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The SEC Clears an ICO under Regulation A+: Blockstack Holds the First Regulated Token Offering

The Securities and Exchange Commission (“SEC”) qualified an initial coin offering (“ICO”) by Blockstack PBC on July 10, 2019, marking the first time that the SEC has cleared a securities offering of digital assets. The \$40 million offering of Stacks Tokens (the “*Tokens*”) is being made under Tier 2 of Regulation A (known as “Reg A+”), a quasi-public offering process which permits the marketing of up to \$50 million in securities in a twelve-month period¹. The Blockstack offering may provide other cryptocurrency companies with a roadmap for fundraising and the distribution of digital assets in compliance with the federal securities laws, but the Blockstack model does contain complexities that may prove daunting for would-be emulators.

Blockstack, founded in 2013, spent ten months and \$2.8 million on its Reg A+ offering. Reg A+ was adopted as part of the 2012 Jumpstart Our Business Startups Act (the “*JOBS Act*”), and has fewer disclosure requirements than a full-blown registration statement on Form S-1.

Buyers of Tokens will not have any equity ownership in Blockstack, but rather will be able to use the Tokens as currency or fuel in Blockstack’s network, a blockchain-based software platform on which developers can build “decentralized applications.” The Blockstack network has been functional since 2015 and has over 100,000 registered users and 171 live applications.

The company funded the development of the Blockstack network with \$5 million in venture capital financing and \$47 million raised from a 2017 token offering that used Regulation D as an exemption under the U.S. securities laws.

To date, issuers of digital assets, such as the Tokens, have used Regulation D in order to comply with U.S. securities laws, as Blockstack did in its 2017 offering. Regulation D does not require any SEC clearance akin to the “qualification” of a Reg A+ offering. However, since a token securities offering over the internet, as a practical matter, will involve a “general solicitation,” companies have generally been forced to use a subset of Regulation D called Rule 506(c), which limits the sale of tokens to accredited investors who have either a net worth of \$1 million or an annual income of \$200,000. By contrast, tokens qualified in a Reg A+ offering may be sold not just to accredited investors but also to any other persons for whom the tokens purchased do not exceed 10% of the greater of their annual income or net worth².

In addition to the more limited disclosure required by Reg A+, vis-à-vis a registration on Form S-1, and the broader investor base, vis-à-vis Regulation D, Reg A+ also offers a solution – albeit a conditional one – for the Securities Exchange Act of 1934 (the “*1934 Act*”) registration problem. Under the 1934 Act, a company that has \$10 million in assets and a class of securities that is held of record by more than 500 non-accredited investors or more than 2,000 investors overall must register as a public company, file periodic reports and comply with a number of other requirements applicable to reporting companies. It is an easy matter for a token offering

¹ Reg A+ was adopted as a result of the JOBS Act in 2012 and has a \$50 million limit for offerings in any twelve-month period, as opposed to the \$20 million limit in a traditional Regulation A offering.

² This requirement applies to a Reg A+ (Tier 2 Regulation A) offering in which the securities are not listed on a national exchange.

and the subsequent trading of the tokens to result in more than 2,000 holders of record of the tokens, thus triggering reporting company obligations under the 1934 Act. However, Regulation A offers an exemption from 1934 Act registration as a reporting company, provided that the company is in compliance with its reporting obligations under Reg A+³ and that the company retains a transfer agent. (Apparently, Blockstack successfully argued that the transfer agent requirement is inapplicable to its token offering because transfers are registered automatically on the blockchain.) However, once a company reaches a certain size, this exemption no longer applies.⁴ Thus, as discussed below, if Blockstack does not succeed in recharacterizing its tokens as non-securities, it may eventually have to meet its obligations as a reporting company under the 1934 Act.

The Tokens qualified in the Reg A+ offering are not “restricted securities” under the federal securities laws and are, in theory, freely tradeable. But, at present, there is no trading market for digital assets such as the Tokens. The Tokens would not be tradeable on existing cryptocurrency exchanges because such exchanges are not registered as securities exchanges with the SEC and are, accordingly, not permitted to trade securities. Moreover, there are no registered securities exchanges or alternative trading systems at this time that are approved by the Financial Industry Regulatory Authority (“FINRA”) to trade the Tokens or any other similar digital assets for that matter.

Blockstack is planning on the eventual transition to an independent, decentralized Blockstack network that it does not control. According to recent guidance from the SEC in its Framework for “Investment Contract” Analysis of Digital Assets (the [“Framework”](#)), a token may lose its character as a security under the federal securities laws if it is usable in a decentralized network that is not dependent on the entrepreneurial or managerial efforts of any particular person. As discussed in the Framework and our recent [Client Alert](#), tokens are viewed by the SEC as “investment contracts” and, hence, securities if they involve the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others, a formulation known as the *Howey* test after the 1946 Supreme Court case. Blockstack believes that the evolution of the Blockstack network will result in a surrender of its control over the network, as core developers other than those employed by Blockstack will become primarily responsible for the development and future success of the network. Thus the “efforts of others” prong of the *Howey* test may no longer be met in the near future, and the reporting of information by Blockstack may not be necessary to protect the interests of holders of the tokens. Such a development, if the SEC were to agree with Blockstack’s position, would solve the 1934 Act reporting company problem described above and would enable the trading of the tokens on existing cryptocurrency exchanges.

As a final observation, the SEC seems to have a “Goldilocks” approach to ICOs. Inadequate development of a token ecosystem smacks of fraud and a get-rich-quick scheme that will doom an attempt to register or qualify an ICO with the SEC. At some point, however, a sufficiently developed and decentralized network will liberate the token from being characterized as a security, and registration (or an exemption) with the SEC will not be necessary. The SEC seems to view Blockstack’s ICO as “just right” in terms of the level of development of its network/ecosystem.

In spite of the success of the Blockstack Reg A+ offering, how and whether to pursue the arduous path of a Reg A+ or a fully registered offering, versus pursuing development of a token and network through financing by other means, including offerings exempt under Regulation D, will continue to be difficult questions for ICO issuers and their securities counsel.

³ Reporting obligations under Regulation A include annual and semi-annual reports and are much less demanding than those under the 1934 Act.

⁴ The conditional exemption is only available to an issuer that has a public float of less than \$75 million, determined as of the last business day of its most recently completed second fiscal quarter, or, in the absence of a public float, annual revenues of less than \$50 million, as of the most recently completed fiscal year.

Additional Information

If you have any questions regarding this Client Alert, please contact your Kutak Rock attorney or one of the authors listed below. For more information regarding our practices, please visit us at www.KutakRock.com.

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