and provincial officials

Digital tokens are a more recent development in capital formation.¹³⁷ These offerings present yet another difference between crowdfunding and 1933 Act registered offerings. On the one hand, these digital token offerings are a novel and innovative solution for company capital formation that appears to be intriguing the public. In the short term, companies are beginning to raise money to grow their businesses, advance the business' mission, and satisfy the crowd's healthy appetite to invest. In that respect, investment crowdfunding via Reg. CF shows promising signs of being an innovative bridge towards the goal of capital formation. However, if issuing a token was as simple as providing a consumer good to an interested buyer, the story would be over. The coins might be located next to a comic book or beanie baby collection and no one would care. However, there is a variety to the characteristics of digital tokens. A digital token could be used as a functional utility used to consume a product or service, as an investment security with possible growth potential, or as a commodity like gold or silver.¹³⁸

It is important to note a few distinctions in ICO digital tokens and Reg. CF blockchain-based tokens. To put the two in perspective, one should first understand the varying volumes of the offering activity over the past few years. First, Rohr and Wright reported that in 2016 less than \$100 million in ICO digital tokens were sold, but by October 2017, that number grew to over \$3.7 billion.¹³⁹ Current estimates show that by March 2018, ICO digital tokens had continued to grow rapidly to \$11.3 billion, with a single \$1.7 billion transaction by a company named Telegram.¹⁴⁰ However, the top 100 cryptocurrencies sold

on Bitcoin scams The state agencies are also pursuing suspicious cases of initial coin offerings, or ICOs, a fundraising technique used by both legitimate and illegitimate cryptocurrency projects in ways that resemble initial public offerings of stock.”).

¹³⁷ See *infra* Part I.C; see also Knyazeva, *supra* note 42 (regarding Reg. A financing, Knyazeva states that as of October 31, 2016, prospective issuers had publicly filed offering statements for 147 Reg. A+ offerings, for \$2.6 billion in financing). Of the exempt filings, Reg. D offerings for 2016 had 23,292 offerings totaling over \$2 trillion dollars. See Jonathan Nieh, *Update on Regulation D: Data from 2016 Form D's*, CROWDFUND INSIDER (April 19, 2017), <https://www.crowdfundinsider.com/2017/04/97876-update-regulation-d-data-2016-form-ds/>.

¹³⁸ See *infra* Part I.C.

¹³⁹ See Rohr & Wright, *supra* note 21, at 465.

¹⁴⁰ David Floyd, *\$6.3 Billion: 2018 ICO Funding Has Passed 2017's Total*, COINDESK (April 19, 2018), <https://www.coindesk.com/6-3-billion-2018-ico-funding-already-outpaced-2017/> (noting that in just the first quarter of 2018, \$6.3 billion of ICO digital tokens were raised, representing 118% of the 2017 total of \$5 billion).

globally have a market capitalization of over \$208 billion, with Bitcoin having a market capitalization of \$112.7 billion in September 2018,¹⁴¹ which dropped to \$58 billion by December 6, 2018.¹⁴²

Growing rapidly, but at a lesser magnitude than ICO digital tokens, are Reg. CF digital tokens, which didn't begin selling at all until the fall of 2017.¹⁴³ The offerings then grew to \$22 million between November 2017 and June 30, 2018.¹⁴⁴ Relatively speaking, there is no real comparison with the global explosion that has taken place between ICO digital tokens and Reg. CF digital tokens. Reg. CF digital tokens are a small, but growing part of the token expansion. However, what distinguishes these offerings is that the Reg. CF investors are members of the public, not necessarily sophisticated investors.

To determine whether digital tokens offered under Reg. CF are investment contracts and thus, potentially securities, one would look to the *Howey* standard.¹⁴⁵ Under the *Howey* standard, whether there is an "investment contract" under the Securities Act depends on "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." In addition, the Court in *Howey* further clarified, "[i]f that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value."¹⁴⁶

Multiple federal and state agencies are pondering just how digital tokens should be classified and the extent to which agencies should regulate them. Historically, the 1933 Act has created private rights of action to aid the enforcement of obligations pertaining to securities offerings.¹⁴⁷ Towards that

¹⁴¹ COINMARKETCAP, <https://coinmarketcap.com/> (last visited on Feb. 20, 2019). *But cf.*, Kyle Torpey, *Comparing Bitcoin and Other Cryptocurrencies by 'Market Cap' Can Be Very Misleading*, FORBES (Dec. 29, 2017), <https://www.forbes.com/sites/ktorpey/2017/12/29/comparing-bitcoin-and-other-cryptocurrencies-by-market-cap-can-be-very-misleading/#62cbdb832509> ("Many cryptocurrency traders track the price of these digital assets on sites like CoinMarketCap.com, but the key metric that is most often used to compare these cryptocurrencies, market cap, can sometimes be misleading.").

¹⁴² *See Bitcoin*, YAHOO FINANCE, <https://finance.yahoo.com/quote/BTC-USD?p=BTC-USD> (last visited Feb. 20, 2019).

¹⁴³ *See infra* Part I.C.

¹⁴⁴ *See infra* Part I.C.

¹⁴⁵ SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

¹⁴⁶ *Id.*

¹⁴⁷ *See Cyan, Inc. v. Beaver Cty. Employees Ret. Fund*, 138 S. Ct. 1061, 1066 (2018).

end, the SEC has recently appointed Valerie A. Szczepanik to the SEC Division of Corporation Finance to oversee the securities laws and digital asset technologies.¹⁴⁸ Additionally, “[t]he Securities Exchange Act of 1934 . . . which regulates not the original issuance of securities but all their subsequent trading, is [] enforceable through private rights of action.”¹⁴⁹ The SEC is currently monitoring digital tokens as possible securities within the larger category of virtual currencies.¹⁵⁰ “Digital tokens . . . can represent units of value, which may make them look more like commodities[.]”¹⁵¹

Digital tokens have been distinguished from currency. In contrast, digital tokens as digital currency “do[] not have any legal tender status in any jurisdiction.”¹⁵² Bitcoin exemplifies this currency distinction: it is not considered a currency in the United States since it lacks the recognition by any state.¹⁵³

Brian Quintenz of the CFTC has spoken on the complexity of the classification of tokens:

However, just because a product is tokenized does not change its underlying qualities. For example, if Disney World were to tokenize the admissions to its theme parks, those tokens would still be tickets. Tokenizing the tickets does not make them

¹⁴⁸ See Press Release, U.S. Sec. and Exch. Comm’n, SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation (June 4, 2018), <https://www.sec.gov/news/press-release/2018-102>. Szczepanik’s new role is to “coordinate efforts across all SEC Divisions and Offices regarding the application of U.S. securities laws to emerging digital asset technologies and innovations, including Initial Coin Offerings and cryptocurrencies.” *Id.*

¹⁴⁹ *Cyan*, 138 S. Ct. at 1062. The Securities Exchange Act of 1934 is a law governing the secondary trading of securities (stocks, bonds, and debentures) in the United States. Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (2012).

¹⁵⁰ See Mokhtarian & Lindgren, *supra* note 116, at 116 n.10

¹⁵¹ See Baris & Klayman, *supra* note 18, at 70. The Internal Revenue Service defines currency as “the coin and paper money of the United States or any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance.” IRS NOTICE 2014-21, SECTION 2, INTERNAL REVENUE SERVICE, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf> (last visited April 9, 2019).

¹⁵² Dep’t of Treasury, FIN-2013-G001 (Mar. 18, 2018), <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

¹⁵³ Gregory M. Karch, *Bitcoin, the Law and Emerging Public Policy: Towards a 21st Century Regulatory Scheme*, 10 FLA. A & M U. L. REV. 193, 231 (2014); see also Lorena Yashira Gely-Rojas, Note, *Cryptocurrencies and the Uniform Commercial Code: The Curious Case of Bitcoin*, 8 U. OF P. R. BUS. L. J. 129, 132–34 (2017).

currencies and it does not make them securities. It makes them tickets. Similarly, tokenizing a security does not change the fact that it is a security.¹⁵⁴

Quintenz further explained why he thought there might be a frenzy around digital tokens:

As I postulated two days ago at the City Week conference in London, I see three main motivations for the broader tokenization revolution. One motivation for a company or entity to tokenize a product is purely as a marketing ploy—to take advantage of the popular and speculative mania surrounding all things “token.” . . . A second motivation to create a token is to enable and realize the efficiency of the blockchain construct in assigning and tracking ownership. This is having, and will continue to have, an impact on title transfer and settlement processes. Think of this as the back office tokenization revolution. Lastly, a third motivation is to utilize the transferability of tokens to create a secondary market for any and all non-tangible things—the eBay of Intangibles so to speak—for rights, services, permissions, etc., that the seller allows to be transferred between parties.¹⁵⁵

Because violations of § 5 may result in rescission, cautious companies proceed gingerly by filing under the Reg. CF exemption.¹⁵⁶ Commissioner Quintenz noted the transformative nature of coins in ICO transactions, stating that “[t]hey may start their life as a security from a capital-raising perspective but then at some point . . . turn into a commodity.”¹⁵⁷ The next

¹⁵⁴ Brian Quintenz, Commissioner, U.S. Commodity Futures Trading Comm’n, Remarks at the Eurofi High Level Seminar (Apr. 26, 2018), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz11>.

¹⁵⁵ *Id.* Commissioner Quintenz also complimented the secondary market development: “Empowering a secondary market’s price discovery and valuation functions for products that were previously untransferable—such as extra storage space on a home computer—is a fascinating development.” *Id.*

¹⁵⁶ Indeco, Offering Statement (Form C) (June 27, 2018). Indeco’s CEO explains why his company had enough concerns to proceed and file with the Securities Exchange Commission. He took the position that the token offering could be considered something other than a “utility” and more likely a “security.” *Id.* See also David Levine, *Indeco Launches First Token Pre-Sale Under SEC’s Regulation Crowdfunding Rules*, MEDIUM (Dec. 5, 2017), <https://medium.com/indeco/indeco-launches-first-token-pre-sale-under-secs-regulation-crowdfunding-rules-e82dad79345>.

¹⁵⁷ Lukas Schor, *Explaining The “Simple Agreement for Future Tokens” Framework*, MEDIUM (Nov. 29, 2017), <https://medium.com/@argongroup/explaining-the-simple-agreement-for-future-tokens-framework-15d5e7543323> (describing Commissioner Quintenz’ statement as “probably the most specific comment by the Commodity Futures Trading Commission regarding the classification of ICO’s and shows quite well the bipolar nature of many tokens”).

Section discusses the rationale and methodology for this research study and what can be learned from investment crowdfunding data.

The growth of digital tokens in Reg. CF offerings raises three troubling concerns. First, Reg. CF digital tokens are showing a greater momentum than other Reg. CF offerings. As digital tokens could have different characteristics, an investor would need to review the particular description very closely. Consider Rohr and Wright's argument that tokens lack "homogeneity."¹⁵⁸ Query, what then are investors purchasing? Moreover, as digital tokens are being sold to investors to finance unbuilt technological funding portals and services for future ICO transactions, Reg. CF investors are taking the greatest risks of loss. These unsophisticated and non-accredited investors are subject to a set of different investor qualifications and resale restrictions than purchasers ICO transactions, which are closely monitored by the SEC. This is not the case with digital token offerings under Reg. CF.

Second, the company disclosures contain the standard legend and the risks of investing in these type of transactions:

A crowdfunding investment involves risk. An investor should not invest any funds in this [o]ffering unless he or she can afford to lose his or her entire investment. In making an investment decision, investors must rely on their own examination of the [i]ssuer and the terms of the [o]ffering, including the merits and risks involved . . . The securities have not been recommended or approved by any federal or state securities commission or regulatory authority. Furthermore, these authorities have not passed upon the accuracy or adequacy of this document. The [SEC] does not pass upon the merits of any [s]ecurities offered or the terms of the [o]ffering, nor does it pass upon the accuracy or completeness of any offering document or literature . . . These Securities are offered under the 4(a)(6) Exemption; however, the SEC has not made an independent determination that the [s]ecurities are exempt from registration.¹⁵⁹

¹⁵⁸ See Rohr & Wright, *supra* note 21, at 463.

¹⁵⁹ See Pokeology, Crowdfunding Offering Statement, NEXTSEED, at 14 (Nov. 2017), <https://www.sec.gov/Archives/edgar/data/1720051/000172005117000001/document1.pdf>.

Other Reg. CF offerings go further, outlining some of the risks of investing in blockchain-based tokens:

The chain code concept, the underlying software application and software platform . . . is still in an early development stage and unproven. There is no warranty or assurance that the process for creating [] Tokens will be uninterrupted or error-free and there is an inherent risk that the software could contain defects, vulnerabilities, weaknesses, bugs or viruses causing the complete loss of [] contributions and/or [] Tokens. Additionally, there are other risks associated with the acquisition, storage, transfer and use of [] Tokens, including those that . . . may not be [anticipated]. Such risks may further materialize as unanticipated variations or combinations of the risks.¹⁶⁰

The research begs the question, why, after reading these disclaimers, would anyone invest in digital token offerings? If the blockchain token concept does not materialize, it is likely that the companies seeking to use them will not have adequate funding to repay the obligation and the investors may lose all or a portion of their investment.

Third, the SEC needs to rethink how to advise unsophisticated investors, who may not have an income to fall back on if the investment fails, as do accredited investors.¹⁶¹ It is uncertain whether the underlying premise for the offerings will create a framework for “digital assets used in connection with decentralized services, applications, and communities.”¹⁶² As promising as these offerings may be, digital tokens are fundamentally based on a theoretical idea.

While federal agencies and the courts sort out their respective roles in regulating cryptocurrencies,¹⁶³ there is a quiet digital token revolution occurring within smaller Reg. CF campaigns.

¹⁶⁰ *TrustaBit, Blockchain for Delayed Flights*, at 24, <https://trustabit.io/wp-content/uploads/2017/11/TrustaBit-final.pdf>.

¹⁶¹ Another common disclaimer in offering memoranda of Reg. CF offerings is “[a] crowdfunding investment involves risk. An investor should not invest any funds in this Offering unless he or she can afford to lose his or her entire investment.” See *Pokeology*, *supra* note 159, at 14.

¹⁶² Juan Batiz-Benet et al., *The SAFT Project: Toward a Compliant Token Sale Framework*, PROTOCOL LABS, at 1 (Oct. 2, 2017), <https://saftproject.com/static/SAFT-Project-Whitepaper.pdf>.

¹⁶³ There are a variety of proposals regarding how each agency could consider regulating, however that is not the subject this Article. The Author does take the position that it is time for Congress to recognize that digital currencies are blooming in the United States and globally. Congressional clarity on the digital currencies would be useful.

B. *Digital Token Research and Summary of Findings*

1. Rationale and Methodology for Research Study

There is an ongoing need for federal and state agencies, companies, and investors, to analyze available data to assess the current state of capital formation and employment under this new regulation. A better understanding of the offerings and transactions that have transpired over the past several years would provide a template for future successful offerings, better investor protection, and better crafted regulatory policies aimed at accomplishing the normative goals of the regulations. This Section explains the methodology behind the research project.

This research study sought to determine if the impacts of Reg. CF regulations have been worthy of lament or applause. To determine those effects, we turn to researching the available data. After undertaking a review of the prior SEC Edgar Data, this Article provides information, findings, and analysis relating to Reg. CF campaigns in the United States.¹⁶⁴ Researchers for this Article retrieved and reviewed 1,112 SEC Form C notice filings and other SEC filings completed by companies from Reg. CF's adoption date through June 30, 2018.

From May 2016 through June 30, 2018, companies filed 1,112 Form C notice filings in Reg. CF transactions,¹⁶⁵ offering over \$600 million of securities to investors. These Form C filings provide critical data about the companies that seek to offer equity, debt, and investment contracts, the funding portals that provide the portal structure, and the transactions that are offered to the crowd of potential investors.

A proactive monitoring of data can illustrate the growth, success, and failures of companies. This would be valuable information to help policy makers continue to accurately set state and federal policy designed to enhance innovation nationwide as well as protect investors.¹⁶⁶ This research provides insights on what has transpired since the adoption of Reg. CF. Further, this

¹⁶⁴ See Form C., *supra* note 12.

¹⁶⁵ Of the 1,112 Form C filings, several were excluded because of duplication, a subsequent withdrawal of the filing, or a request filed as a Form C, but merely an extension of the timeframes.

¹⁶⁶ *E.g.*, Parsont, *supra* note 24, at 341 (recommending that the SEC generate empirical data and conduct a special study on capital-raising impediments and investor protection).

Article analyzes the crowdfunding marketplace and highlights emerging developments and trends, along with insights on Reg. CF's impact on innovation.

The data included digitally filed responses to the following questions:

1. *Company Demographics*: Describe the names, incorporation location and principal office of companies registering investment offerings under the Crowdfunding Act.¹⁶⁷
2. *Offering Details*: Type of security; Target offering; Minimum offering and maximum offering; Data to quantify the amount of securities offered per period and over time.
3. *Funding Portal Details*: Description of the name of the funding portal or self-funder for each offering and the compensation terms.
4. *Employee Details*: The number of employees the company disclosed on Form C.
5. *Aggregate Amount*: of capital sought by companies disclosed on Form C.

There are limits to the data collection from the SEC Edgar database. First, data on Edgar does not include unregistered investment crowdfunding campaigns. Unregistered campaigns could stem from other allowed securities transactions exempt under other sections of the Securities laws, such as ICOs, IPOs, or other Reg. D and 33 Act filings. Alternatively, the securities may not register because the transaction is exempt under a state-level intrastate crowdfunding exemption. There could conceivably be campaigns that companies are choosing not to register anywhere for various ill-advised reasons. Also, several foreign registrants with principal offices located in the United States are not included in the choice of entity location data.

The research in this Article differs from earlier work in that it was not seeking to assess the success or failure of any particular offerings, the totality of the success of the offerings, or to make a prediction about whether scholars could call this crowdfunding investment era a success. Rather, the intention was to frame what we can infer about the scope of investment crowdfunding and to provide insights about the information

¹⁶⁷ Additionally, for each company, the Central Index Key ("CIK") was also noted. The CIK is a unique, public number that is assigned to each entity that submits filings to the SEC. Use of the CIK allows the SEC to differentiate between filing entities with similar names.

retrieved.¹⁶⁸ To that end, evaluation of the data provides insights on: (1) investment crowdfunding's momentum; (2) the companies that had sought capital from investors; (3) the intermediation of the securities/transactions; and (4) geographical scope, choice of entity and notable inferences about the type of securities that were offered to investors. As mentioned before, since digital tokens were noted, more detail was provided on these securities.

2. Definition of Success

Accomplishing the normative goals of job creation, access to capital, inclusion, and efficiency, would generally be thought of as a success under Reg. CF. However, more research, over time, is needed to determine whether the regulations have succeeded in goal attainment. For purposes of this research project, this Article defines success by three measures—company engagement, the amount of capital actually raised, and the investors successfully obtaining a positive return on their investment. The level of company engagement in offering capital under Reg. CF is important because if companies are not utilizing this safe harbor exemption then it is obsolete and serves no purpose. If they are turning to this form of investment crowdfunding, then at least they are engaging. Another successful outcome would be for these companies to raise capital and put that capital to use to create jobs and undertake their operations. If shareholders are not receptive to company offerings, then again, the regulations are of no utility. Also, it is as important that investors are successful, which is defined as the likelihood of a positive return on investment.

In addition to the number of companies participating and the level of the transactions, the number of funding portals would provide insights about the developing story of investment crowdfunding. If many companies wanted to seek capital through Reg. CF, but there were no funding portals to help them accomplish the objective, we would be discussing the dreams and hopes of what Reg. CF could be. However, funding portals provide a separate story, as further discussed below.

¹⁶⁸ Within scope, one might assess risks and rewards. However, the results of many of the campaigns are still ongoing. Thus, assessing the risks and rewards could be the subject of a future article.

3. Summary of the Findings

a. *Momentum in Investment Crowdfunding*

There is an overlap in the recent discussions about emerging FinTech and its effect on legal theory and society. FinTech-enabled transactions include tools of contracting and commerce.¹⁶⁹ Consequently, it is hard to imagine that investment crowdfunding on internet funding portals would not be considered within that definition or an expansion of that definition. There is much to be learned about the funding portals that are provided for the companies to raise money and their role in educating investors about transactions.

By analyzing SEC Edgar data concerning the funding portals that provide the internet funding portals for the securities, new revelations and inferences are possible. The Form C filings reveal which funding portal is hosting the offering and their respective costs of doing the transactions. Also, the data illustrates the level of a funding portal's choice in the type of transactions a funding portal may choose to support. Professor Schwartz's distinctions drawn between the United States and New Zealand undergird the tension between efficiency versus inclusion.¹⁷⁰ The data hint at levels of influence that may minimize inclusion in investment crowdfunding while enhancing efficiencies for the funding portal. Further, the analysis also provides data about the funding portal's choice of company transactions around the country.

Data is provided on the funding portals and their intermediation. One trend noted is towards efficiency, as fewer funding portals handle a greater portion of the transactions. At the same time, as investment crowdfunding campaigns are growing, there are also more funding portals responsible for doing a few transactions. The investment crowdfunding geographic concentrations and dispersal are noted by Professor Magnuson as a form of "diffusion" in the FinTech Markets.¹⁷¹ Magnuson argues that FinTech has "defied [the] conventional

¹⁶⁹ Christopher G. Bradley, *Fintech's Double Edges*, 93 CHI.-KENT L. REV. 61, 77 (2018) (arguing that FinTech has a broad definition and is divided into three types, especially in the consumer area: efficient information gathering and monitoring; tools of contracting and commerce; and enforcement and dispute resolution tools).

¹⁷⁰ See generally Schwartz, *supra* note 14, at 885–86.

¹⁷¹ William J. Magnuson, *Financial Regulation in the Bitcoin Era*, 23 STAN. J. L. BUS. AND FIN. 159, 163.

understanding” of concentration of financial markets.¹⁷² In FinTech markets, the players have “smaller sections of the market, focus on narrow industry areas, and often are made up of a number of nimble start-ups . . . or even computer servers.”¹⁷³ From the data collected, between 2017 and 2018, funding portals have increasing concentrations of deals, while at the same time, there are more funding portals that are hosting a greater number of the campaigns. A future research project could evaluate the role and impact of this level of funding portal concentration and dispersion on business capital formation.

Reg. CF digital token offerings sold to investors are growing at a greater pace than traditional investment crowdfunding securities offerings. If the growth continues at this pace, these Reg. CF digital tokens will expand the type and quality of securities historically offered to investors. The Reg. CF digital tokens are also disrupting the investment marketplace, as these initial transactions are a leverage to other, future ICOs. This development may provide both potentially positive and negative disruptive qualities to the investment marketplace depending on the success of blockchain technology.

Despite the market’s infancy, findings suggest that investment crowdfunding has enjoyed sustained momentum. There is greater breadth in the number of companies performing these publicly offered crowdfunding campaigns. Campaigns can be measured by the increasing numbers of company principal office locations throughout the country, increasing amounts and types of securities offerings, and increasing variety in the companies that are participating. Since Reg. CF’s inception, over 1,100 companies have offered over \$600 million of securities to investors under Reg. CF. These amounts represent a sizable expansion in investment crowdfunding under these regulations, which rebuts the notion that few would use the exemption.

b. Securities and Digital Token Risk

Investors have had the opportunity to invest in a variety of companies’ securities offerings. Investors in Reg. CF offerings need not be accredited, wealthy, or financially sophisticated,¹⁷⁴ to

¹⁷² *Id.* at 168.

¹⁷³ *Id.* at 166.

¹⁷⁴ *Informed Investor Advisory: Crowdfunding*, N. AMERICAN SEC. ADMIN. ASS’N, (July 24, 2018), <http://www.nasaa.org/12842/informed-investor-advisory-crowdfunding/> (last visited Feb. 21, 2019).

participate in these transactions. Investors can invest amounts ranging from \$2,000 to \$107,000 in a twelve-month period depending on their income and net worth.¹⁷⁵ Securities offerings have ranged from traditional, common, and preferred stock offerings, to less traditional options like convertible debt, membership, and partnership units, investment contracts, and digital tokens. The SEC considers crowdfunding investments as exempt from registration, and the securities have resale restrictions that raise liquidity issues.¹⁷⁶

The type of securities that investors may buy from company crowdfunding campaigns and the risks that may flow from these agreements are important lines of legal research. Legal inquiry into business transactions is different from business inquiry regarding the transactions. In a business inquiry, one would want to know whether the company has good fundamentals,¹⁷⁷ whether it is a good business risk, and whether the market conditions are right for this particular type of venture so that the investor can receive a return on his or her investment. But evaluating the text of securities and investment contracts in order to determine legality and risk is the realm of securities lawyers and tax professionals.

There is a level of uncertainty and risk with a company offering digital tokens phrasing their offerings in the blockchain for both the company and the investor. The classification of these type of securities is unsettled with questions as to whether the digital tokens are securities, commodities, or utilities. This leads to concerns about actual investment outcomes for the investors who range from the sophisticated to the unsophisticated, and from the accredited to the non-accredited. In Form C filings, companies are required to identify risks that are specific to the business and its financial condition.¹⁷⁸ Generally, companies disclose language relating to risks of an

¹⁷⁵ *Id.* Hypothetically, an investor could invest \$0.25 or larger dollar amounts offered by issuers. Most deals have larger entry points for investment. For example, although a share may cost \$0.25 per share, a minimum contribution might be 100 shares, resulting in a \$25 investment.

¹⁷⁶ Securities Exchange Act of 1934, 15 U.S.C. § 77d(a)(6) (2012). *See also* Regulation Crowdfunding Release Nos. 33-9974, U.S. SEC. & EXCHANGE COMM'N, <https://www.sec.gov/rules/final/2015/33-9974.pdf> (last visited Oct. 28, 2018).

¹⁷⁷ Business fundamentals might include: due diligence regarding the proof of concept, a viable business plan, the leadership and human resources, the finances and profitability, the product/service, promotion, and the place.

¹⁷⁸ Form C, *supra* note 12.

economic downturn, political events, and technological developments (such as hacking and the ability or inability to prevent hacking).¹⁷⁹ Enhanced risks for early-stage companies that are greater than the typical risk of a startup, are another cause for concern.¹⁸⁰

There are a variety of other types of information that are retrievable from the data, including geographical data, choice of entity, and principal office locations. Only a brief summary of the data concerning geographic location of all investment crowdfunding transactions is included in this Article. The scope of the geographical investment crowdfunding data may have broader implications regarding the reasons why capital blackouts in certain areas around the country are occurring. Also, jurisdiction and principal office location is a robust topic, which also can be covered in a broader research paper.

c. Company Choice of Entity and Principal Offices

This research study did not retrieve incorporation or organizational documents. However, what is apparent from the Form C notice filings is that a larger concentration of companies selected Delaware as the preferred choice of entity than in 2016.¹⁸¹ Choice of entity provides context to the law applying to “the scope of directors’ fiduciary duties, permissible charter and bylaw terms, and shareholder voting rights,” which are considerations “controlled by the law of the state of incorporation, regardless of whether the corporation has any real economic ties to that location.”¹⁸² Empirical work on choice of entity also can “illuminate how parties actually behave” and how the “parties

¹⁷⁹ See, e.g., Mobile Spike, Form C Disclosure Questionnaire (Form C) (May 17, 2016), <https://www.sec.gov/Archives/edgar/data/1674319/000167431916000003/mobilespikeformc.pdf>.

¹⁸⁰ See Patrick McCarney, Note, *False Start: Carving a Niche for Established Small Business Participation in Regulation Crowdfunding Rules Designed for Startups*, 51 IND. L. REV. 277, 296 (2018).

¹⁸¹ See *infra* Part I.C. More research would be needed to determine the reasons for this flight to Delaware. It could be a function of larger deals, herd behavior, or other legal, business, and tax considerations. See also Magnuson, *supra* note 171, at 178 (explaining reasons for herd behavior in FinTech markets). “This may occur in several different ways, but perhaps the simplest involves computer programs sharing certain programming templates. If an algorithm proves successful in the market, other actors may be tempted to simply copy or replicate the algorithm.” *Id.*

¹⁸² Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583, 597 (2016).

would be likely to behave in response to legal rules.”¹⁸³ Professor Cherry notes that corporations engage in races to the bottom, not only in selecting the jurisdiction of incorporation that will govern their internal corporate affairs, but in labor and regulatory considerations as well.¹⁸⁴

In the context of digital coin disputes, choice of entity will likely be an important jurisdictional question. Recently, the United States Supreme Court’s decision in *Cyan v. Beaver County Employees Retirement Fund*, permitted some claims under the 1933 Act to be brought in state courts (as well as federal courts).¹⁸⁵ The private bar has predicted that there will be a surge in state court actions asserting that ICOs contain materially false information.¹⁸⁶ A federal judge in the Northern District of California recently cited *Cyan*.¹⁸⁷ These decisions provide state courts with some precedent to proceed on a variety of claims brought by civil litigators, including claims under Rule 10b-5.¹⁸⁸ Companies offering securities under Reg. CF are not exempt from these securities law provisions, even though the transactions are smaller in size. Consequently, there is a growing preference toward a Delaware incorporation. Last, the Reg. CF offerings are mostly concentrated as common stock, simple agreements for equity, and convertible debt offerings, with an emerging trend in digital tokens.

¹⁸³ Kyle Chen et al., *Empirical Study Redux on Choice of Law and Forum in M&A: The Data and its Limits*, 16 J. BUS. & SEC. L. 1, 31–32 (2016).

¹⁸⁴ Miriam A. Cherry, *A Taxonomy of Virtual Work*, 45 GA. L. REV. 951, 960–61 (2011).

¹⁸⁵ 138 S. Ct. 1061, 1069 (2018).

¹⁸⁶ Nicolas Morgan et al., *ICO Battlefields Proliferate: Preparing for Private Litigation and Regulation Now*, THE RECORDER (Apr. 27, 2018), <https://www.law.com/therecorder/2018/04/27/ico-battlefields-proliferate-preparing-for-private-litigation-and-regulation-now/?slreturn=20180813122201> (noting the role of the private bar to “flesh out the application of long-standing legal concepts to the novel issues raised”). See, e.g., Class Action Complaint, *Wildes v. Bitconnect International PLC*, No. 18-cv-80086-DMM, 2018 WL 4864836 (S.D. Fla. Jan. 24, 2018).

¹⁸⁷ *Baker v. Dynamic Ledger Solutions*, No. 17-cv-06850-RS, 2018 WL 656012 (N.D. Cal. 2018).

¹⁸⁸ Morgan et. al, *supra* note 186, at 4 (“[T]he *Cyan* ruling not only gives plaintiffs a choice of forums in Securities Act claims, but potentially allows for multiple concurrent actions regarding the same ICO—an outcome that not only leads to the potential of inconsistent rulings, but certainly will increase the cost of defending this type of litigation.”).

d. Investment Crowdfunding Generally

Studying the Reg. CF parties, funding portals, and offerings, provides a better understanding of whether the normative goals set forth by the Crowdfund Act have been attained. When we consider what the data means, the conversation quickly becomes normative. Is Reg. CF the best way for companies to form capital? Is there a better way to create jobs than this current investment crowdfunding framework? To the extent the data defies our thinking about what is happening in investment crowdfunding markets, without more research, we will not be able to know for sure whether the positive story is as good as it gets, because these small companies could not raise any more money than they did under Reg. CF. Alternatively, is the negative story (i.e. not raising more capital through Reg. CF) merely the flip side of a positive story because companies not using Reg. CF found other alternative financing opportunities to their capital needs?

The next Section provides additional details about the data.

C. Shedding Light on Data

There appears to be a limited benefit in Reg. CF offerings, which is illustrated in the next Section. What we know is that investors have historically been able to invest in large enterprises and those investments have produced both social and economic benefits (and losses) for the companies and the shareholders. That data is highlighted daily with disclosures to the SEC, and articles in the Wall Street Journal, New York Times, Forbes, and Barron's. Further, what we also know is that accredited and sophisticated investors have been able to invest in companies that file under a variety of safe harbor exemptions and under the 1933 Act but startups still have trouble raising capital. Companies that have these investors available to them could tap into other safe harbor exemptions and file under Reg. A or Reg. D.

Consequently, it appears that the major benefit of Reg. CF investment crowdfunding is to provide a place where companies can reach into the general public of unsophisticated or unaccredited investors. If these companies had access to sophisticated or accredited investors, they likely would file under another safe harbor exemption. The fact that the general public is solicited is one reason that regulators should evaluate what is actually being offered to investors.

1. Quantum Thought?

There is quantitative data and then there is the meaning that we assert about the data. After reviewing the data, Nick Szabo's idea to simultaneously consider mutually contradictory possibilities allows for skepticism in analyzing the data. Szabo states:

[Q]uantum thought, as I call it—although it already has a traditional name less recognizable to the modern ear, scholastic thought—demands that we simultaneously consider often mutually contradictory possibilities.¹⁸⁹

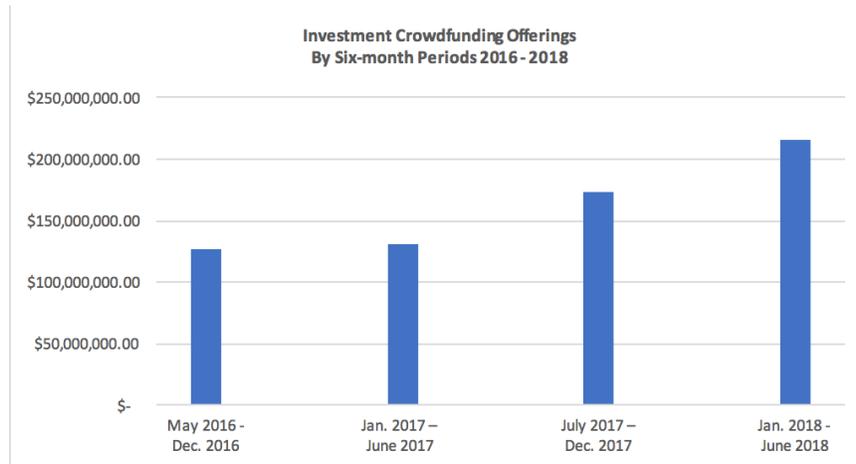
The next portion of this Article sets forth the data of the study. The terms that apply to them might vary depending on the party interpreting the data. Is the idea that over \$600 million was offered under Reg. CF a cause to celebrate or does it show that Reg. CF offerings pale in comparison to the broader ICO or IPO markets? When we look at the growth progression of digital tokens, we could hypothesize that there is a 500% growth in digital token offerings, year over year. Yet, the total aggregate numbers of digital token offerings remain small in comparison to investment crowdfunding generally or the larger ICOs. The same reasoning could be applied to the data that relates to the progress of funding portals throughout the country. Arguably, more funding portals are developing across the nation. However, there are pockets where there are no funding portals and some funding portals primarily offer digital tokens, which may or may not be the best investment for unsophisticated investors. Thus, normative claims about what is happening are reserved for more study and a better understanding that will come with time.

Below are a series of charts that capture the data from the research study:

¹⁸⁹ Nick Szabo, *More Short Takes*, UNENUMERATED (July 1, 2012, 10:47 PM), <http://unenumerated.blogspot.com/2012/07/more-short-takes.html>. Tom Robertshaw states that to practice quantum thought, one is reminded that “no matter how confident we are, we should be the first to question our own point of view” and affirming statements of Nick Szabo, “we can be both for and against a proposition because we can be ‘considering at least two significantly possible but inconsistent hypotheses, or because we favour some parts of a set of ideas but not others.’” *Practicing Quantum Thought*, TOM ROBERTSHAW (Aug. 14, 2017), <https://tomrobertshaw.net/2017/08/practicing-quantum-thought/>.

FINDING A1: ESTIMATED \$600 MILLION INVESTMENT CROWDFUNDING OFFERINGS 2016-2018

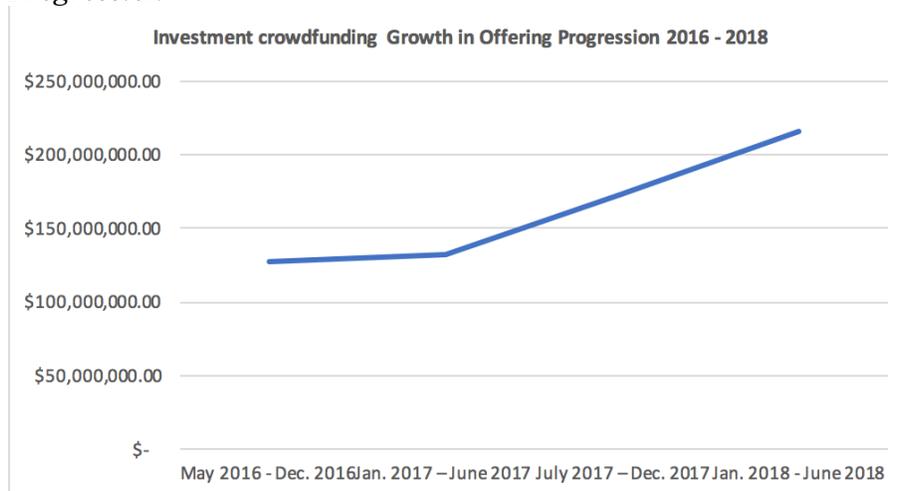
Chart 1 – Investment Crowdfunding All Reg. CF Offerings 2016 – 2018



May-Dec 2016 - \$126.98 Million; Jan-June 2017 - \$131.6 Million; July-Dec 2017 - \$173.36 Million; Jan-June 2018 - \$215.5 Million

FINDING A2: GROWTH PROGRESSION NOTED IN 2017

Chart 2 – Investment Crowdfunding Reg. CF 2016-2018 Growth Progression



May-Dec 2016 - \$126.98 Million; Jan-June 2017 - \$131.6 Million; July-Dec 2017 - \$173.36 Million; Jan-June 2018 - \$215.5 Million

FINDING A3: BY 2018, DELAWARE AS CHOICE OF ENTITY PREFERRED

Chart 3 – 2018 Company Choice of Entity compared to 2016 Choice of Entity

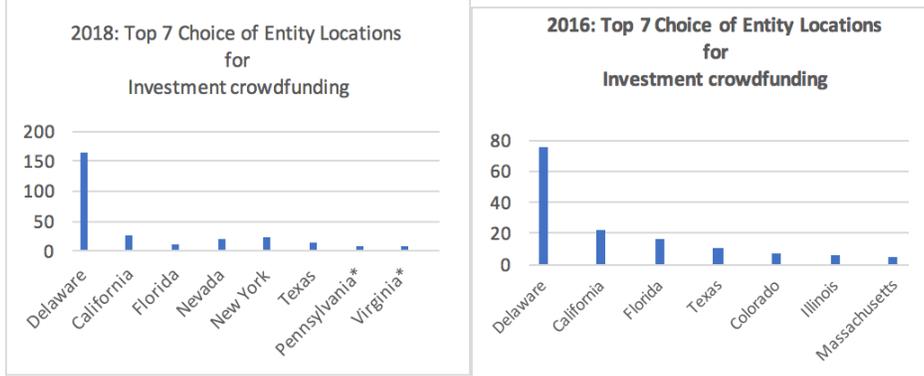
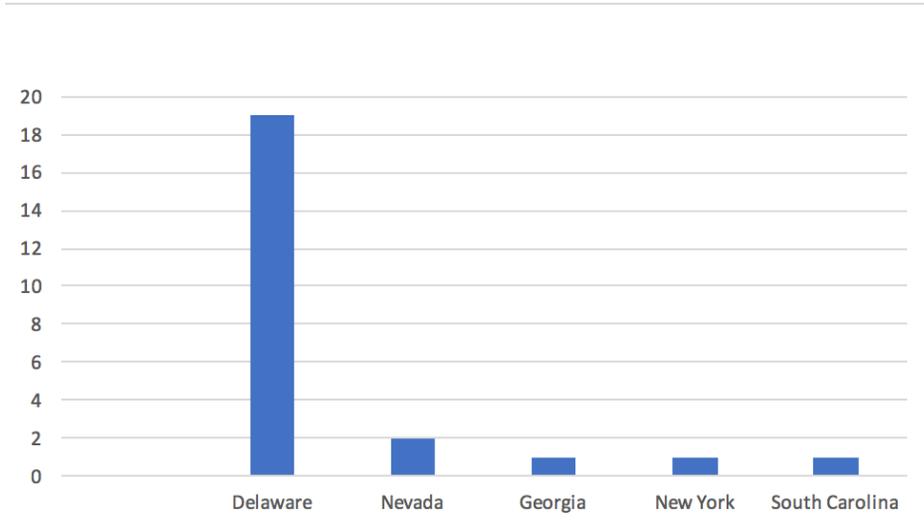


Chart: *Pennsylvania and Virginia were tied for 7th place

FINDING A4: DELAWARE PREFERRED AS THE CHOICE OF ENTITY FOR DIGITAL TOKEN OFFERINGS

Chart 4 – 2018 Company Choice of Entity for Digital Token Offerings



2. From SAFE to Blockchain-Based Digital Tokens

In this section, we explore how digital tokens have been characterized in the Reg. CF offerings between 2016 and 2018 and the scope of the offerings.

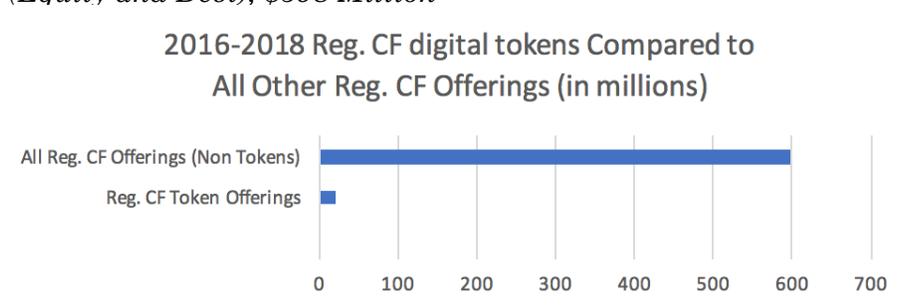
Companies included over \$22 million of Reg. CF securities offerings with tokens in investment crowdfunding offerings beginning in November 2017 through June 2018. These new digital token investment contracts have increased by 500% starting in 2017 to 2018. Considering there were no Reg. CF digital tokens in 2016, they have increased 2000% since 2016.

It is important to note that the vast number of digital tokens offered throughout the United States are not offered under Reg. CF. There is a larger spectrum of all Reg. CF campaigns, in comparison to ICO campaigns. Reg. CF digital token transactions remain a small, albeit important, slice of capital raising. To better understand this point, it is best to view the spectrum graphically. Between 2016 and 2018, companies sought to raise over \$615 million under Reg. CF—of that amount, \$22.2 million related to digital tokens. Estimates graphically illustrate that digital tokens currently are less than 3% of total Reg. CF offerings.

a. Growth of Digital Tokens in Reg. CF

FINDING B1: REG. CF TOKENS OFFERINGS SMALL IN COMPARISON TO ALL REG. CF INVESTMENT CROWDFUNDING OFFERINGS

Chart 5 – All Reg. CF Offerings, \$615 Million; Digital Token Offerings, \$22.2 Million; and All Other Reg. CF Campaigns (Equity and Debt), \$598 Million

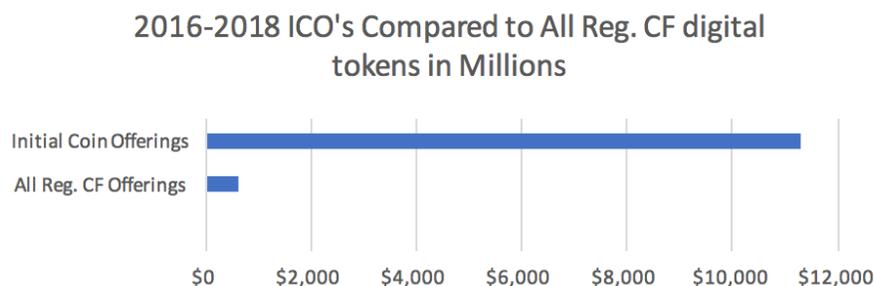


Also, to understand the context of Reg. CF digital token offerings in comparison to ICOs, the next graph illustrates that the aggregate dollar amount of Reg. CF digital token offerings is

exceedingly small compared to the aggregate dollar amount of ICO offerings. In fact, Reg. CF digital tokens, representing over \$22 million in offerings, are less than .2% of total coin offerings.

**FINDING B2: REG. CF TOKENS OFFERINGS SMALL
IN COMPARISON TO ICO OFFERINGS OF
\$11.3 BILLION**

Chart 6 – Composite of estimated coin offerings, including ICO's (\$11.3 Billion), All Reg. CF offerings (\$620 Million) of which digital token offerings (\$22.2 Million) – Comparison



Considering this context, digital token offerings under Reg. CF could be considered small in comparison to the movement currently happening with ICOs. These small digital tokens are providing early-stage companies capital to launch later stage transactions.

During the first half of 2018, over \$16.9 million of securities were offered with digital assets tied to blockchain, otherwise described as Reg. CF digital tokens. For the six-month period in 2018, there is a developing second phase of investment contracts. In the first phase, investment crowdfunding transactions included SAFEs and revenue-sharing instruments,¹⁹⁰ giving investors the right to future shares in a company. However, the company may never receive a future equity financing or elect to convert the securities upon such future financing. In addition, the company may never undergo a liquidity event such as a sale of the company or an IPO. If neither the conversion of the

¹⁹⁰ See Wroldsen, *supra*, note 6, at 555, 569–70, 573–76 (discussing the offering of revenue-sharing and SAFE instruments under Reg. CF); *see also* Heminway, *supra* note 13, at 7.

securities nor a liquidity event occurs, the purchasers could be left holding the securities in perpetuity as long as the company is in business. The securities have numerous transfer restrictions and will likely be highly illiquid, with no secondary market in which to sell them. The securities are not equity interests, have no ownership rights, have no rights to the company's assets or profits, and have no voting rights or ability to direct the company or its actions. If someone invests, he or she is betting that the company will be worth more in the future.

It should be noted that many offerings are still in progress. In Chart 7, the Author provides data as to the date and maximum amount of the offering; the capital raised as of November 30, 2018, the name of the company and the digital token offered; and the company principal office location and the choice of entity location.

**FINDING B3: DIGITAL TOKEN OFFERINGS
GROWING MORE RAPIDLY IN 2018**

Chart 7 – Reg. CF digital tokens offerings¹⁹¹

Amount of 2018 Offerings	Capital Raised by Nov. 30, 2018	Form Filings (C/A and C-W)	Name of Company and Digital Token	Dates of Token Offering (2018)	Entity Choice / Principal Office
\$ 898,000	\$171,287.00	Form C/A – Extended until 2018.Oct2	Indeco Financial Syndicate Inc's <i>Debt Until Securities Token Offering (DUSTO)</i>	Jun. 28	Del./Va.
\$1,070,000	-	Form C/A- Extended until 5/30/ 2019 Reg. A Filed for \$20 Million 2018.Aug8	Item Banc Inc.'s <i>IBE Tokens (IBE)</i>	Jun. 18	S.C./S.C.
\$1,069,999	\$94,166.40	Form C/A- Extended until 2018.Sept5	Dashing Corp., Inc's <i>Dashing Tokens</i>	Jun. 6	Del./Or.
\$1,070,000	\$10,388.00	Form C/A- Extended until 2018.Dec31	Test Foundation, Inc.'s <i>Token Debt Payable by Assets</i>	May 31	Del./Cal.
\$1,070,000	0*	Withdrawn* Form C-W Filed	Access Network Labs, Inc. <i>Token Debt Payable by Assets</i>	May 30	Del./N.Y.

¹⁹¹ This listing of information does not include debt offerings of companies that are not offering tokens in the original offer. *See, e.g.*, Blockstack Token, LLC offering \$1.07 million on March 1, 2018 to raise capital with a debt offering; a target of \$200k at \$1 price. Reg. CF Form C. Also, Unico Blockchain Inc., which is offering class B non-voting common stock at \$10 per share, with a minimum target offering of \$10,000 and a maximum offering of \$80,000. Additional information regarding the actual capital raised was retrieved from the Startengine website for Indeco, *Indeco: Offering a Crypto Asset That Fuels a Cleaner Economy*, STARTENGINE, <https://www.startengine.com/indeco> (last visited Feb. 21, 2018), and Witnet. *See Witnet*, REPUBLIC, <https://republic.co/witnet> (last visited Feb. 21, 2019).

\$1,070,000	\$16,581.00	Form C/A - Extended until 10/29/2018	TrustaBit, LLC's <i>TAB Tokens</i>	May 29	Del./Cal.
\$107,000	\$22,290.00*	Withdrawn* Form C-W Filed	Time Token, Inc.'s <i>Preferred Equity Time (PET) Tokens</i>	May 23	Del./Ariz.
\$1,070,000	\$118,200.00	Form C/A- Extended until 10/29/2018	CEN, Inc.'s <i>Basic Intelligence (BIT) Tokens</i>	May 15	Del./Cal.
\$1,070,000	-	Form C/A- Extended	EventJoin, Inc.'s <i>SAB Tokens</i>	May 11	Del./Cal.
\$1,070,000	\$29,800.00	Form C/A- Extended until 2019.Feb4	JWL Com, Inc. <i>JWL Coins</i>	May 4	DE/Cal.
\$1,070,000	\$122,487.00	Form C/A- Extended until 2018.Aug21	Citizen Health Project, Inc.'s <i>MEDEX or MDX Tokens</i>	Apr. 24	Del./Miss.
\$1,070,000	10,866.00	n/a	One Sphera Inc. <i>CC Tokens</i>	Apr. 20	Nev./Nev.
\$1,070,000	\$157,234	Form C/A- Extended until 2018.Dec31	GeoPulse Exploration, Inc.'s <i>CannCoin Tokens</i>	Apr. 20	Nev./Nev.
\$107,000	-	n/a	Fullmeta Corp.'s <i>META Tokens</i>	Apr. 20	Del./Utah

\$106,998	\$11,342.52*	Withdrawn* Form C-W Filed	FrToken, Inc.'s <i>CHIKN Tokens</i>	Apr. 20	Del./N.M.
\$1,070,000	\$80,141.00	Form C/A- Extended until 2018.Nov3	Erndo, Inc.'s <i>Violet Tokens</i>	Apr. 20	Del./Del.
\$1,000,000	\$15,550.00	Form C/A- Extended until 2018.Sept18	Supporter Inc.'s <i>SP Tokens</i>	Apr. 19	Ga./Ga.
\$1,070,000	\$152,741.00	Form C/A- Extended until 2018.Sept10	MintHealth, Inc.'s <i>Mintheath Tokens</i>	Apr. 19	Del./Cal.
\$107,000	\$27,040.68	Form C/A- Extended until 2018.Sept14	Crowdcoverage, Inc. <i>COVR Tokens</i>	Apr. 19	Del./Nev.
\$1,070,000	\$36,700.80	Form C/A- Extended until 2018. July31 Form D filed under 506(c) for a \$20 Million Offering	EpigenCare, Inc.'s <i>EPIC Tokens</i>	Mar. 20	N.Y./N.Y.
\$1,070,000	\$1,069,983	Form D filed for a \$13.9 Million Offering	Witnet Foundation, Inc.'s <i>WIT Tokens</i>	Mar. 1	Del./N.J.
\$17,375,997	\$2,113,166	TOTAL 2018			

In 2018, most of the companies that raised capital by offering digital tokens were primarily tech-related startup companies. The type of tech-startups varied by the target clients, goods, or service markets. For example, most of the companies identified as funding portals or technology businesses seeking to develop blockchain networks; six companies broadly identified as tech companies with health, consumer health registry, or biotech applications; one company was developing a platform for cannabis sales; two developed web based marketing services; one a jewelry product; tech insurance services; and another a tech security company.

By contrast, during 2017, only four companies offered digital tokens in offerings. The types of companies varied, from medical records to sports (football), renewable energy, and solar energy startups. All four 2017 offerings included investment contracts and, in each case, a SAFT. Additionally, each of the four digital token offerings is tied to the development of a blockchain distributed ledger.

**FINDING B4: DIGITAL TOKENS REPRESENTED
FOUR OFFERINGS IN 2017**

Chart 8 – Reg. CF Digital Tokens in the 2017 Offerings

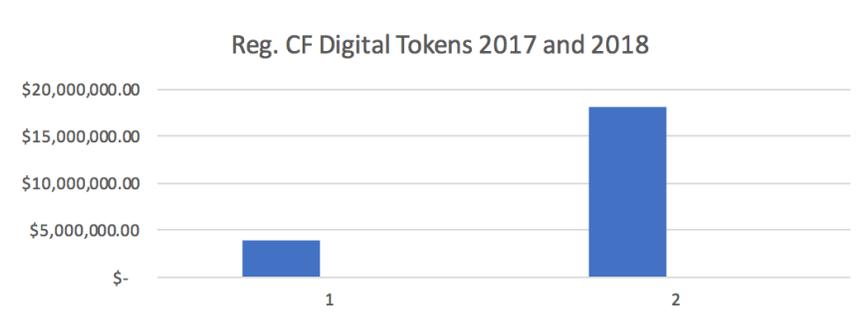
Amount of 2017 Offerings	Amount of Capital Raised 2017	Name of Digital Tokens	Date of Token Offering (2017)	Entity Name
\$1,070,000	\$466,896	SAFT: Mission: To use blockchain technology to establish a better, more secure and transparent framework for Electronic Medical Record that vastly improves the quality of care for patients and helps reduce healthcare providers' costs.	Dec. 29	MedChain, Inc.
\$1,070,000	\$1,068,600	SAFT: <i>Fanchise Tokens</i> Mission: Built on the Blockchain and designed to combine the passion of live sport, the competition of fantasy sports, the engagement of video games, and the global reach of esports, the FCFL is the first pro sports league truly created for the digital age.	Dec. 11	Fanchise League Company, LLC

\$1,070,000	\$106,450	SAFT: Mission: a real-world company building revenue generating renewable energy assets that is also developing an Ethereum-based blockchain currency platform. With the ability to implement smart contracts on a distributed ledger, the Sun Fund token will bring liquidity and a store of value for renewable energy assets while also helping to disintermediate global financial and energy markets.	Nov. 17	Sun Fund Renewables, Inc.
\$744,000	\$172,287 Filed a Form C/A to extend the deadline to 2018.Jan.18	SAFT: <i>Indecoin Tokens</i> Mission: To be a stable crypto asset for stored value, an investment vehicle and an engine for the expansion of the clean economy, including solar energy, battery storage and smart controls and sensors for energy efficiency. Our network will support four independent roles with distinct, interoperable smart contracts.	Nov. 9	Indeco, LLC
\$3,954,000	\$1,813,233	Totals		

b. Growth Compared to Other Capital Formation

FINDING B5: COMPARISON OF DIGITAL TOKENS FROM 2017 TO 2018

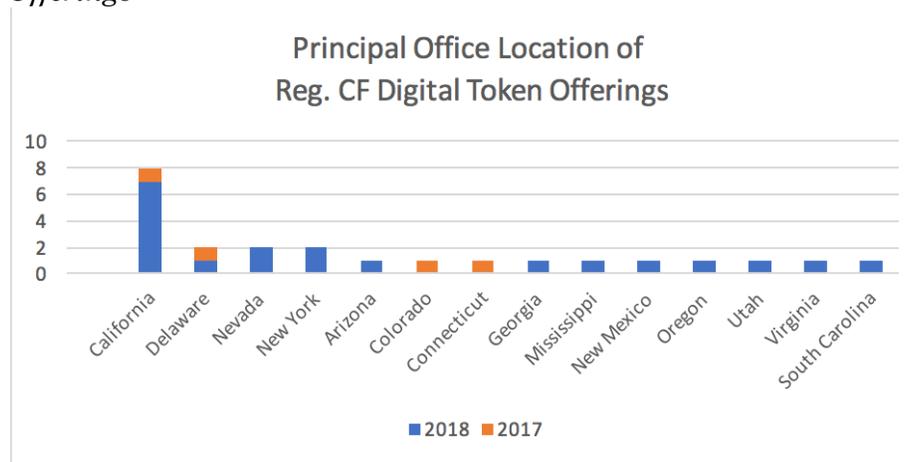
Chart 9 – Reg. CF Digital Tokens under Reg. CF 2017-2018



The locations of the principal offices of companies offering securities under Reg. CF are set forth below. The principal locations are western states, such as California, Nevada, Arizona, Colorado, New Mexico, Utah, and Oregon. The next grouping is companies with principal locations in Delaware, New York, Connecticut, Virginia, Georgia, South Carolina, and Mississippi. This research project does not address the reasons why there is not participation in digital tokens by companies in states outside of coastal areas.

FINDING B6: PRINCIPAL OFFICE LOCATIONS ARE PRIMARILY LOCATED IN CALIFORNIA; THEN DELAWARE, NEVADA AND NEW YORK

Chart 10 – Principal Office Location of Reg. CF Digital Token Offerings



**FINDING B7: GROWTH PROGRESSION OF DIGITAL
TOKENS IS ACCELERATING IN LATE 2017
THROUGHOUT 2018**

Chart 11 – Reg. CF 2016-2018 Growth Progression of Reg. CF Digital Tokens

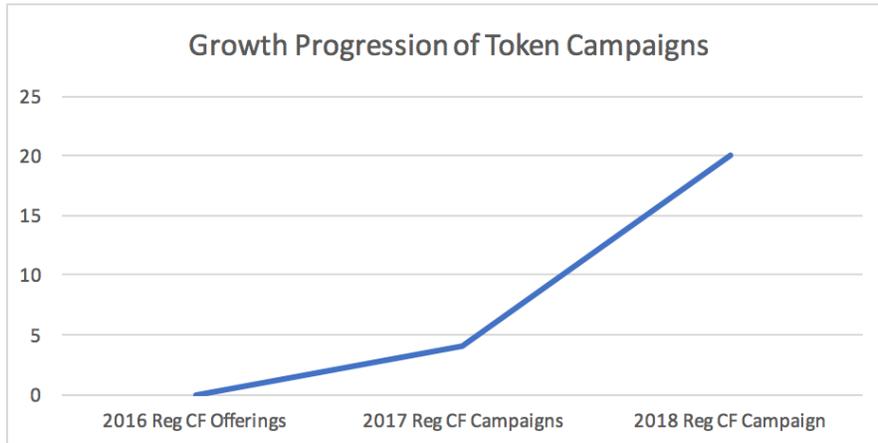


Chart: Zero campaigns in 2016; four campaigns in 2017; twenty campaign2018.

3. Funding Portal Intermediation Findings

One of the requirements of Reg. CF is that companies use a funding portal to host the offering. The role of the funding portal is best described in Werbach's description of an intermediary:

What makes activity happen in this arrangement is the intermediaries' ability to aggregate activity on both sides. Financial services relationships are a good example of intermediary trust. Commercial banks sit in the middle of the transaction flow between depositors and borrowers...Investment banks structure and intermediate financial transactions in capital markets.¹⁹²

¹⁹² WERBACH, *supra* note 18, at 28.

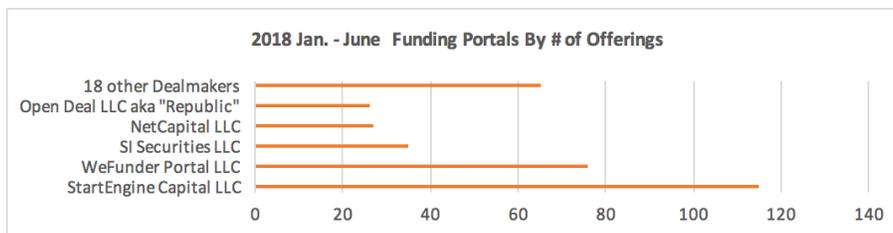
FINDING C1: REGISTERED FUNDING PORTALS EXPANDED ACROSS THE COUNTRY

As of July 11, 2018, there were forty-three funding portals registered to serve in that role for the companies offering securities under Reg. CF. These entities served the crowdfunding market by providing structure for the transactions over the past three years.

The chart below provides a listing of the top five funding portals completing a majority of all of the investment crowdfunding transactions for this period. There are two notable inferences from this data. First, StartEngine Capital, LLC is doing the lion's share of the investment crowdfunding offerings, which suggests that this particular funding portal has an effective system for raising capital. Second, the number of overall funding portals is increasing, but fewer funding portals are conducting more offerings.

FINDING C2: FUNDING PORTALS CONSOLIDATED OFFERINGS AND MORE FUNDING PORTALS REGISTERED

Chart 12 – 2018 Jan - June Funding Portals By Number of Offerings



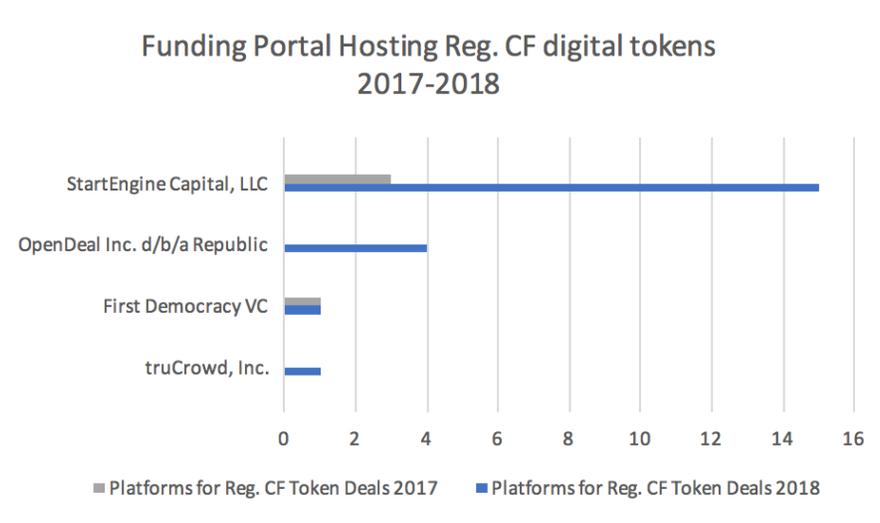
During the prior six-month period from January to June 2017, StartEngine Capital, LLC, WeFunder, and SI Securities, LLC were the three leading funding portals for investment crowdfunding offerings. Next, First Democracy VC and OpenDeal, LLC also performed a number of transactions. From January to June 2017, the same five funding portals hosted offerings.

The principal funding portals that assist companies with digital token offerings are Start Engine Capital, LLC, Open Deal, Inc. d/b/a Republic, First Democracy VC, and truCrowd, Inc. The

chart below illustrates just how many more offerings StartEngine Capital, LLC is conducting compared to other funding portals in the digital token space. Also, the chart illustrates where most of the digital token offerings are hosted and the pace at which they grew from 2017 to 2018. The funding portal, StartEngine Capital, LLC is substantially greater than any other funding portal, which calls into question the scope and growth of Reg. CF digital tokens in investment crowdfunding.

FINDING C2: FUNDING PORTALS ACCELERATING BUT CONCENTRATION IN FOUR FUNDING PORTALS IN 2018

Chart 13 – 2017 - 2018 Funding Portals By # of Offerings for Reg. CF digital tokens



4. Terms and Conditions of Offerings

As might be expected in different industries, the descriptions of SAFTs or other digital token investments can vary significantly. For example, in the Fanchise Sports League, Inc. digital token offering, the company provides its investors the right to vote on games and provides an opportunity to participate in a \$1 million purse on football team winnings, based on the number of digital tokens that the investor owned, however, this

Reg. C-W offering was withdrawn.¹⁹³ This right to vote on games is unique to this particular transaction as it engages the investor in the company's games and allows them to potentially win when their team wins. Another company, MedChain, would allow its utility tokens to be "used within the network to purchase entry credits facilitating Electronic Medical Record storage and access control."¹⁹⁴

The right to actually receive a digital token or some other non-security utility token varies by the offering. Most of the 2018 companies discuss the right to receive a future utility token, contingent upon the company's creation of a network based upon blockchain and distributed ledger technology.¹⁹⁵ Or companies include other language, such as, "the right to receive future utility tokens when and if the company creates a network based upon blockchain and distributed ledger technology."¹⁹⁶ In some offerings, the investors are allowed to choose whether they receive back cash or a "possible" digital token. Some companies state that only they will decide whether the investor receives digital tokens, common stock, or other cash payment.

Voting rights also vary across transactions. In most transactions, the investor does not have voting rights in company decisions. However, there are various decisions on which an investor could vote, such as what new promotional events the company could have. For example, when Fanchise League discusses the FAN Token Ecosystem, it states "[t]he Fan Access Network and FAN Tokens are going to revolutionize the experience of being a sports fan, and the FCFL will be the first league built on and powered by the Fan Access Network."¹⁹⁷

¹⁹³ Fanchise League, LLC Form C filed November 12, 2017 and Form C-W filed April 30, 2018. Fanchise Sports League, Inc. also hosted a crowdfunding campaign on Indiegogo which surpassed their \$5 million ask by December 23, 2017. *See* FCFL, <https://medium.com/@FCFLio/fan-token-pre-sale-update-we-exceeded-our-goal-8559ae2491b7> (last visited on April 8, 2019) ("Ten-day campaign was the first token sale ever hosted by crowdfunding leader Indiegogo (in conjunction with MicroVentures) and garnered attention from the likes of the New York Times, Forbes, and CoinDesk."). These offerings were to be followed up with a public digital token sale for fans looking to gain early access to voting power in March or early April of 2018. *See* Fan Token Blog, <http://blog.fantoken.network/frequently/> (Dec. 28, 2017).

¹⁹⁴ *See MedChain*, STARTENGINE, <https://www.startengine.com/medchain> (last visited on Feb. 21, 2019) (describing their SAFT offering).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *The Fan Token Ecosystem*, FCFL BLOG (Mar. 1, 2018), <http://blog.fantoken.network/fan-token-ecosystem/>.

**FINDING C3: TERMS OF DIGITAL TOKEN
OFFERINGS HAVE VARIOUS TERMS**

Chart 14 – Terms and Conditions of Digital Token Offerings

RIGHTS TO TOKENS	Right to receive future utility tokens based on an uncertain future event (e.g. blockchain and distributed ledger technology)
CONTINGENCY	Based upon the successful development of Tokens, the company creates a network based on the blockchain upon which the Tokens function.
TIMING	Uncertain
EVENT	Optional, not guaranteed
VOTING RIGHTS	Tied to decisions of the company or decisions related to other promotions and events of the company; Right to Vote on Games
PARTICIPATION RIGHTS	The right to participate in purses and team winnings, based on number of Tokens investor owns
DECISION FOR THE CONTINGENT EVENT	The company
TOKEN AVAILABILITY	On wallets on open source and/or future tradeable exchanges
TIED TO OTHER SECURITIES	Common or Debt plus Tokens
REPAYMENT	In Tokens, Cash, Common Stock
REPAYMENT OPTION DECISION TO RECEIVE CASH OR TOKENS	Investor or the company

II. CONCERNS WITH DIGITAL TOKEN OFFERINGS

A. *What is Troubling About Digital Token Offerings?*

Investment crowdfunding company offerings include a range of common stock, convertible debt, tokens and coins offered to investors. The data infers that investment crowdfunding offerings have led to mixed results and some troubling developments. On the positive side, this research supports the assertion that investment crowdfunding has had momentum, even though still in its infancy. There is greater breadth in publicly offered crowdfunding campaigns. Those campaigns can be measured by the increasing numbers of company principal office locations throughout the country, increasing amounts and types of securities offerings, and an increasing variety of companies that are participating. These amounts represent a sizable expansion in investment crowdfunding under Reg. CF. The next Section discusses the troubling concerns with digital token offerings, which include uncertainty and risk, cancelled offerings, and goals of Reg. CF that have yet to be attained.

1. Uncertainty and Risk

The more troubling discovery from this research is the accelerating movement of companies offering Reg. CF blockchain-based tokens to investors. These investment contracts include a possible conversion to a token or coin that is distributable upon the success of blockchain ledger technology. The greatest concern is the uncertainty of blockchain technology. To the extent that companies are raising funds based on that success, the likelihood of raising the necessary funds becomes more speculative. Investment contracts with token conversions are written such that risk is a given and that there is no guarantee the services or tokens will ever come to fruition.

The Form C/A's, C-U's and C-W's provide a picture of companies that may be having difficulty raising capital on the funding portal. Form C-U allows a company to extend the time that it can seek funding.¹⁹⁸ The first of the negative results relates to companies that are not able to raise the funding that they seek.

¹⁹⁸ *Regulation Crowdfunding*, *supra* note 5.

When raising capital, businesses must fulfill their business needs as well as stay apprised of changing regulations in order to protect their investors and reduce legal liability. To the extent that businesses successfully raise capital, but fail to appreciate shareholder interests or potential liability, business losses and securities and fiduciary liability can become real concerns. A good example of this balancing is the case of Indeco Financial Syndicate, Inc., which touts itself as one of the first companies to file a registration for tokens under Reg. CF.¹⁹⁹ On the same day as the Indeco Reg. CF filing, the SEC froze the assets of another company based in Quebec that had raised \$15 million but failed to register their token offering.²⁰⁰

An example of a more successful fundraising campaign is Witnet Foundation, a Delaware company with a principal office in the state of Washington. Witnet raised \$1,069,983 from 688 investors by March 2018.²⁰¹ One difference in this company's offering from typical Reg. CF and other securities offerings is that instead of the company repaying its debt obligation with cash, the company plans to repay the obligation with Wit tokens and 20% interest.²⁰²

As Witnet and Indeco suggest, companies face a variety of dilemmas in raising capital. On the one hand, a company seeks to maintain a sustainable business venture. To do that requires a basic accountability to their business plan while not being blind to new innovation. A company must always perform the necessary compliance in order to avoid state or federal regulatory discipline. Innovation is believed to be the main driver of long-term economic growth in the United States.²⁰³ But innovation includes uncertainty, which in turn, presents the dilemma for a company in considering what possibly could go wrong. To that end, a best practice would be to think of what could go wrong and plan to minimize potential liabilities. However, minimizing

¹⁹⁹ *Indeco*, STARTENGINE, <https://www.startengine.com/indeco> (last visited Feb. 21, 2019) (Indeco CEO David Levine is interviewed by Peter Armstrong on the CBC show, "On the Money"); *see also* Press Release, Indeco, Indeco Launches First Token Pre-sale under SEC's Regulation Crowdfunding Rules (Dec. 5, 2017), <https://medium.com/indeco/indeco-launches-first-token-pre-sale-under-secs-regulation-crowdfunding-rules-e82dad79345>.

²⁰⁰ *See* DAO Report, *supra* note 116, at 16; Levine, *supra* note 156.

²⁰¹ *Witnet*, REPUBLIC, <https://republic.co/witnet> (last visited Feb. 21, 2019).

²⁰² *Id.*

²⁰³ Brian Kingsley Krumm, *Fostering Innovation and Entrepreneurship: Shark Tank Shouldn't Be the Model*, 70 ARK. L. REV. 553, 555 (2017).

liabilities may require not always giving the most valued investors exactly what they may demand. Thus, the dilemma hinges on how to harness investor satisfaction in an ever technologically advancing society.

In Reg. CF capital formation, the ecosystem includes the companies, the funding portals mandated by the SEC to be used in these offerings, the employees, and the crowd. Companies raising capital via Reg. CF are required to be assisted by funding portals in their first steps towards “going public.” The SEC requires that funding portals follow a variety of rules or be subject to § 5(c) of the Securities Act and sections of the Securities Exchange Act.²⁰⁴ Funding portals have additional legal exposure and must make sure to comply with their own registration requirements.²⁰⁵ To date, companies with token offerings have been assisted by only four funding portals, while overall, there were forty-three funding portals registered.

Companies that use Reg. CF have employees. As creating jobs for employees is one of the normative goals of investment crowdfunding, over the past two years, companies have disclosed the hiring of over 5,300 employees, on average. The number is smaller for companies engaging in token offerings, with an average of 149 employees. The investors are also essential to this ecosystem. Their particular interest in purchasing coin-based securities/currencies may also be driving the demand for these products. The good news about Reg. CF is that the current financial movement drives an ecosystem for businesses to raise funds, and hire employees. The downside is that the token frenzy may wane, which may lead to unemployment in the long term.

There are risks to investors also. Worst case, investors will be left with shiny coins to satisfy the obligations and the companies would be left to ward off future disputes.

²⁰⁴ See SEC v. Muehler, No. 2:18-cv-01677-CAS(SKx), 2018 WL 1665637, at *1 (C.D. Cal. 2018) (granting the SEC’s motion for a preliminary injunction against the defendant in a case “assert[ing] claims against defendants for (1) violations of Section 5(c) of the Securities Act of 1933, 15 U.S.C. § 77q(a) . . . for (2) violations of Sections 10(b), 15(a), and 20(e) of the Exchange Act of 1934, 15 U.S.C. § 78j(b) . . . 78t . . . and for (3) violations of Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5”).

²⁰⁵ The SEC must demonstrate a *prima facie* case that defendants have violated § 5(c) of the Securities Act. Section 5(c) of the Securities Act makes it “unlawful for any person . . . to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed” 15 U.S.C. § 77e(c) (2012).

One solution to enhanced risk and potential investor dissatisfaction is to provide robust and clear offering disclosures. Although difficult to do when funding is needed, companies must recognize that due diligence requires a long-term view, which includes paying close attention to funding that has a low probability of repayment. Further, state and federal securities agencies can be helpful by providing clarity on the allowance or disallowance of certain types of securities. Tokens are just the latest development in a type of security or reward offered. We can only imagine the outer limits of virtual securities to come.

One difference in Reg. CF digital tokens is that there are notice filings with the SEC. Because of that fact, token-funded companies are likely to be more cautious than companies that either are not registering because they do not think they are offering a security, or because they are trying to circumvent the law. This difference may play out with fewer matters involving fraud, manipulation, and deception, than may be found with unregistered ICOs.

However, what is more troubling is the complexity of the offerings and the open question of whether these investors have a basic understanding of what they are buying. This part of the story will continue to unfold as companies provide disclosures to their buyers as time goes on. With respect to companies, the warning signs are present. There is volatility in current blockchain-based transactions that are currently trading. If the company succeeds, then they not only have successfully raised capital, but will also have potentially happy investors. To the extent that the company does not meet its mission of successfully creating a token utility, commodity, or security, and the token fails to meet the goals of the offering, then those companies would be best served by thinking about the alternative plan to the failure of the offering, which makes Professor Heminway's assertion so relevant here.²⁰⁶ As we are in an age of alternative entities, alternative finance, and alternative facts, it behooves companies, their advisors, investors, and the agencies that have oversight over these transactions, to think long and hard about the responsibility we have to each other and to ourselves.

²⁰⁶ Joan MacLeod Heminway, *Professional Responsibility in an Age of Alternative Entities, Alternative Finance, and Alternative Facts*, 19 TENN. J. BUS. L. 227, 256, 259 (2017).

Should we be troubled by the development that Reg. CF is being used for pre-coin token offerings as a leverage to other coin offerings?²⁰⁷ Rather than failing to register, companies are engaging in digital token transactions that are exempt from registration in light of the regulatory uncertainty. This part is understandable as a company would want to avoid securities liability and unintended consequences.²⁰⁸ But the Reg. CF offering may be just a means to another larger digital token offering end. Arguably, that leverage is a good thing.

The greater inclusion of pre-token/coin conversions raises long-term sustainability concerns for companies and long-term viability concerns for investors. The existence of digital token offerings under Reg. CF—albeit small in number and relatively insubstantial in dollar value as compared to the total number of Reg. CF offerings and the total number of ICOs—raises many questions for companies and investors. What are the considerations for companies in choosing Reg. CF digital tokens and how should investors respond? To the extent that companies are relying on the § 4(a)(6) exemption from registration, should these types of coin offerings and sweeteners be registered as ICOs? What limits should the SEC set to protect the crowd from bearing the brunt of the risk of valueless cryptocurrency

²⁰⁷ See DAO Report, *supra* note 116. The SEC recently investigated The DAO organization, which sold DAO tokens to fund investments. *Id.* The founders described it as a "crowdfunding contract" to raise funds to create a company in crypto space. *Id.* at 4. The press release notes that although crowdfunding was used to describe the design, it would not qualify for an exception under Regulation Crowdfunding because the platform or organization was not registered as "a broker-dealer or a funding portal." *Id.* at 4 n.11.

²⁰⁸ There are very few cases/matters relating to investment crowdfunding company violations or controversies. However, *Allen Hydro Electric Corporation* related to the offering of debt securities through "an online equity crowdfunding website." *In re Allen Hydro Energy Corp.*, No. 17-028, 2017 WL 4325088 at *1 (Ohio Dept. Commerce 2017). The Ohio Department of Commerce found that the Corporation had several violations of Reg. CF. *Id.* at *1–*4. The violations in the Consent Agreement included: a failure to follow the disclosure requirements; Allen Hydro Electric's "[b]usiness [p]lan did not have a reasonable basis in fact"; and they failed to follow proper procedures. *Id.* at *2. In light of these violations, Respondent's crowdfunding attempt did not qualify for the crowdfunding exemption. *See id.* at *3. Additionally, the SEC issued several Comment Letters to Worthpoint Corporation and Sagoon, Inc. *See generally* Letter from Jeanne Campanelli, Partner, KHLK LLP, to Barbara C. Jacobs, Assistant Director, Securities and Exchange Commission (Dec. 23, 2016) (SEC digital archives). The SEC noticed there was an offer to exchange common stock purchased under Reg. CF for other shares. *See id.* Both companies stated that it was to "grant those shareholders the greater informational rights and ability to freely resell their shares that Regulation A provides, and place all the company's shareholders on an equal footing." *Id.*

repayments or convertible instruments that may never convert to equity or anything of value? Will the SEC abdicate authority to the extent that companies disclose that risk of loss to the investing crowd is great or will they intervene to set parameters on this new blockchain-based token movement? It is predictable that if businesses fail, investors will feel taken advantage of, thus creating heightened legal risk for companies.²⁰⁹

2. Inadequate Disclosures

Another negative indicator in the Reg. CF crowdfunding data is that the disclosures may comply with the requirements of securities law, but still fail the investors.²¹⁰ The reasons may have to do with the inability to portray through disclosure the level of risk that is involved in investing in the particular company.²¹¹ This is even truer in the case of blockchain-based token offerings under Reg. CF.²¹² Most governmental agencies have a difficult time explaining the risks for purchasing a blockchain-based token, let alone a startup company working with a group of advisors, funding portals, and employees new to this technology.²¹³ Most unsophisticated investors would not likely have the background to understand the terms of these offerings.²¹⁴ Even though the disclosures may appear adequate, it seems unlikely that investors would understand whether it is likely or unlikely that they will ever receive a digital token and whether the company is able to implement its version of smart contracts on the blockchain.²¹⁵ This leads to the third negative indicator, which relates to where those disclosures, or lack thereof, leave unsophisticated investors.

²⁰⁹ Two questions, not addressed in this Article, relate to the uncertainty of blockchain's success as most of the ICO or Reg. CF offerings are tied to the blockchain. Further, the strength or flaws of the company's business model are also important.

²¹⁰ See Hinman, *supra* note 3.

²¹¹ See *id.*

²¹² See *id.*

²¹³ See John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 604 (2013).

²¹⁴ See *id.* at 605.

²¹⁵ See *id.*

3. Investors in Limbo

Before the recent crash of coins, it may have been difficult for investors to think clearly with so many varying reports of coin purchasers profiting in large amounts.²¹⁶ It sounds good, but investors should understand the distinctions between companies, services, offerings, timetables, and terms and conditions, because these terms can have an adverse effect on them. The worst case is that an investor spends hard-earned cash on a company's capital campaign and loses her money. The likely case is that an investor will be left in limbo wondering whether the company's goods or services will ever allow for a token to be issued and exchanged on some future distributed ledger.²¹⁷

An illustration of investors in limbo is evident in frequent postings by investors who purchased Indeco Dusto digital tokens. Several months after Indeco exceeded its minimum capital request, raising over \$171,000, investors began to ask about the progress of the development of the digital tokens and the blockchain. Below are the string of posts (as included on the StartEngine website) between a frustrated investor and the company on the StartEngine funding portal website on November 30, 2018:²¹⁸

Potential Investor, 6 months ago

*Still no peep. The writing seems to be on the wall and yet I saw Indeco continues to sell the theoretical tokens at a discount on other forums. I should have known better.*²¹⁹

Around a month later, a company representative responds:

Indeco – Issuer, 6 months ago

Hi [Potential Investor]—we've been focusing on building out the platform and qualifying for our Security Token Offering with the SEC. It's a brutal process.

Now that we're solidly in business, with revenue and technology (no longer a theoretical company), I'll be in closer touch.

You should have my personal email address as I've sent notes to all investors in the past. Feel free to contact me directly. Happy to give investors my cell # as well.

²¹⁶ Rohr & Wright, *supra* note 21, at 506-07.

²¹⁷ *Id.* at 507-08.

²¹⁸ *Indeco, Comments*, STARTENGINE, <https://www.startengine.com/indeco> (last visited Feb. 22, 2019).

²¹⁹ *Id.*

When we pull off the STO, you'll be glad you invested. :)

*David*²²⁰

A couple of months later, the Investor inquires again:

Potential Investor, 3 months ago

*Have not have [sic] much communication other than the post below related to the status of the SAFT investment. The March 2019 deadline is coming up where are [sic] SAFTs could potentially become worthless. Is the company on track to issue tokens soon or before the deadline? The lack of communication and updates makes it seem as if the company is waiting until the expiration date so that the SAFTs expire worthless. I have reached out many times on the Indeco website and through this platform asking for updates and have never received a response to my e-mails which does not give me confidence in the project being successful. I think many SAFT investors would like some communication on the status of this investment with the expiration date coming up. Also if the expiration date in March is reached does the company plan on extending the deadline per the provision in the SAFT agreement or will the company let the SAFTs expire?*²²¹

Potential Investor, 3 months ago

*Is anyone from the company ever going to reply back and give us s [sic] recent update? I have reached out through the portal and the company web[s]ite numerous times. Starting to think are [sic] money is gone... shouldn't be that hard to get s [sic] response from someone.*²²²

Around a month later, a company representative responds:

Indeco – Issuer

*The SAFTs will not expire. They'll be converted to tokens.*²²³

4. Cancelled Offerings

Another troubling concern is that not all companies have successfully raised funds through these digital token offerings, as some have been cancelled. Some companies fail to raise the capital needed for their emerging enterprises. However, to the

²²⁰ *Id.*

²²¹ *Id.*

²²² *Id.*

²²³ *Id.*

extent there is uncertainty about the outcome of digital token transactions, the lack of participation could be a good thing for the potential investors and possibly the companies. Not investing minimizes or eliminates the higher transaction risk based on blockchain technologies. On the other hand, if companies can raise capital and grow successful businesses, providing needed services and goods to the community, then the failure to participate in Reg. CF investment crowdfunding will impact the potential economic growth for years to come.

Three companies withdrew from their Reg. CF digital token offerings during the time period of this Article. One example is Access Network Labs, Inc., a Delaware incorporated company located in New York, which launched a token debt asset offering.²²⁴ Access Network had a noble goal of “[c]reating access to financial and technological tools for the world’s [sic] 1.7 billion unbanked adults through the development of a sustainable decentralized bank.”²²⁵ The minimum funding goal was \$100,000, with a minimum investment of \$50 in return for an Access Token.²²⁶ Their maximum funding goal was to raise \$1.07 million.²²⁷ Access Network Labs had a breakdown for the token sale: 30% of the tokens were dedicated to growing the branchless banking infrastructure and user base; 30% of the tokens were to be dedicated to rewarding the development of applications; and the remaining were tokens towards the sale (21%); founding team (12%); community rewards (3%); and advisors (4%).²²⁸ However, after initially amending the offering, the company withdrew the offering on July 27, 2018.²²⁹

²²⁴ Access Network Labs, Inc., Offering Statement (Form C) (May 29, 2018), <https://www.sec.gov/Archives/edgar/data/1739626/000173962618000001/formc.pdf> (offering Token DPA, Series S-a DPAs (Debt Payable by Assets), 100,000 units at a \$1.00 price).

²²⁵ *Access Network*, REPUBLIC, <https://republic.co/access-network> (last visited Feb. 22, 2019).

²²⁶ *Id.*

²²⁷ *See id.*

²²⁸ *See id.*

²²⁹ *EDGAR Search Results*, U.S. SEC. AND EXCH. COMM’N, <https://www.sec.gov/cgi-bin/browse-edgar?CIK=1739626&owner=exclude&action=getcompany> (last visited Feb. 22, 2019); *see also Access Network*, REPUBLIC, <https://republic.co/access-network> (last visited Feb. 22, 2019) (showing caption of “Access Network has withdrawn their campaign.”). The reason for the withdrawal is not listed on the website. *Id.* A withdrawal could also indicate a retooling or finding capital through another exempt or non-exempt offering.

Two other companies withdrew their digital token offerings during this period. Time Token, Inc. had a principal office in Arizona and was incorporated in Delaware.²³⁰ On May 23, 2018, Time Token sought to raise \$107,000 for its goal of merging blockchain technology with vacation rental real estate, to bring liquidity to the vacation rental market.²³¹ Their digital tokens were called Preferred Equity Tokens (“PET”).²³² However, by September 9, 2018, Time Token withdrew its offer to sell PET tokens to the general public after raising over \$22,000.²³³ A third example was Frtoken, Inc., a company based in New Mexico and incorporated in Delaware.²³⁴ Frtoken offered a CHIKN Token on April 20, 2018 with phrases, to include a decentralized blockchain-based platform that allows companies to pay audiences directly for watching ads and answering surveys.²³⁵ The CHIKN token represented a single share of Series B Common Stock of this company.²³⁶ After raising \$11,000 of the \$107,000 maximum funding sought, then filed a Form C-W and withdrew the offering on October 1, 2018.²³⁷

It is also possible that these companies underestimated the costs or potential liabilities. In the case of Frtoken, they raised over the minimum ask of \$9,000,²³⁸ which in this regulatory environment, may not have been enough to remain sustainable.

It would take additional research to determine why these companies were not successful in their crowdfunding campaigns. The top four most common reasons that a company fails are that there was no market need for their goods or services; they simply ran out of money; they didn’t have the right team formed; or they lacked the proper competitive advantages to continue with the business.²³⁹ Timing of offerings is also important, and to the extent that the offering does not go well, that may present

²³⁰ Time Token, Inc., Offering Statement (Form C) (May 23, 2018).

²³¹ *Id.*

²³² See Time Token, Progress Update (Form C-U) (Aug. 30, 2018).

²³³ See *id.*; see also Time Token, Offering Statement Withdrawal (Form C-W) (Sep. 7, 2018).

²³⁴ Frtoken, Inc., Offering Statement (Form C) (Apr. 20, 2018).

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ Frtoken, Inc., Offering Statement Withdrawal (Form C-W) (Oct. 1, 2018).

²³⁸ *Id.*

²³⁹ Triin Linamagi, *The Most Common Reasons Startups Fail*, FAST COMPANY (Apr. 1, 2015), <https://www.fastcompany.com/3044519/7-of-the-most-common-reasons-startups-fail> (noting some companies run out of cash before they are able to raise the funds).

problems for the company. However, it is also possible that a withdrawal could indicate a retooling or landing alternative capital from a private source.

5. Crowdfund Act Goals Yet To Be Attained

In light of the research findings, it is highly questionable whether the normative goals of the Crowdfund Act have been fulfilled. There is still much work to be done on the two goals of encouraging small business growth and furthering employment, specifically to “help entrepreneurs raise the capital they need to put Americans back to work and create an economy that’s built to last.”²⁴⁰ There are two reasons for this concern. First, considering investment crowdfunding’s potential as a decentralizing, democratizing tool, that has not happened.²⁴¹ With more encouragement and decreased costs, we may see more activity. Second, the rapid growth that is occurring in blockchain-based tokens shares similarities with the proliferation of unsound mortgages in the 2008 mortgage debacle. One must hope that this trend will turn out differently. Also, there are geographical considerations that have impacts on the future success of capital formation. Some areas of the country are not participating in either investment crowdfunding generally, or in the more specialized digital token offerings.

6. Alternative Financing

For companies, theoretically, there are a variety of financings that would be available for amounts under \$1 million.²⁴² Some of the most common alternative financing measures for financing up to \$1 million include friend and family financing, bank and government loan financing, factoring, and peer to peer lending.

²⁴⁰ Press Release, The White House, Office of the Press Sec’y, President Obama to Sign Jumpstart Our Business Companies (JOBS) Act (Apr. 5, 2012) (<https://obamawhitehouse.archives.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act>).

²⁴¹ Rohr & Wright, *supra* note 21, at 466–67.

²⁴² See DONALD F. KURATKO, ENTREPRENEURSHIP THEORY, PROCESS, PRACTICE, SOURCES OF CAPITAL FOR ENTREPRENEURIAL VENTURES 232 (2008); see also Lee, *supra* note 7, at 68–69.

Friends and family financing is defined as funding from members of the business owners' family and friends who provide loans for debt or cash for equity in the company.²⁴³ Family and friend's contributions are additional to cash and other contributions provided by the owners, themselves (commonly called bootstrapping).²⁴⁴ This early stage financing is not discussed in this Article, since it is typically provided at the early stages of the business and not in this growth cycle of the business.

Bank and government loans are a traditional way for a business to get capital by obtaining a loan from their bank, community development organization, small business investment company, or other lender.²⁴⁵ The business can also seek a guarantee of their loan from the Small Business Administration.²⁴⁶

"Factoring is the outright purchase of a business' outstanding accounts receivable by a commercial finance company or 'factor' " at a rate typically between 70% and 90% of the receivable at the time the company purchases it.²⁴⁷

Peer to peer lending is a means for a borrower to get a cheaper loan than the banks and credit card companies offer through a peer to peer network. "Websites such as Prosper and Lending Club . . . function like a bank loan officer, taking loan applications, checking credit scores, employment and debt levels. These peer to peer networks state that they reject 90 percent of applicants. Lending Club, for instance, requires a minimum FICO score of 660, above the national average credit score of 690."²⁴⁸

For companies with excellent credit ratings, access to accredited and sophisticated investors, or angel networks, other alternatives may be available, such as angel investments,

²⁴³ See Lee, *supra* note 7, at 50.

²⁴⁴ *Id.*; see also JEROME KATZ & RICHARD P. GREEN, III, *ENTREPRENEURIAL SMALL BUSINESS* 500–01 (2014).

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ Tom Klausen, *The Difference Between Factoring and Accounts Receivable Financing*, ALLBUSINESS, <http://www.allbusiness.com/the-difference-between-factoring-and-accounts-receivable-financing-14847411-1.html> (last visited on Mar. 9, 2016).

²⁴⁸ Jim Gallagher, *Is Lending to Strangers Smart Investing?*, ST. LOUIS POST-DISPATCH (Jan. 27, 2013), https://www.stltoday.com/business/local/is-lending-to-strangers-smart-investing/article_7f79bb0b-5c6a-5399-a4b3-f352ba8fc877.html.

venture capital financing, private placements and initial public offerings. It is unlikely that the companies availing themselves of financing under Reg. CF, have these tools available to them.

B. Positive Findings

1. Some Companies' Successful Offerings

A positive outcome of investment crowdfunding was that a number of successful offerings occurred during this time period. On April 6, 2018, Wellbeing Brewing Company, LLC, a St. Louis based company organized in Missouri, conducted a Reg. CF crowdfunding offering.²⁴⁹ The company sought to raise a minimum of \$125,000 up to a maximum of \$200,000 and provide investors convertible notes paying 6% interest, which would be payable by April 6, 2023.²⁵⁰ The company's goal is to create a healthy craft beer for customers who do not drink alcohol.²⁵¹ This novel customer product was well received by investors, which allowed Wellbeing to raise \$199,000 from seventy investors and successfully close their offering within three months' time.²⁵² Wellbeing conducted its offering via Nvsted.²⁵³ Nvsted is a St. Louis Regional Economic Development Partnership which developed a funding portal through its website Nvstedwithus.com.²⁵⁴

MedChain, Inc., a Delaware incorporated company located in Colorado, quickly became oversubscribed for its offering of a minimum of \$10,000 of common stock with a SAFT to a maximum of \$1.07 million.²⁵⁵ The company seeks to develop a

²⁴⁹ Wellbeing Brewing Co., Offering Statement (Form C) (Oct. 3, 2018), <https://www.sec.gov/Archives/edgar/data/1731872/000173187218000002/formc.pdf>.

²⁵⁰ *Id.* See also WELLBEING BREWING COMPANY, <https://wellbeingbrewing.com/> (last visited Feb. 22, 2019).

²⁵¹ Wellbeing Brewing Co., Offering Statement, *supra* note 249.

²⁵² NVSTED, <https://nvstedwithus.com/> (last visited March 7, 2019).

²⁵³ Brian Feldt & Jacob Barker, *St. Louis Economic Development Partnership Launches Nvsted, a New Crowdfunding Platform*, ST. LOUIS POST-DISPATCH (Apr. 18, 2018), https://www.stltoday.com/business/local/st-louis-economic-development-partnership-launches-nvsted-a-new-crowdfunding/article_e539c20c-04c8-5475-85a9-cfc87e25bd13.html.

²⁵⁴ Jacob Barker, *St. Louis Economic Development Partnership Launching Crowdfunding Platform*, ST. LOUIS POST-DISPATCH (Feb. 16, 2018), https://www.stltoday.com/business/local/st-louis-economic-development-partnership-launching-crowdfunding-platform/article_50f3a1bf-7564-5e38-b2c6-f8b54b130193.html.

²⁵⁵ *MedChain*, STARTENGINE, <https://www.startengine.com/medchain> (last visited Feb. 22, 2019); see also *MedChain*, Offering Statement (Form C) (Oct. 7,

“community-driven solution” to the growing field of electronic medical records and electronic protected health information.²⁵⁶ Although the company did not raise the maximum amount sought, after raising \$466,896, MedChain closed the offering to additional investors.²⁵⁷

Another example of a successful offering is Farm from a Box, Inc.²⁵⁸ Farm from a Box, Inc. is a California benefit corporation, incorporated on February 6, 2012, with principal offices located in San Francisco.²⁵⁹ This company has developed an innovative, modularly designed farm system that provides tools and technology needed to support a two-acre off-grid farm. The company manufactures and sells its farm system to consumers and large-scale buyers with the hope of connecting communities to healthy, sustainably grown food, and revolutionizing local food production.²⁶⁰ They initially set SAFEs²⁶¹ with funding goals of a minimum amount of \$25,000 and maximum amount of \$535,000.²⁶² However, they amended their offering amounts to \$100,000 with a greater maximum of \$999,999 in a later Form C/A filing.²⁶³ Although not their maximum target goal, the company ultimately raised \$148,999 from 240 investors and

2018), https://www.sec.gov/Archives/edgar/data/1726640/000166516018000130/xslC_X01/primary_doc.xml (last visited Oct. 7, 2018).

²⁵⁶ *MedChain*, STARTENGINE, <https://www.startengine.com/medchain> (last visited Feb. 22, 2019).

²⁵⁷ *Id.*

²⁵⁸ *Farm from a Box*, REPUBLIC, <https://republic.co/farm-from-a-box> (last visited Feb. 22, 2019).

²⁵⁹ Farm from a Box, Amendment to Offering Statement (Form C/A) (July 21, 2016), <https://www.sec.gov/Archives/edgar/data/1679373/000167937316000006/FFABformC.pdf>; see also FARM FROM A BOX, www.farmfromabox.com (last visited Feb. 22, 2019).

²⁶⁰ FARM FROM A BOX, <https://www.farmfromabox.com> (last visited Mar. 7, 2019); see also *Farm from a Box*, REPUBLIC, <https://republic.co/farm-from-a-box> (last visited Mar. 7, 2019); Farm From a Box, Annual Report, (Form C-AR) (May 1, 2018), www.sec.gov/Archives/edgar/data/1679373/000167937316000006/FFABformC.pdf.

²⁶¹ The SAFEs were called Crowd Safe, an investment contract between investors and companies, wherein the investment is “in exchange for the chance to earn a return—in the form of equity in the company—if it’s acquired or has an IPO.” *How the Crowd Safe Works*, REPUBLIC, <https://republic.co/learn/investors/crowdsafe> (last visited Feb. 22, 2019). The Crowd Safe was developed by the Platform Republic. *Id.*

²⁶² *Farm from a Box*, REPUBLIC, <https://republic.co/farm-from-a-box> (last visited Feb. 22, 2019).

²⁶³ Farm from a Box, Amendment to Offering Statement (Form C/A) (July 21, 2016) (identifying an offering deadline of December 16, 2016).

concluded their first campaign in March 2018.²⁶⁴ As this company is a startup with a bold idea, they will continue to need capital, which suggests there is still risk for their initial investors.²⁶⁵

For companies that sought to form capital with digital tokens, there were two of note that leveraged the Reg. CF offering and continued to raise greater levels of capital. Item Banc, Inc., is a tech company located and organized in South Carolina that is supporting basic human need products in five categories: food, building materials, basic clothing, paper products, and hygiene.²⁶⁶ On June 18, 2018 Item Banc offered \$1.07 million under Reg. CF of IBE Tokens to the general public.²⁶⁷ This offering occurred after the company had filed a notice of exempt offering under Reg. D Rule 504.²⁶⁸ In August 2018, after one extension request on the previous filings, Item Banc amended the earlier filings and filed a Form 1-A with Reg. A disclosures about its \$20 million offering of IBE tokens.²⁶⁹ EpigenCare, Inc., a digital biotech company, located and organized in New York, leveraged the initial Reg. CF filing immediately following a Reg. D Rule 506(c) offering.²⁷⁰ On March 20, 2018, Epigen, Inc. filed both a Form C to offer \$1.07 million of EPIC Tokens and a Form D to offer \$20 million of the tokens.²⁷¹ In a later Form C-U filing, Epigen, Inc. reported that it did not meet its maximum goal of raising over \$1 million under the Reg. CF.²⁷² The company was able to raise over \$36,700 under Reg. CF and continued to raise funds from accredited investors in the Reg. D filing.²⁷³

²⁶⁴ *Farm from a Box*, REPUBLIC, <https://republic.co/farm-from-a-box> (last visited Feb. 22, 2019).

²⁶⁵ See Wroldsen, *supra* note 6, at 551–53 (discussing potential and risks of SAFE investments).

²⁶⁶ See ITEM BANC, <https://itembanc.nl/> (last visited Mar. 7, 2019).

²⁶⁷ Item Banc, Offering Statement (Form C) (June 18, 2018).

²⁶⁸ Item Banc, Notice of Exempt Offering of Securities (Form D) (May 30, 2018).

²⁶⁹ Item Banc, Amendment to Offering Statement (Form C/A) (June 14, 2018).

²⁷⁰ EpigenCare, Inc., Notice of Exempt Offering of Securities (Form D) (Mar. 20, 2018).

²⁷¹ EpigenCare, Inc., Offering Statement (Form C) (Mar. 20, 2018).

²⁷² EpigenCare, Inc., Notice of Exempt Offering of Securities (Form D) (Mar. 20, 2018).

²⁷³ EpigenCare, Inc. (Form C, C/A, C-U and D/A), <https://www.sec.gov/cgi-bin/browseedgar?CIK=1727821&owner=exclude&action=getcompany&Find=Search>.

2. Coastal Dispersion and Preference

Other ways to measure the scope of investment crowdfunding include evaluating the geographical distribution of the company transactions; the choices of entity made by the companies; and offering characteristics. Over the two-year period that this Article focused on, changes have occurred. The most pronounced changes relate to a diffusion in intermediation, concentration of the offerings geographically, a preference toward incorporating or organizing LLCs in Delaware, and a normalizing of the types of securities offered.

The bulk of digital token offering financings are mainly located on the west coast. The geographic distribution, set forth in this study, illustrates the regional divide with respect to investment crowdfunding, and even more so, in digital token transactions, where offerings essentially are developing on the west coast.²⁷⁴ This coastal concentration in digital token offerings and funding portal dispersal nationwide appears to be similar to what Professor Magnuson called “diffusion” in the FinTech Markets.²⁷⁵ This dispersal illustrates pockets of digital token offerings concentrated within two to four funding portals, but a wider variety of funding portals and offerings nationwide.

While this investment crowdfunding study did not look at incorporation or organizational documents, what is apparent from the Form C filings is that there is more concentration of companies selecting Delaware as the preferred choice of entity than in 2016.²⁷⁶ These choices of entity seem related to “the scope of directors’ fiduciary duties, permissible charter and bylaw terms, and shareholder voting rights”—which Professor Lipton states “are controlled by the law of the state of incorporation, regardless of whether the corporation has any real economic ties to that location.”²⁷⁷ Empirical work on choice of entity has also “illuminate[d] how parties actually behave” and how the “parties

²⁷⁴ *See id.*

²⁷⁵ *See Magnuson, supra* note 171, at 163–65.

²⁷⁶ More research would be needed to determine the reasons for this flight to Delaware. It could be a function of larger transactions, herd behavior, or other legal, business, and tax considerations. *See id.* at 178 (explaining reasons for herd behavior in FinTech markets: “This may occur in several different ways, but perhaps the simplest involves computer programs sharing certain programming templates. If an algorithm proves successful in the market, other actors may be tempted to simply copy or replicate the algorithm.”).

²⁷⁷ Lipton, *supra* note 182, at 597.

would be likely to behave in response to legal rules.”²⁷⁸ Professor Chen’s study contradicted the fact that business corporations that heavily favored Delaware as the state of incorporation actually preferred New York for choice of law and forum in the context of merger agreements.²⁷⁹

3. A Business Disruption?

“All business disruptions begin with business innovations.”²⁸⁰ There are several reasons that investment crowdfunding may contribute to business disruption and innovation. First, as CFTC Commissioner Quintenz claimed, digital tokens “hav[e] and will continue to have, an impact on title transfer and settlement processes,” or otherwise a “back office tokenization revolution.”²⁸¹ There is a belief that “digital assets are here to stay.”²⁸² It will be just a matter of time before digital ledger technology will be able to verify entries between parties and scale to the proportion required for continuous use.

What is more unlikely is that smart contracts will alleviate the need for middle men and women, until there is a potential reduction in transaction costs and regulatory costs.²⁸³ Just recently, when the cost of Bitcoin dropped below the support level of \$6,000, pundits argued that the market price for Bitcoin could drop to \$0 because the mining transaction cost would be more than the potential investment.²⁸⁴ This suggests that beneath the blockchain layer, there are middle men, and without social or economic incentives, it is unclear how the blockchain sustains

²⁷⁸ Chen et al., *supra* note 183, at 31–32.

²⁷⁹ *Id.* at 3–4. “This conclusion is contrary to the conclusion reached in the Eisenberg and Miller study that, if a company is incorporated in Delaware, the company has a tendency to choose New York law.” *Id.* at 6.

²⁸⁰ Eric Biber et al., *Regulating Business Innovation as Policy Disruption: From the Model T to Airbnb*, 70 VAND. L. REV. 1561, 1571 (2017).

²⁸¹ See Brian Quintenz, Commissioner, U.S. Commodity Futures Trading Comm’n, Remarks at the Eurofi High Level Seminar (Apr. 26, 2018), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz11>.

²⁸² See Baris & Klayman, *supra* note 18, at 83.

²⁸³ See Biber et al., *supra* note 280, at 1572–73 (“Entrepreneurs seek to minimize their transaction costs and production costs by selecting the most efficient size and type of business organization.”); see also R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 397 (1937).

²⁸⁴ Atuyla Sarin, *Opinion: Bitcoin is Close To Becoming Worthless*, MARKETWATCH (Dec. 4, 2018), <https://www.marketwatch.com/story/bitcoin-is-close-to-becoming-worthless-2018-12-03>.

itself without drivers. It is evident that theoretically, smart contracts can allow self-regulation without third party intervention.

Second, as Reg. CF offerings are growing, the need for a company to seek venture capital and angel investor funding may be replaced by this new mechanism for financing.²⁸⁵ Arguably, the manner in which investment crowdfunding may disrupt these markets depends on the continued success of Reg. CF. Commentators argue that there are several ways venture capital could be disrupted by investment crowdfunding: actual democratization of access to capital; the traditionally underfunded can become successfully funded by this new access to capital; and that there is a proliferation of companies that do not seek the same exit and end goals as venture capitalists.²⁸⁶

There has been no sizeable disruption in investment crowdfunding, digital tokens, or in capital formation as of this writing. Again, the story of business disruption and innovation will take some time to determine if companies, the marketplace, investors, and the communities, are measurably changed because of the offering of the variety of securities under Reg. CF. In the event that companies are able to create a fully viable digital token reliant on blockchain technology, that endeavor could be an innovative business disruption.

**FINDING D1: BUSINESS DISRUPTION IS LIKELY IF
DIGITAL TOKENS RELIANT ON THE BLOCKCHAIN
ARE REALIZED**

There is one way that Reg. CF digital tokens are disrupting the investment marketplace and one way they are not. One positive disruption is that these offerings can leverage other, future ICOs. This development may provide potentially good disruptive qualities to the investment marketplace depending on the success of blockchain technology.

On the other hand, there appears to be no disruption outside of the coastal areas and larger cities throughout the county. For example, funding portals generally have some control over what offerings are hosted nationally. The idea that a novel innovation in the state of Montana could find capital through and connect to

²⁸⁵ See Marks, *supra* note 3, at 2.

²⁸⁶ See *id.* at 3–6.

investors interested in this idea is unlikely. Reg. CF financing is not yet democratizing capital and innovating in that manner. Second, there are a host of traditionally underfunded individuals, groups, neighborhoods, and companies that have yet to benefit from new blockchain-based technologies. Unless there are better ways to connect the traditionally underfunded with funding portals and structures, that disruption has yet to evolve. Third, currently, the data suggests that companies currently offering capital are still connected to the idea of exit strategies. Most notable are the companies that are reliant on blockchain as a business strategy and the likelihood that the business concept will obtain further investment after the initial investment under Reg. CF. Thus, Reg. CF is not yet disruptive in these positive ways.

What advocates of capital formation would not want is to have an adverse disruption occur. To the extent that investors begin to invest in poorly conceived or speculative investments, this activity could have a negative effect on attracting new investors to these markets. This could lead to effects similar to those witnessed during the housing mortgage crisis of 2008, where a large influx of participants in the market faced dire consequences when the market collapsed. The concern is that investors not be put in a similar position as investors and purchasers in 2008. The next Part provides some solutions to these troubling developments in digital tokens.

III. LOOKING TOWARDS THE FUTURE

Six hundred million dollars seems like a significant amount of financing. However, that figure pales in comparison to ICOs, Reg. A, Reg. A+, Reg. D, 1933 Act IPOs, and other capital raising alternatives. Although this research does not quantify the unmet business need for capital nationwide, the initial normative goals were to help entrepreneurs and to grow employment nationwide. At the same time, the idea that investors may lose their investments is not a positive tradeoff for capital formation and employment.

In light of the research, this Article provides recommendations for a path forward. The first relates to actions that the SEC should consider immediately. The second suggestion is for companies to consider. The last provides suggestions for economic development organizations.

A. *SEC Re-Evaluation of Reg. CF*

The first recommendation is the most difficult to frame. On the one hand, if the SEC regulates too much, then innovation in new types of securities and capital formation can die. On the other, if the SEC regulates too late, then they are reacting to a worst-case scenario where investors have already lost their money and companies are potentially liable. The SEC must balance the time and manner in which it regulates. That being the case, first, the SEC should re-evaluate whether Reg. CF will be able to attain the goals of job creation and capital formation, in light of the current status of investment crowdfunding and the ongoing sales of SAFTs and digital tokens. Unfortunately, this solution will ripen only after the investment crowdfunding campaigns discussed in this Article have concluded and other metrics have concluded, such as the expiration of the blockchain development and a period of time to evaluate the sustainability of participating companies. Potential evaluation time periods could be a first step after the offering period ends for all companies with offerings through June 30, 2018. How much capital did these particular companies raise? The second step would be to evaluate the success or failure of the companies that offered digital tokens reliant on blockchain development. Did these companies accomplish their goal and did they provide investors with digital tokens? The third step would be to evaluate the success of these companies after a minimum five-year period to determine whether the companies are sustainable or facing financial difficulties, in the worst case, bankruptcy. These evaluation steps will provide great information for the SEC.

In the short term, the SEC should publish detailed guidance for unaccredited and unsophisticated investors. Much of the SEC's attention has been directed towards unregistered ICOs and IPOs with material misstatements sold to accredited investors. As the proliferation of Reg. CF digital tokens continues and there is no certainty in blockchain technology, it is imperative that the SEC provide guidance directly to smaller investors intrigued by Reg. CF coin investments. Current SEC guidance is helpful, but while the language typically references ICOs, it does not distinguish between the ICO market and Reg. CF transactions. Shareholders might think that the warnings regarding ICOs do not apply to them. However, as companies are getting their first batch of funding from small investors

before advancing to ICO markets and venture capital funding, it is important for the SEC and investment advisors to educate those small investors who may be taking the greatest investment risk. More guidance may deter what happened when investors purchased synthetic collateralized debt obligations (“CDOs”)²⁸⁷ or “mortgage-backed securities that lost value when the housing bubble burst.”²⁸⁸ In that advisory, the SEC must clarify its position on Reg. CF digital tokens for these investors.

Alternative financing options may be considered an ideal solution for the investors who will read the materials, but not so much for those who do not. That being the case, there would be a greater chance that some investors would properly weigh the risk of loss to their own financial situation. Better yet, if these investors had advisors, the advisor could assist them in better understanding the terms and conditions in which they plan to invest. One cannot underestimate the level of potential loss in these offerings.

B. Issuers Should Weigh Other Financing “Alternatives”

Companies, particularly those that are tipping into tokens, should thoughtfully consider alternatives to Reg. CF digital tokens. There remains a level of speculation in these transactions, which could result in liability or greater risk than the alternative financings. Companies should fully consider a backup plan in the event of an unsuccessful token asset offering, whatever the reason for the failure.²⁸⁹ Although investment crowdfunding shows signs of being an innovative bridge to capital, this Article notes some developments that raise uncertainties for companies and investors.

Some of the inferences are encouraging, and raising \$600 million is a good start. However, other aspects of the scope of investment crowdfunding transactions, such as the escalation of digital assets in Reg. CF transactions, show some warning signs. Lawmakers, scholars, and industry representatives should continue to closely monitor this rapidly growing development to help foster a healthy, inclusive, and efficient expansion of company capital.

²⁸⁷ Jennifer O'Hare, *Synthetic CDOs, Conflicts of Interest, and Securities Fraud*, 48 U. RICH. L. REV. 667, 678 (2014).

²⁸⁸ *Id.*

²⁸⁹ Reasons might include slow timing of the blockchain; the business concept does not evolve; or merely because digital token sales begin to flatten.

Companies should carefully weigh “alternatives” to the coin alternative of raising capital. To the extent that the company has no clue what a cryptocurrency or blockchain is, they should consider alternatives to this form of investment. It is possible that developing a new digital asset to be traded on the blockchain is exactly what that company needs to grow its business. That decision comes with due diligence and the right partners to help form the right strategies for the business.

C. *Economic Development Organizations Lead the Alternatives*

Nvested is an excellent example of an economic development organization partnering with others to develop a funding portal to raise capital for companies in the state of Missouri.²⁹⁰ After a successful campaign to launch Wellbeing Brewing, LLC, the funding portal announced recently that it is available to launch other offerings for companies.²⁹¹ To realize the goals of capital and job creation, economic development organizations would seemingly play a greater role in expanding opportunities for companies to connect with potential investors.

Dozens of states are not participating in Reg. CF offerings. The question as to why that is may be a function of other alternatives that are available to companies in non-participating states, but also may be a need for organizations to develop funding portals that are ready, willing, and able to assist with the launching of these offerings. If it is not the will, what appears to be missing in states that are not participating is the way to participate. That is where economic development organizations can play a significant role in this new method of capital formation.

CONCLUSION

This research study provides a snapshot of investment crowdfunding’s broadening scope as a vehicle for capital formation. Part II discussed what success under Reg. CF would be. It suggested that success would be: companies engaged; companies raising capital; and investors with a likely potential of a return on investment. Using that success metric, the results

²⁹⁰ Nvstedwithus.com is a website owned and operated by STL Critical Technologies JVI, LLC and is registered as a funding portal with both the SEC and the Financial Industry Regulatory Authority (FINRA). See also Felt & Barker, *supra* note 253; Barker, *supra* note 254.

²⁹¹ NVSTED, <https://nvstedwithus.com/raise-funds> (last visited on Feb. 22, 2019).

are mixed. As parts of the story are still unfolding, the final story of company/investor success or failure remains to be told. However, what we can glean from the study is that companies are engaged in capital campaigns using Reg. CF. Some companies have been able to raise capital, while others continue to fail. Investors, however, are seemingly at risk of losing their investments as the securities are developing and reliant on theoretical ideas. Time will tell whether those who were the first to invest in blockchain-based digital tokens will be successful or not.

To recap, with respect to the types of securities offered, one can label this emergence as either troubling or a looming disaster that is waiting to happen. The offering of blockchain-based tokens is novel, but selling these securities to unsophisticated and non-accredited investors is not ideal in the best case, and a travesty, in the worst case. These concerns give traction to scholars who have expressed concerns about the type of securities that might be offered under Reg. CF. When Reg. CF was adopted, digital tokens were not initially conceptualized at the time of the approval of the regulations. The great uncertainty of these securities adds to the concern that startup companies will not succeed with their business goals and will not raise the boats of investors along with the communities they seek to serve.

However, there are encouraging developments in Reg. CF investment crowdfunding. First, there is an expansion of a variety of securities markets for the crowd to invest in companies as they so choose. There is an availability of an assortment of investments that allow the crowd to capitalize enterprises. And more companies are able to avail themselves of a public access to capital with their first step towards “going public.” In addition, funding portals are developing across the country and providing a technological solution for fundraising campaigns.

The investment crowdfunding phenomenon of securities digitally offered to the public has the potential to disrupt both the way companies capitalize their business and the manner in which funding portals and the crowd support these companies.²⁹²

²⁹² See WALES, *supra* note 17, at 218 (discussing global securities crowdfunding); Schwartz, *supra* note 14, at 889 (“Securities crowdfunding, while born in the United States, has become a worldwide phenomenon, with New Zealand leading the charge.”); see also Zachary J. Robins & Timothy M. Joyce, *How to Crowdfund and Not Fall Flat on Your Face: Best Practices for Investment Crowdfunding Offerings and the Data to Prove It*, 43 MITCHELL HAMLINE L. REV. 1059, 1073–90 (2017)

As Reg. CF offerings are growing, the need for companies to seek venture capital and angel investor funding may be replaced by this new mechanism for financing to a degree. Arguably, the manner and extent to which investment crowdfunding may disrupt these markets depends on the continued success of Reg. CF, blockchain technology, and the interest of investors.

It is argued that there are three ways venture capital could be disrupted by investment crowdfunding: actual democratization of access to capital; traditionally underfunded venture capital can become successfully funded by this new access to capital; and exit and end goals of companies diverge from venture capitalists.²⁹³ However, considering these three reasons the data does not reflect any sizeable disruption at this time.

A final concern is whether investment crowdfunding could be disruptive in a negative way. To the extent that investors begin to invest in poorly conceived or speculative investments and lose their money, this activity could have a negative effect on future investors in the marketplace. To ensure that investors do not revisit the devastation of the mortgage crisis of 2008, caution is the word of the day. Still, the possibility of a future being recreated by the successful development of blockchain technology is not a bad dream to have.

(including a review of selected data after the first anniversary year 2016 and recommendations on best practices for companies and lawmakers). The types of ventures seeking capital are quite diverse: health/fitness, technology, restaurants, liquor, gaming, cryptocurrencies, and movie production companies. *Id.* at 1076.

²⁹³ See Marks, *supra* note 3, at 3–6.