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## **Munchee Inc.: A Turning Point for the Cryptocurrency Industry\***

### **INTRODUCTION**

Initial coin offerings (“ICOs”) are one of the hottest topics in corporate finance. An ICO is a form of crowdfunding where start-ups or online projects raise money by creating and selling their own virtual tokens.<sup>1</sup> Seemingly free from the burdens of registration under the Securities Act of 1933 (“Securities Act” or “Act”),<sup>2</sup> ICOs attracted almost \$4 billion in investments in 2017, exceeding the total value of venture capital investments in blockchain projects.<sup>3</sup>

The Securities Act requires that, absent an exemption, all offerings and sales of securities be registered with the Securities and Exchange Commission (“SEC”). Registration requires certain disclosure documents.<sup>4</sup> These include a prospectus—which details the company’s business, management, and financial performance—and periodic reports filed with the SEC that disclose the company’s operating performance to investors.<sup>5</sup> Securities issuers incur substantial costs to comply with SEC registration and periodic reporting requirements. In an initial public offering, issuers incur, on average, underwriter fees of between 4% and 7% of the gross proceeds, plus an additional \$4.2 million in legal, accounting, and other costs directly attributable to the offering.<sup>6</sup> Additionally, the

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1. Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html> [https://perma.cc/K7V3-AFHf]. For a more detailed background on ICOs, see OFFICE OF INV’R EDUC. & ADVOCACY, SEC, INVESTOR BULLETIN: INITIAL COIN OFFERINGS (2017), [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings) [https://perma.cc/8MX8-ZYNJ].

2. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).

3. ERNST & YOUNG, EY RESEARCH: INITIAL COIN OFFERINGS (ICOs) 6 (2017), [www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/\\$File/ey-research-initial-coin-offerings-icos.pdf](http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/$File/ey-research-initial-coin-offerings-icos.pdf) [http://perma.cc/8PSD-VFRB].

4. See 15 U.S.C. § 77g (2012) (identifying “[i]nformation required in registration statement” and accompanying documents).

5. See id. §§ 77e(b), 78m(a).

6. PRICEWATERHOUSECOOPERS, CONSIDERING AN IPO TO FUEL YOUR COMPANY’S FUTURE? INSIGHT INTO THE COSTS OF GOING PUBLIC AND BEING PUBLIC 20 (2017), [https://www.pwc.com/hu/hu/szolgaltatasok/konyvvizsgalat/szamviteli-tanacsadas/kiadvanyok/cost\\_of\\_an\\_ipo\\_2017.pdf](https://www.pwc.com/hu/hu/szolgaltatasok/konyvvizsgalat/szamviteli-tanacsadas/kiadvanyok/cost_of_an_ipo_2017.pdf) [http://perma.cc/NM7D-NNZE]. These are average

average public company incurs costs of at least \$1 million annually to comply with SEC regulations.<sup>7</sup>

Many promising early-stage start-ups seek financing from venture capital funds or other private investors. Typically, to obtain venture capital financing, start-up founders must sell some of their equity in the growing business. The regulatory burden is lower than conducting a public offering, but founders often must cede some degree of control over the management of the business, as well as a portion of their interests in their businesses' profits.<sup>8</sup>

Prior to December 2017, many viewed ICOs as falling outside the reach of federal securities laws and SEC jurisdiction despite indications that the SEC intended to regulate these offerings.<sup>9</sup> Because of this, ICOs appeared to be a source of financing that avoided the burdens associated with a registered offering and lacked the downsides of obtaining private financing. Entrepreneurs who chose to conduct ICOs believed that cryptocurrency offered a way to finance growth (while avoiding SEC oversight and regulations) and maintain full control over operations and profits of the growing business.<sup>10</sup>

In December 2017, the SEC instituted cease and desist proceedings against Munchee Inc. in *Munchee Inc.* (proceedings referenced throughout as "*Munchee*"), finding that its ICO was an unregistered securities offering in violation of section 5 of the Securities Act.<sup>11</sup> This Recent Development argues that the SEC's reasoning in *Munchee* is far-reaching and that its enforcement action represents a turning point for the cryptocurrency industry, calling into question the continued usefulness of ICOs as a form of financing.

The analysis proceeds in five parts. Part I lays out the facts of *Munchee*. Part II analyzes the SEC's application of the "Howey test"

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costs, and in more complex offerings, issuers may incur substantially higher legal and accounting fees.

7. *Id.* These include accounting and legal costs necessary to comply with the Securities Exchange Act and SEC regulations.

8. See *infra* Section IV.A (evaluating the benefits of an ICO after the SEC's enforcement action against Munchee Inc.).

9. See Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, 2017 WL 7184670, at \*1 (July 25, 2017) (discussing inconclusive SEC investigation into virtual tokens).

10. See Popper, *supra* note 1.

11. Munchee Inc., Securities Act Release No. 10445, 118 SEC Docket 5, at 1–2 (Dec. 11, 2017) (SEC cease and desist order).

from *SEC v. W.J. Howey Co.*,<sup>12</sup> which courts use to determine whether an “investment contract” is a security. Part III discusses the implications of *Munchee* on future ICOs, proposing that future offerings must register with the SEC or fit one of several poorly tailored existing exemptions. Part IV questions the costs and benefits of raising capital through a regulated ICO post-*Munchee* and suggests that, in many cases, ICOs are no longer an attractive form of financing. Finally, Part V argues that, despite severe consequences for the cryptocurrency industry, the SEC’s decision to intervene in the cryptocurrency markets was in line with its mission to protect investors; ensure fair, orderly, and efficient markets; and facilitate capital formation.

### I. MUNCHEE INC. OVERVIEW

In *Munchee*, the SEC definitively determined that certain cryptocurrencies offered in ICOs fit the definition of “securities” under the Securities Act<sup>13</sup> and are therefore subject to the Act’s registration requirements.<sup>14</sup> The respondent, Munchee Inc., was a typical ICO issuer: an early stage start-up business that chose to raise capital through an unregulated ICO rather than seek venture capital funding.<sup>15</sup> The company developed an iPhone application for customers to review restaurant meals.<sup>16</sup> In connection with the development of the application, Munchee Inc. offered and sold digital tokens known as “MUN” on a blockchain or distributed ledger.<sup>17</sup>

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12. 328 U.S. 293 (1946). “The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” *Id.* at 301.

13. “Security” is defined under section 2(a)(1) of the Securities Act. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(a)(1) (2012). Securities include stock, notes, security-based derivatives, and “investment contracts.” *Id.* Investment contracts are investments of money in a common enterprise with the expectation of profits from the efforts of others. *Howey*, 328 U.S. at 298–99.

14. *Munchee Inc.*, 118 SEC Docket 5, at 2.

15. For a discussion of the impact of ICOs on the venture capital industry, see Yuliya Chernova, *Who Needs Venture Capital When You Have Initial Coin Offerings?*, WALL ST. J. (Sept. 14, 2017), <https://www.wsj.com/articles/coin-mania-forces-vcs-to-sidelines-on-cryptocurrency-1505388633> [https://perma.cc/X9ML-X37N (dark archive)]; Theodore Schleifer, *Silicon Valley is Obsessed With ICOs—Here’s Why*, RECODE (Sept. 19, 2017), <https://www.recode.net/2017/9/19/16243110/initial-coin-offering-ico-explained-what-is-money-bitcoin-digital-currency> [https://perma.cc/QRT7-EMZM].

16. *Munchee Inc.*, 118 SEC Docket 5, at 1.

17. *Id.* For a basic overview of blockchain, see *What is Blockchain Technology? A Step-by-Step Guide for Beginners*, BLOCKGEEKS, <https://blockgeeks.com/guides/what-is-blockchain-technology/> [http://perma.cc/6J9C-4U76].

Ultimately, Munchee Inc. envisioned developing an “ecosystem” where users would “buy advertisements, write reviews, sell food, and conduct other transactions using MUN.”<sup>18</sup>

More importantly, MUN served a financing purpose. Munchee Inc. offered MUN to the public to raise \$15 million to finance the development of the iPhone application and other operational expenses.<sup>19</sup> In the offering, the company proposed issuing 225 million MUN out of a finite supply of 500 million tokens.<sup>20</sup> The company retained the remaining 275 million tokens to pay rewards to its application users, pay employees, and facilitate future advertising transactions.<sup>21</sup> The company intended to use the proceeds from the offering to fund marketing and user acquisition, increase the size of the development team, pay legal and compliance fees, and “ensure the smooth operation of the MUN token ecosystem.”<sup>22</sup>

To integrate the tokens into its business plan, Munchee Inc. proposed creating an ecosystem where content creators could earn tokens by using the application. For example, the company would use MUN to pay users to write food reviews.<sup>23</sup> MUN could be used to make in-app purchases, and the company proposed working with restaurants to arrange agreements where its customers could use MUN to purchase restaurant meals.<sup>24</sup> The company highlighted in its offering document, or white paper, that the increased use of the application would increase the value of the tokens by creating greater demand.<sup>25</sup>

The company intended for investors to freely trade MUN. Munchee Inc.’s white paper noted that the company would “ensure that MUN token is available on a number of exchanges in varying jurisdictions” to ensure the conversion of the tokens to dollars or

18. *Munchee Inc.*, 118 SEC Docket 5, at 1, 4.

19. *Id.* at 3.

20. SANJEEV VERMA, NGHI BUI & CHELSEA LAM, MUNCHEE TOKEN: A DECENTRALIZED BLOCKCHAIN BASED FOOD REVIEW/RATING SOCIAL MEDIA PLATFORM 10, 18 (2017), <https://www.theventurealley.com/wp-content/uploads/sites/5/2017/12/Munchee-White-Paper.pdf> [http://perma.cc/573Z-ST2B].

21. *Munchee Inc.*, 118 SEC Docket 5, at 3.

22. VERMA ET AL., *supra* note 20, at 20. The exact breakdown of the use of proceeds was as follows: (1) 35% to be “applied to marketing, user acquisition, and promotion”; (2) 40% to be “applied to growing the development team”; (3) 10% to be applied to legal costs to make sure the company was compliant with relevant laws in all countries; and (4) 15% to be “reserved for maintenance and to ensure the smooth operation of the MUN token ecosystem.” *Id.*

23. *Munchee Inc.*, 118 SEC Docket 5, at 4.

24. *Id.*

25. VERMA ET AL., *supra* note 20, at 11.

other cryptocurrencies.<sup>26</sup> Munchee Inc. represented that MUN would be tradeable on at least one exchange within thirty days of the offering, and the company would use its retained token holdings to support a liquid market in MUN.<sup>27</sup> Additionally, when soliciting investors during the offering process, the company highlighted the potential for appreciation in the value of the tokens.<sup>28</sup> To increase the value of the tokens as the company's business improved, Munchee Inc. also indicated that it would take tokens out of circulation to increase their scarcity as restaurants signed up to use the application.<sup>29</sup>

Given the offering's material deviations from federal securities law,<sup>30</sup> the Munchee Inc. ICO attracted the attention of the SEC. In December 2017, the SEC issued a cease and desist order against the company for violating section 5 of the Securities Act.<sup>31</sup> In the adjudication, the SEC determined that MUN tokens were securities as defined in section 2(a)(1) of the Securities Act,<sup>32</sup> and the ICO constituted an unregistered offering of securities in violation of the Act.<sup>33</sup>

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26. *Id.* at 11–12.

27. *Id.* at 20.

28. Quoc Nghi, *7 Reasons You Need to Join the Munchee Token Generation Event*, MEDIUM (Oct. 29, 2017), <https://blog.munchee.io/7-reasons-you-need-to-join-the-munchee-token-generation-event-bf706e5dd068> [https://perma.cc/7SNY-Z48M]. In a bulleted list of reasons to invest in MUN tokens, the company highlighted that “[a]s more users get on the platform, the more valuable your MUN tokens will become.” *Id.* Munchee Inc.’s founders also hosted a podcast during the offering where they explained that “the more restaurants we have, the more quality content Munchee Inc. has, the value of the MUN token will go up.” *Munchee Inc.*, 118 SEC Docket 5, at 5; *see also* Munchee, FACEBOOK (Oct. 25, 2017), <https://www.facebook.com/muncheeapp/posts/508678116159681> [http://perma.cc/3HGB-SRVB] (claiming “199% [gains] on MUN token at ICO price”).

29. VERMA ET AL., *supra* note 20, at 17.

30. For example, the Munchee Inc. ICO lacked a prospectus that complied with the Securities Act, and management promised significant gains in the value of the tokens that could not be substantiated. *See supra* note 28 and accompanying text. While Munchee Inc.’s ICO was not necessarily fraudulent, Securities Act requirements exist not only to prevent fraud but also to protect investors by requiring disclosure of material information about the issuer and to prohibit embellishment of the future performance of an issuer’s securities. *See The Laws That Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 1, 2013), <https://www.sec.gov/answers/about-lawshtml.html> [https://perma.cc/9ZTL-WECK]. The lack of substantiated information given to investors in Munchee Inc.’s ICO triggered the need for the SEC to take action.

31. *Munchee Inc.*, 118 SEC Docket 5, at 1–2 (finding that “Munchee violated Sections 5(a) and 5(c) of the Securities Act”).

32. *Id.* at 2; *see also* 15 U.S.C. § 77b(a)(1) (2012) (defining “security” under the Securities Act).

33. *Munchee Inc.*, 118 SEC Docket 5, at 9–10.

## II. THE SEC'S APPLICATION OF THE *HOWEY* TEST

To determine that MUN were investment contracts and therefore securities under section 2(a)(1) of the Securities Act,<sup>34</sup> the SEC applied the *Howey* test.<sup>35</sup> In *SEC v. W.J. Howey Co.*, the Supreme Court articulated a four-element test to determine whether an investment is an investment contract and therefore a security.<sup>36</sup> Under *Howey*, an investment contract exists if: (1) an investment of money is made, (2) in a common enterprise, (3) with profits, (4) resulting only from the efforts of others.<sup>37</sup> Investors in MUN clearly invested money in a common enterprise, so the SEC focused on whether investors purchased MUN with the expectation of profits derived from the efforts of others.<sup>38</sup>

### A. *Investors Purchased MUN as For-Profit Investments*

In *Howey*, the Supreme Court focused on the actual purpose for which the company offered instruments to determine whether an investment was for profit.<sup>39</sup> In *Howey*, the defendant sold shares that included both small parcels of land on an orange farm and a service contract under which the defendant would tend to the land.<sup>40</sup> The defendant sold these packages exclusively to nonfarmer investors.<sup>41</sup> The individual plots were also too small to farm, leading the Court to hold that the land and service contract packages were intended to be for-profit speculative investments rather than purchases of productive land.<sup>42</sup> Building on *Howey*, in *United Housing Foundation, Inc. v. Forman*,<sup>43</sup> the Supreme Court held that “form should be disregarded for substance and the emphasis should be on economic reality” when

34. § 77b(a)(1).

35. *See Munchee Inc.*, 118 SEC Docket 5, at 8.

36. SEC v. W.J. Howey Co., 328 U.S. 293, 300–01 (1946).

37. *See id.*

38. In making this determination, the key issues are whether the investor purchased the asset to earn profits and whether those profits were primarily derived from the efforts of others. *Id.* at 299–300; *see also Munchee Inc.*, 118 SEC Docket 5, at 8–9 (discussing MUN investors’ expectation of profits and that the “profits were to be derived from the significant entrepreneurial and managerial efforts of others”). There is some overlap in the analysis of these two prongs of the *Howey* test, as they both involve a determination of whether an investment asset was intended to be a passive investment. *See Long v. Shultz Cattle Co.*, 881 F.2d 129, 139 (5th Cir. 1989) (combining the final two elements of the *Howey* test into a single “third prong” including “the expectation of profits solely from the efforts of others”).

39. *Howey*, 328 U.S. at 299–300.

40. *Id.* at 295–96.

41. *Id.* at 296.

42. *See id.* at 299–300.

43. 421 U.S. 837 (1975).

determining whether an instrument was purchased for profit.<sup>44</sup> In its investment contract analysis, the Supreme Court focused on the investor's purpose in purchasing the contracts, further supporting the contention that the parties' subjective understanding about the transaction is relevant to determine whether an investment is made for profit.<sup>45</sup> Accordingly, courts applying *Howey* conduct an independent analysis of whether an asset is purchased for profit, regardless of how the parties labeled the asset.

In its enforcement against Munchee Inc., the SEC correctly held that the company offered, and investors purchased, MUN as for-profit investments rather than units of exchange.<sup>46</sup> Munchee Inc.'s white paper described the value and purpose of MUN as "utility tokens."<sup>47</sup> Utility tokens, or tokens used as a mode of exchange as well as a passive investment, provide access to a company's product or service and are similar to currencies.<sup>48</sup> Pure utility tokens are not intended to be investments and would generally not be subject to securities laws.<sup>49</sup> In this instance, however, the SEC looked beyond the utility token label and examined the economic substance of MUN.<sup>50</sup> The SEC's analysis ultimately found that the tokens were offered as investments rather than units of exchange,<sup>51</sup> noting that the offering materials and sales literature stressed the possibility of capital appreciation in the tokens.<sup>52</sup> For example, one Facebook solicitation represented that investors in MUN should expect 199% gains on their ICO investment.<sup>53</sup> The SEC also stressed that, at the time of the offering, there were no services currently available to

44. *Id.* at 848 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

45. *See id.* at 858; *see also SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 583–84 (2d Cir. 1982) (considering that a company exclusively targeted financial investors with no experience selling dental supplies as a factor in determining that licenses to sell dental supplies were intended to be passive investments).

46. Munchee Inc., Securities Act Release No. 10445, 118 SEC Docket 5, at 8–9 (Dec. 11, 2017).

47. *See VERMA ET AL., supra* note 20, at 3 ("[A]s this is a sale of utility tokens, it is not being provided through any of the exemptions under the United States Securities Act.").

48. Josiah Wilmoth, *ICO 101: Utility Tokens vs. Security Tokens*, STRATEGIC COIN (Dec. 18, 2017), <http://strategiccoin.com/ico-101-utility-tokens-vs-security-tokens/> [http://perma.cc/7X79-758S].

49. *See id.*

50. *See Munchee Inc.*, 118 SEC Docket 5, at 9.

51. *See id.* at 8.

52. *See id.* at 9 ("Investors' expectations were primed by Munchee's marketing of the MUN token offering.").

53. *See id.* at 6.

purchase with MUN.<sup>54</sup> Finally, the company targeted its offering to cryptocurrency investors rather than potential application users.<sup>55</sup> In its offering documents, the company compared MUN to other assets that had created profits for investors and targeted marketing of the offering to investors who had previously participated in those offerings.<sup>56</sup> Although Munchee Inc. labeled MUN as “utility tokens,” it clearly offered MUN to investors as for-profit investments.

#### *B. MUN Investors Would Derive Profits “From the Efforts of Others,” Not User Contributions*

The SEC also correctly held that investors would derive profits “from the significant entrepreneurial and managerial efforts of others,” particularly by Munchee Inc. and its executives developing the MUN ecosystem.<sup>57</sup> In *SEC v. Glenn W. Turner Enterprises, Inc.*,<sup>58</sup> the Ninth Circuit held that securities purchasers could offer their selling efforts, not just their money, as consideration so long as the returns from the investment were primarily dependent on the efforts of others.<sup>59</sup> As a result, an investment may still qualify as a security even if the purchaser’s own efforts play a part in increasing the investment’s value.<sup>60</sup>

Token holders submitting content to the application would, in part, drive appreciation in the value of MUN.<sup>61</sup> Nevertheless, the SEC concluded that investors would still primarily derive profits from the efforts of others.<sup>62</sup> In reaching this conclusion, the SEC focused on the importance of developing the MUN ecosystem to the value of the tokens.<sup>63</sup> For example, the company committed to providing a secondary market for the tokens within thirty days of completing the offering and indicated that it would use reserve tokens to provide liquidity to generate an active trading market.<sup>64</sup> This appeared to be a

54. *See id.* at 4 (describing the ecosystem that Munchee Inc. *would* create with the funding from the ICO).

55. *Id.* at 6 (“Munchee and its agents targeted the marketing of the MUN tokens offering to people with an interest in tokens or other digital assets that have in recent years created profits for early investors in ICOs.”).

56. *Id.* at 9.

57. *Id.*

58. 474 F.2d 476 (9th Cir. 1973).

59. *See id.* at 482.

60. *Id.*

61. *See Munchee Inc.*, 118 SEC Docket 5, at 8–9.

62. *See id.*

63. *See id.*

64. VERMA ET AL., *supra* note 20, at 20; *see also* *Munchee Inc.*, 118 SEC Docket 5, at 9.

conscious effort on Munchee Inc.'s part to provide investors with liquidity to convert their investment to cash or other cryptocurrencies. The SEC also highlighted the company's efforts to increase the value of the tokens as use of its application increased.<sup>65</sup> The value of the tokens would rise as more users joined the application.<sup>66</sup> Additionally, the company planned to limit supply by removing tokens from circulation as more restaurants partnered with the application, which would further increase the value of the coins.<sup>67</sup> This also tied MUN's performance to the company's performance—as the application gained more users, increased demand and the company's efforts to limit supply would cause a corresponding increase in the value of MUN in the same manner that the value of corporate stock increases as a company increases earnings.

The SEC persuasively applied the *Howey* test to conclude that MUN were investment contracts and therefore securities as defined by the Securities Act. Though the technology underlying MUN differed from traditional investments, MUN were offered as passive financial investments to individuals who never intended to use the company's application. SEC Chairman Jay Clayton recently echoed this reasoning at a congressional oversight hearing, stating:

[B]y and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws. . . . Merely calling a token a “utility” token or structuring it to provide some utility does not prevent the token from being a security. Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law.<sup>68</sup>

Chairman Clayton's comments suggest that *Munchee* was not an exceptional case and that the SEC will continue to enforce securities laws in the context of an ICO. Future issuers will need to consider

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65. See *Munchee Inc.*, 118 SEC Docket 5, at 8–9.

66. *Id.*

67. VERMA ET AL., *supra* note 20, at 17.

68. *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 115th Cong. 6–8 (2018) (statement of Jay Clayton, Chairman, SEC).

SEC regulations when determining whether an ICO is an effective way for their businesses to raise capital.

### III. CONSEQUENCES OF THE *MUNCHEE* DECISION

Given the persuasiveness of the SEC's application of the *Howey* test and the unremarkable facts of the MUN offering, the SEC's holding in *Munchee* will have far-reaching consequences for companies considering an ICO. The SEC will likely regulate most ICOs and subject them to registration requirements, which reduces flexibility for issuers and adds expense to the offering process. This calls into question their usefulness to issuers going forward.

#### A. *The SEC Will Enforce Section 5 Against ICOs in the Absence of Fraud*

Section 5 of the Securities Act does not require a showing of fraud to justify an SEC refusal order or a cease and desist proceeding.<sup>69</sup> Despite this, many cryptocurrency promoters posited that the SEC would focus its efforts on preventing fraud and would not bring enforcement actions against issuers that sold unregistered cryptocurrencies to fund legitimate businesses.<sup>70</sup> *Munchee* discredited this position.<sup>71</sup> While *Munchee* Inc.'s ICO was unregistered and its sales literature contained overly promotional statements, the SEC did not find fraud.<sup>72</sup> This confirms that section 5 imposes the same requirements and sanctions on cryptocurrency issuers as any other issuer.

#### B. *Cryptocurrency Issuers Likely Cannot Avoid the Definition of Security*

In *Munchee*, the SEC made clear that cryptocurrency issuers will, in most cases, be unable to structure their ICOs to circumvent securities laws. Under heightened SEC scrutiny, efforts to structure a

69. See Securities Act of 1933 § 5, 15 U.S.C. § 77h(b)–(c) (2012).

70. See Erin Griffith, *The Hustlers Fueling Cryptocurrency's Marketing Machine*, WIRED (June 12, 2018), <https://www.wired.com/story/the-hustlers-fueling-cryptocurrencies-marketing-machine/> [http://perma.cc/8UZZ-W9LH].

71. See *The SEC Just Issued a Warning to Cryptocurrency Investors*, REUTERS (Dec. 12, 2017), <https://www.cnbc.com/2017/12/11/bitcoin-latest-sec-jay-clayton-warns-on-cryptocurrencies-munchee-ico.html> [http://perma.cc/7C4Z-25U5] (claiming the *Munchee* enforcement “showed [the] SEC would step in to address ICOs for registration violations even if there were no claims of fraud”).

72. See *Munchee* Inc., Securities Act Release No. 10445, 118 SEC Docket 5, at 10 (Dec. 11, 2017) (finding section 5(a) and (c) violations but not fraud).

cryptocurrency offering to avoid the definition of a security will likely fail.

First, though underdeveloped, Munchee Inc.'s platform was operational at the time of the ICO.<sup>73</sup> This could have weakened the argument that the buildout of the platform was the primary generator of the returns on token investments.<sup>74</sup> The SEC still found that management of the application and efforts to attract restaurants to the platform were sufficient to constitute "profit . . . resulting from Munchee Inc.'s efforts."<sup>75</sup> After *Munchee*, companies cannot avoid Securities Act registration requirements simply by claiming that the ICO-funded project is complete.

Second, *Munchee* makes clear that labeling cryptocurrencies as utility tokens is insufficient to exclude cryptocurrencies from the definition of a security.<sup>76</sup> Munchee Inc. had an existing platform on which the tokens could immediately serve as currencies rather than merely passive investments.<sup>77</sup> Though the cryptocurrency community distinguishes between utility tokens and securities tokens,<sup>78</sup> the SEC evaluates the substance of the transaction and whether the parties intended the instrument to be a passive investment.<sup>79</sup> Accordingly, if offering materials for an ICO stress the investment benefits of tokens, and marketing efforts target coin investors rather than potential customers, the SEC will treat the cryptocurrency as a security regardless of its label.

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73. See Roger Aitken, *U.S. SEC Stops ‘Munching’ Munchee’s ICO After Reg Concerns Raised*, FORBES (Dec. 12, 2017), <https://www.forbes.com/sites/rogeraitken/2017/12/12/u-s-sec-stops-munching-munchees-ico-after-registration-concerns-raised/#39dbb6ab3144> [http://perma.cc/PA99-LBAS] (noting that Munchee Inc. intended to raise funding through the ICO to improve an existing iPhone application).

74. See *id.* (discussing the vague use of a token's "functionality" in efforts to avoid regulation).

75. *Munchee Inc.*, 118 SEC Docket 5, at 8–9.

76. *Id.*

77. See *id.* at 9 (describing uses of MUN tokens on the Munchee Inc. app).

78. See, e.g., Micha Benoliel, *Understanding the Difference Between Coins, Utility Tokens and Tokenized Securities*, STARTUP GRIND (Aug. 8, 2017), <https://medium.com/startup-grind/understanding-the-difference-between-coins-utility-tokens-and-tokenized-securities-a6522655fb91> [http://perma.cc/ZY9U-D4UJ] (distinguishing between utility tokens and "tokenized securities," which are subject to SEC regulation); Wilmoth, *supra* note 48.

79. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848–49 (1974); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

*C. Securities Act Registration Exemptions Are Likely Available but Unattractive*

The SEC's reasoning in *Munchee* indicates that, with few exceptions, cryptocurrencies are securities. This raises the question of whether cryptocurrency issuers might still avoid registration by meeting one of several registration exemptions under the Securities Act.

These exemptions necessarily involve restrictions on using the ICO structure and proceeds. Four groups of exemptions may be relevant to an ICO: Regulation D,<sup>80</sup> Regulation A,<sup>81</sup> the intrastate crowdfunding exemptions,<sup>82</sup> and Regulation Crowdfunding.<sup>83</sup> As a technical matter, companies could almost certainly structure an ICO to meet any one of these exemptions, but each has certain requirements that limit their attractiveness to ICO issuers. Three key drawbacks are (1) restrictions on transferability, (2) restrictions on solicitation, and (3) capital raising caps.

1. Restrictions on Transferability

First, several registration exemptions restrict investors from freely transferring their shares. Section 506 of Regulation D restricts resales of securities purchased in the exempt offering.<sup>84</sup> SEC Rule 144 provides a safe harbor for compliance with the restriction on transferability requirement.<sup>85</sup> For nonreporting companies,<sup>86</sup> a minimum of one year must elapse before the investor purchasing in the exempt offering may transfer the securities to a secondary purchaser.<sup>87</sup>

Intrastate offering exemptions also restrict resale by purchasers in the offering. Both the intrastate offering exemption and the intrastate crowdfunding exemption require that securities purchased in the offering "come to rest" with residents of the state in which the

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80. 17 C.F.R. §§ 230.500–.506 (2018).

81. *Id.* §§ 230.251–.263.

82. 15 U.S.C. § 77c(a)(11) (2012); 17 C.F.R. §§ 230.147–.147A (2018).

83. 15 U.S.C. § 77d(a)(6) (Supp. 2017).

84. § 230.506.

85. *Id.* § 230.144.

86. Nonreporting companies are companies not subject to periodic reporting requirements under section 13 or section 15(d) of the Securities Exchange Act of 1934. Given that ICO issuers almost certainly have not previously issued securities to the public, they are almost certainly nonreporting companies.

87. 17 C.F.R. § 230.144(d)(1)(ii) (2018).

offering took place.<sup>88</sup> SEC Rule 147, which provides a safe harbor for the intrastate offering exemption, and Rule 147A, which provides requirements to comply with the intrastate crowdfunding exemption, both restrict resales to investors outside the state within six months of the offering.<sup>89</sup>

Restrictions on resale significantly limit the attractiveness of exempt ICOs to potential investors. Venture capital funds that have participated in ICOs have cited liquidity as a major reason to purchase cryptocurrencies rather than purchase equity.<sup>90</sup> It may take a venture capital fund several years to exit a traditional equity investment in a start-up business, while cryptocurrencies are readily convertible to cash.<sup>91</sup> Restrictions on resale, however, eliminate this advantage without providing the benefit of control that a venture capital investor typically receives from an equity investment. Restrictions on transfers also limit the usefulness of the intrastate offering exemptions. Before *Munchee*, ICOs were global in scale.<sup>92</sup> Solicitations were made over the internet and could reach investors all over the world. Limiting an ICO's reach to one state would greatly reduce its utility to issuers.

## 2. Restrictions on Solicitation

Restrictions on solicitation are a second limitation to exempt ICOs. Rule 506(b) of Regulation D prohibits general solicitation.<sup>93</sup> As a result, issuers offering securities under the exemption cannot advertise the offering to the public.<sup>94</sup> Rule 506(c) permits general solicitation to accredited investors but allows no more than thirty-five

88. See, e.g., *Busch v. Carpenter*, 827 F.2d 653, 656 (10th Cir. 1987) (“The SEC has consistently maintained that a distribution of securities must have ‘actually come to rest in the hands of resident investors—persons purchasing for investment and not with a view to further distribution or for purposes of resale.’” (quoting Opinion on the Definition of Parent, Securities Act Release No. 1256, 11 Fed. Reg. 10,958, 10,959 (May 29, 1937))).

89. 17 C.F.R. §§ 230.147(e), .147A(e) (2018).

90. Richard Kastelein, *What Initial Coin Offerings Are, and Why VC Firms Care*, HARV. BUS. REV. (Mar. 24, 2017), <https://hbr.org/2017/03/what-initial-coin-offerings-are-and-why-vc-firms-care> [http://perma.cc/U67H-KDR3].

91. *Id.* Cryptocurrencies can be freely traded like public equity investments, whereas equity investments in private, start-up businesses tend to be hard to exit and are considered long-term investments. *Id.*

92. See, e.g., VERMA ET AL., *supra* note 20, at 4 (noting “[m]any international jurisdictions have indicated that token sales may qualify as sales of investment contracts”).

93. 17 C.F.R. § 230.506(b)(2) (2018).

94. *Id.*

nonaccredited<sup>95</sup> investors to purchase securities.<sup>96</sup> Both provisions of Regulation D also require that purchasers be knowledgeable, sophisticated, and able to understand and bear the risk of the investment.<sup>97</sup> Because cryptocurrency issuers tend to be little-known start-up businesses, solicitation is important to garner sufficient investor interest to conduct the ICO. Rule 506(b) offerings are therefore likely infeasible for cryptocurrency issuers because access to the general public is limited or entirely unavailable. If the issuer instead relies on Rule 506(c), compliance with the accredited-investor requirement compels the issuer to verify the identities of the investors.<sup>98</sup> Verification violates one of the fundamental principles of cryptocurrencies—anonymity of transactions.<sup>99</sup>

The intrastate offering exemptions also impose restrictions on solicitation. Section 3(a)(11) of the Securities Act prohibits out-of-state offerees.<sup>100</sup> The intrastate crowdfunding exemption under Rule 147A relaxes this requirement considerably by permitting issuers to make offers to nonresidents but still prohibits issuers from selling securities to nonresident offerees.<sup>101</sup> Territorial restrictions on the offering greatly limit its scope and the issuer's ability to raise capital.

Regulation Crowdfunding also significantly limits solicitation by issuers. Regulation Crowdfunding mandates use of a funding portal, a crowdfunding intermediary through which investors can purchase securities, to offer and sell securities.<sup>102</sup> Funding portals must be

95. Accredited investors include institutional investors and individuals with a net worth of greater than \$1,000,000, excluding the value of their personal residence, or with annual income of greater than \$200,000. *Id.* § 230.501(a). Married individuals are considered accredited investors if their joint net worth exceeds \$1,000,000 or their joint annual net income exceeds \$300,000. *Id.* § 230.501(a)(5). Because many ICOs seek smaller investments from large groups of individual investors, restrictions on the ability of issuers to market ICOs to nonaccredited investors impedes the typical offering process.

96. *Id.* § 230.506(c)(2)(i).

97. OFFICE OF INV'R EDUC. & ADVOCACY, SEC, INVESTOR BULLETIN: PRIVATE PLACEMENTS UNDER REGULATION D (Sept. 24, 2014), [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_privateplacements.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html) [https://perma.cc/MDR9-5DH9].

98. 17 C.F.R. § 230.506(c)(2)(ii) (2018).

99. *Bitcoin Transactions Aren't as Anonymous as Everyone Hoped*, MIT TECH. REV. (Aug. 23, 2017), <https://www.technologyreview.com/s/608716/bitcoin-transactions-arent-as-anonymous-as-everyone-hoped/> [https://perma.cc/86D3-UT5A]. Blockchain transactions are intended to be anonymous, though anonymity is not perfect because online pseudonyms could possibly be linked to their user. *Id.* Requiring verification of parties involved in a cryptocurrency transaction would eliminate “[o]ne of the great promises of this technology.” *Id.*

100. See 15 U.S.C. § 77c(a)(11) (2012).

101. 17 C.F.R. § 230.147A (2018).

102. *Id.* § 227.100(a)(3).

registered with the SEC and meet certain requirements.<sup>103</sup> The issuer itself may not advertise the offering except in a notice that directs investors to the funding portal and gives basic factual information about the offering and the issuer's business.<sup>104</sup> The mandated form of solicitation in Regulation Crowdfunding threatens one of the key promises of cryptocurrency offerings—decentralization.<sup>105</sup> SEC regulation already threatens decentralization, and mandating distribution through certain broker-dealers and funding portals would totally centralize cryptocurrency offerings.

### 3. Capital Raising Caps

A final limitation on the use of federal securities exemptions to conduct an ICO are caps restricting the amount of capital that can be raised in an exempt offering. Rule 504 of Regulation D, Regulation A, and Regulation Crowdfunding all impose caps on the amount of capital that can be raised under each exemption.<sup>106</sup> In 2017, the average amount raised in an ICO was \$12.7 million.<sup>107</sup> The largest ICOs skew this number,<sup>108</sup> but it is still well above the \$5 million and \$1.07 million caps on capital raising within a twelve-month period imposed by Rule 504 and Regulation Crowdfunding, respectively.<sup>109</sup>

Regulation A also caps the amount of capital that can be raised using the exemption.<sup>110</sup> The exemption provides for two tiers of

103. *Id.* § 227.400.

104. *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC (Apr. 5, 2017), <https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#4> [<https://perma.cc/4NGU-SJL9>].

105. See Mike Orcutt, *Bitcoin and Ethereum Have a Hidden Power Structure and It's Just Been Revealed*, MIT TECH. REV. (Jan. 18, 2018), <https://www.technologyreview.com/s/610018/bitcoin-and-ethereum-have-a-hidden-power-structure-and-its-just-been-revealed/> [<https://perma.cc/QCU6-MPJU>]. Proponents consider decentralization advantageous because it reduces the expenses and increased transaction charges that result from government and central bank actions. See Jennifer Spencer, *The Risks and Benefits of Digital Currency*, ENTREPRENEUR (Nov. 2, 2017), <https://www.entrepreneur.com/article/302778> [<https://perma.cc/Y4PW-M7C8>].

106. See 17 C.F.R. §§ 230.504(b)(2), 227.100(a)(1) (2018).

107. Oscar Williams-Grut, *Only 48% of ICOs Were Successful Last Year—but Startups Still Managed to Raise \$56 Billion*, BUS. INSIDER (Jan. 31, 2018), [www.businessinsider.com/how-much-raised-icos-2017-tokendata-2017-2018-1](http://www.businessinsider.com/how-much-raised-icos-2017-tokendata-2017-2018-1) [<https://perma.cc/BW4M-VMYE>].

108. *Id.* “[T]he 10 largest ICOs in 2017 raised nearly \$1.4 billion and roughly 25% of the total capital raised [in ICOs] in 2017.” *Id.*

109. §§ 230.504(b)(2), 227.100(a)(1).

110. OFFICE OF INV'R EDUC. & ADVOCACY, SEC, INVESTOR BULLETIN: REGULATION A (2015), [https://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_regulationa.html](https://www.sec.gov/oiea/investor-alerts-bulletins/ib_regulationa.html) [<https://perma.cc/9V4N-M6JE>].

offerings.<sup>111</sup> Under Tier I, issuers can offer up to \$20 million of securities in a twelve-month period without complying with SEC reporting requirements.<sup>112</sup> Tier II allows the issuer to raise up to \$50 million in a twelve-month period but imposes higher disclosure requirements.<sup>113</sup> Regulation A's caps are high enough to accommodate the average ICO and would have accommodated Munchee Inc.'s ICO. Regulation A is therefore a legitimate option for many cryptocurrency issuers, but it still fails to adequately remove burdensome regulation. Regulation A offerings are more heavily regulated than other exempt offerings—like IPOs, they require considerable disclosures and are subject to SEC oversight.<sup>114</sup>

#### IV. POST-*MUNCHEE*, ICOS OFFER FEW BENEFITS OVER TRADITIONAL SECURITIES OFFERINGS

Most ICOs are likely securities offerings following *Munchee*. Accordingly, issuers must either register their ICO with the SEC and comply with the Securities Act or file under an exemption that may not fit their specific situation. The important question after *Munchee*, therefore, is why an issuer would offer cryptocurrencies when regulatory requirements are the same as an offering of any other security. Cryptocurrency offerings are unlikely to be the same low-cost, unregulated forms of financing they were before *Munchee*, substantially altering the cost-benefit analysis.

##### *A. Remaining Benefits of an ICO*

There are still some advantages to raising capital with an ICO, though they fall well short of the prior advantage of avoiding SEC regulation. First, owners can seek external funding without diluting their interests in the business's profits.<sup>115</sup> Because their businesses are not selling equity, the owners retain 100% of the residual profits.

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111. *Id.*

112. *Id.*

113. *Id.*

114. See, e.g., Tom Zanki, *Reg A+ 'Mini-IPOS' Make Headway with Small Companies*, LAW360 (Oct. 6, 2017), <https://www.law360.com/articles/971717/reg-a-mini-ipos-make-headway-with-small-companies> [https://perma.cc/TW4H-5K3A (dark archive)]. For example, in contrast to Regulation D, Regulation A mandates preparation of an offering circular for investors, which is essentially a scaled-down prospectus. See KATHERINE K. DELUCA ET AL., MCGUIREWOODS LLP, A GUIDE TO REGULATION A+ 9 (2015), <http://media.mcguirewoods.com/publications/2015/White-Paper-on-Regulation-Aplus.pdf> [https://perma.cc/6QAQ-5T2R].

115. Yoolim Lee, *Venture Capital or ICO? Startups Face Cash-Raising Dilemma*, BLOOMBERG (Jan. 21, 2018), <https://www.bloomberg.com/news/articles/2018-01-21/to-ico-or-not-to-ico-that-is-the-question-for-today-s-startups> [https://perma.cc/8AJD-C7JA].

Going forward, issuers could raise capital through registered ICOs as a way of obtaining financing for the business without diluting founders' ownership interests in the underlying profits. The value of the cryptocurrency would likely relate to the performance of the company, but cryptocurrency holders would not own any entitlement to the business's profits. Owners who do not want to give up equity and whose business cannot support debt financing may still consider raising capital through a registered ICO.<sup>116</sup>

Cryptocurrencies also prevent dilution of a founder's ownership and control of the business. Typically, when a company receives venture capital financing, it must give up some degree of control over its business plan in exchange, as well as a board seat.<sup>117</sup> In theory, venture capital investors provide the start-up business's board with expertise and experience, as well as help the company refine and execute its business plan.<sup>118</sup> In practice, however, venture capital's impact on a company can be mixed, with some suggesting venture capital funds often add negative value.<sup>119</sup> Regardless, founders want to maintain control over their vision for the company and often cite control over governance as a larger concern than financing.<sup>120</sup> A business could better prioritize the quality of the product or service by choosing to undertake an ICO. Doing so could reduce pressure from financial investors to reduce costs and prioritize short-term financial returns.<sup>121</sup> If a founder wishes to retain full control of the board and corporate policy, she may find an ICO to be an attractive alternative to venture capital financing.

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116. *Id.* (describing a start-up's decision to raise \$25 million in an ICO rather than through traditional venture capital funding).

117. See Chernova, *supra* note 15; Samer Hamadeh & Adam Dinow, *What You Need to Know About Startup Boards*, TECHCRUNCH (Nov. 5, 2016), <https://techcrunch.com/2016/11/05/what-you-need-to-know-about-startup-boards/> [https://perma.cc/MR59-4QYD].

118. Joseph Chan, *How Do Venture Capital Investors Add Value to Portfolio Companies?*, PILLSBURY WINTHROP SHAW PITTMAN LLP (Oct. 2007), <https://www.pillsburylaw.com/images/content/2/4/v2/2430/3FE607E19A8B7AAC87B931FDD8614997.pdf> [https://perma.cc/E3L9-WCRA] (describing the added value of venture capital to start-up businesses).

119. Kim-Mai Cutler, *Vinod Khosla: 70-80% of VCs Add Negative Value to Startups*, TECHCRUNCH (Sept. 11, 2013), <https://techcrunch.com/2013/09/11/vinod-khosla/> [https://perma.cc/R2NJ-JL49].

120. See Danny Crichton, *Do Good Companies ICO?*, TECHCRUNCH (Dec. 16, 2017), <https://techcrunch.com/2017/12/16/do-good-companies-ico/> [https://perma.cc/7YGE-JGZD].

121. Kastelein, *supra* note 90.

*B. Costs of Including Cryptocurrency in the Capital Structure*

For most businesses, the negative business implications of an ICO, especially with the threat of regulatory enforcement after *Munchee*, dwarf the few benefits of ICO issuances discussed above. Although there are remaining benefits to small businesses, like Munchee Inc., that raise capital through a registered or exempt ICO, the costs of SEC regulation likely outweigh those benefits. In particular, the cost of folding cryptocurrency into the company's business model and the threat of reduced access to capital are substantial.

First, incorporating cryptocurrency into a business is often unnecessary and may confuse the business model. An Ernst & Young study found that most white papers failed to adequately justify the incorporation of blockchain into the company's business models.<sup>122</sup> Rather, "blockchain" and "cryptocurrency" serve as buzzwords to lure investors into an offering.<sup>123</sup> While helpful in attracting financing, incorporating cryptocurrency and maintaining a cryptocurrency exchange is expensive.<sup>124</sup> Incorporating a cryptocurrency network into the business model also introduces cybersecurity risks that would not otherwise exist.<sup>125</sup> Cryptocurrencies are vulnerable to hacking and theft, which can lead to substantial liability.<sup>126</sup>

Incorporating cryptocurrency into a business model also distracts from the underlying business. Many ICOs are undertaken by companies without any developed business.<sup>127</sup> For these companies, the ICO acts as a distraction since the time, effort, and money used to create a cryptocurrency network can often be put to better use

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122. ERNST & YOUNG, *supra* note 3, at 11 ("White papers contain many clichés that attract inexperienced investors, with no reasonable justification for blockchain use.").

123. *See id.*

124. *See* Dmitry Gurkovskiy, *Make Your Own Cryptocurrency: Not Difficult, but Expensive*, NASDAQ (Sept. 27, 2017), <https://www.nasdaq.com/article/make-your-own-cryptocurrency-not-difficult-but-expensive-cm852027> [<https://perma.cc/TZ4N-EQR4>].

125. ERNST & YOUNG, *supra* note 3, at 30–34; *see also* THREATMETRIX, Q4 2017 CYBERCRIME REPORT 37 (2017), <https://www.threatmetrix.com/wp-content/uploads/2018/02/cybercrime-2017-q4-1518132356.pdf> [<https://perma.cc/VQT4-KKBT>].

126. *See* Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934: The DAO, 2017 WL 7184670, at \*9–10.

127. ERNST & YOUNG, *supra* note 3, at 16 (finding that 84% of companies undertaking an ICO were at the idea stage, while only 5% of ICOs were undertaken by companies with running projects); *see also* Popper, *supra* note 1 ("Promising to build' is the operative phrase here, because in almost every case the services that will supposedly make these coins valuable have not yet been finished.").

improving the fundamentals of the business.<sup>128</sup> Munchee Inc. provides a great example of a business for which incorporating cryptocurrency was an unnecessary distraction and perhaps a cover for an underdeveloped business plan.<sup>129</sup> The MUN network was an unnecessary substitute for a cash exchange network; instead of developing a cryptocurrency exchange, the company could have focused on monetizing its core restaurant review application.

Second, many venture capital investors interpret a company undertaking an ICO, rather than seeking financing through more traditional channels, as a signal that the company has an unattractive business plan or poor financial performance. Given limited information, venture capital investors look at certain signals when determining whether to invest in a start-up business.<sup>130</sup> Companies that undertake ICOs tend to be companies that cannot obtain venture capital or other private financing, either because of a weak business model or because management is seeking financing too early for an unproven, underdeveloped business.<sup>131</sup> Many venture capital investors view companies that choose to undertake ICOs as among the lowest-quality companies in search of easily accessible cash.<sup>132</sup> As a result, undertaking an ICO indicates weakness to venture capital investors who might otherwise invest in the company, potentially precluding access to future capital.<sup>133</sup> Lack of access to capital beyond the initial round of financing is a growth killer for an early-stage business.<sup>134</sup>

Finally, incorporating cryptocurrency into a business model may also harm the future value of the start-up. Investors typically apply a “conglomerate discount” to undervalue business models incorporating multiple lines of business.<sup>135</sup> A conglomerate discount

128. See Chernova, *supra* note 15 (“There’s a reason that there’s milestone financing in venture capital . . . [i]t’s super distracting [for founders] when there’s so much money.” (second alteration in original)).

129. See Crichton, *supra* note 120 (discussing how low-quality companies tend to gravitate toward ICOs).

130. *Id.*

131. See Lee, *supra* note 115.

132. See Crichton, *supra* note 120.

133. *Id.* (noting that “an ICO may send a negative signal to traditional equity investors that [a company] failed at fundraising and therefore [is] choosing the next best alternative”).

134. See, e.g., Jim Duffy, *Zombie Startups: Why Are Entrepreneurs Failing to Grow Their Businesses?*, GUARDIAN (Aug. 7, 2017), <https://www.theguardian.com/small-business-network/2017/aug/07/zombie-startups-entrepreneurs-failing-grow-businesses> [<https://perma.cc/J2X7-8QYN>].

135. See, e.g., R. Hal Mason & Maurice B. Goudzwaard, *Performance of Conglomerate Firms: A Portfolio Approach*, 31 J. FIN. 39, 47 (1976); see also Stefan Heppelmann &

could likely be applied to a business like Munchee Inc. that attaches a token exchange to its core business. In the short run, start-up valuations benefit from the interest surrounding blockchain technology and cryptocurrency.<sup>136</sup> As the novelty of these technologies dissipates in the long run, however, investors may treat these companies like others with multiple business lines and undervalue their core businesses.

Undertaking an ICO poses a significant risk to future access to capital, the consequences of which are often severe. Incorporating cryptocurrency into the business model still makes sense if developing a network of exchange is core to the business.<sup>137</sup> Forcing a cryptocurrency exchange into the business model, however, no longer makes sense to a small business given the potentially severe costs and reduced benefits.

## V. EVALUATING THE SEC'S DECISION

Though far-reaching, the SEC's decision was correct from a policy perspective and in line with its mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.<sup>138</sup>

Regulating ICOs protects investors. The SEC requires issuers to disclose all material information so investors have all the necessary information to make an informed investment decision, regardless of the underlying quality of the investment. Cryptocurrency issuers typically release white paper disclosure documents with offerings.<sup>139</sup> However, prior to *Munchee*, unregulated white paper disclosure documents were often riddled with material misstatements and omissions of fact.<sup>140</sup> As a result, the disclosures failed to provide investors with sufficient information to make an informed decision to

Marco Hoffleith, *Holding Structure—from Conglomerate Discount to Management Value Added*, 36 STERN STEWART RES. 1, 3 (2009).

136. See Karsten Wöckener et al., *Regulation of Initial Coin Offerings*, WHITE & CASE LLP (Dec. 15, 2017), <https://www.whitecase.com/publications/alert/regulation-initial-coin-offerings> [<https://perma.cc/J2YK-7V3G>] (reporting that “[t]he international ICO market is operating at its highest levels . . . but the market is anticipated to continue the increase”).

137. *Id.* (explaining how blockchain tracks cryptocurrency trades “securely across independent network components”).

138. OFFICE OF INV'R EDUC. & ADVOCACY, SEC, THE ROLE OF THE SEC, <https://www.investor.gov/introduction-investing/basics/role-sec> [<https://perma.cc/2KFU-LBAD>].

139. See, e.g., VERMA ET AL., *supra* note 20, at 4.

140. For a recent and particularly egregious allegation of material misstatements and omissions highlighting the problems posed by unregulated cryptocurrency white papers, see First Amended Complaint at 2–3, SEC v. AriseBank, No. 3:18-CV-00186 (N.D. Tex. Feb. 2, 2018).

purchase tokens in an ICO, and the SEC exercised its authority to protect the investing public.

Start-ups, like Munchee Inc., that raise capital through ICOs also tend to skip many of the safeguards associated with sales of other types of securities.<sup>141</sup> For example, cryptocurrency issuers often do not check if they are dealing with accredited investors.<sup>142</sup> Nonaccredited investors may not fully understand the risks associated with cryptocurrency investments or have the guidance necessary to invest wisely.<sup>143</sup> The risk that cryptocurrency investors might not fully understand the instruments they are purchasing exacerbates the problems posed by deficient disclosure documents and necessitates SEC intervention.

SEC regulation of cryptocurrency markets also promotes efficient capital formation. As mentioned in Section IV.B, the vast majority of companies raising capital through ICOs do not have operating businesses.<sup>144</sup> In many cases the promised services or products are never developed, and the cryptocurrency serves as nothing more than a financial instrument.<sup>145</sup> Despite this, investments in ICOs approached \$4 billion in 2017.<sup>146</sup> The prevalence of shell-company ICOs dilutes the amount of capital available for investment and leads to inefficient capital formation. Raising the cost of financing through an ICO should dissuade questionable businesses without real capital needs from resorting to an ICO, allowing capital to flow to legitimate projects.

## CONCLUSION

In conclusion, the SEC's decision in *Munchee* was in line with existing Supreme Court precedent defining the Securities Act's reach, as well as the SEC's mandate to protect investors. Therefore, the

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141. Camila Russo, *Ethereum Co-founder Says Crypto Coin Market Is a Time-bomb*, BLOOMBERG (Jul. 18, 2017), <https://www.bloomberg.com/news/articles/2017-07-18/ethereum-co-founder-says-crypto-coin-market-is-ticking-time-bomb> [https://perma.cc/8NH6-PQ2C].

142. *Id.*

143. See SEC, RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE: ACCREDITED INVESTOR DEFINITION 1 (2014), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf> [https://perma.cc/6DWU-DFVG] (noting that certain private offerings can only be sold to "a limited number of sophisticated non-accredited investors" who "must either possess sufficient financial knowledge on their own or be advised by a purchaser representative who has the necessary sophistication").

144. ERNST & YOUNG, *supra* note 3, at 16.

145. See Popper, *supra* note 1.

146. ERNST & YOUNG, *supra* note 3, at 6.

decision will have serious implications for the ICO industry going forward. As one blockchain executive stated in the wake of *Munchee*, “ICOs operating in the Wild West of finance isn’t sustainable. . . . If it talks like a duck and walks like a duck, the SEC will say it’s a duck.”<sup>147</sup> The SEC appears committed to bringing cryptocurrency market regulation to the standard of other securities markets, and it remains to be seen if ICOs continue to be a useful form of financing for start-up businesses when brought under SEC regulation.

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147. Russo, *supra* note 141.

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