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Token Offerings: Three Lessons from Airfox and Paragon

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The Securities and Exchange Commission (the "Commission") announced settled charges last November against CarrierEQ Inc., doing business as Airfox and Paragon Coin Inc. Both companies offered and sold digital tokens to investors without registering them or qualifying for an exemption under the Securities Act of 1933, as amended (the "Securities Act"). The Airfox and Paragon orders represent the first non-fraud, registration cases since the Commission settled charges against Munchee, Inc. in December 2017. As a result, they offer helpful guidance to emerging companies interested in raising capital through an offering of digital tokens.

Below are three important lessons from Airfox and Paragon that emerging companies should consider before offering digital tokens in a capital-raising transaction.

1. The Commission or any federal court most likely will treat your token as an investment contract subject to the provisions of the Securities Act, even if your token has some utility in your application or platform.

After the release of the DAO Report of Investigation (the DAO Report) in July 2017, many issuers tried to distinguish "ecosystem" tokens from the DAO Tokens. An "ecosystem" token is a token that has some use within an application or platform independent of its ability to appreciate in value. The most obvious example would be a token used as a loyalty point which could be exchanged for an issuer's goods or services. Since these tokens did not have all of the hallmarks of a traditional security (such as dividend or voting rights), like the DAO Token, some believed that the Commission might view them differently. The Commission, however, found in Munchee and reiterated in the Airfox and Paragon orders that the analysis in the DAO Report applies equally to "ecosystem" tokens.

Similar to Munchee, the digital tokens in the Airfox and Paragon offerings promised to offer utility to investors within the applications developed by the companies. However, the companies intended to add new functionality to their applications after the offerings and primed investors' expectations to profit from such functionality in online promotional material. Each of the companies also assured investors that they would promote a secondary market for their tokens and control the supply of their tokens. Given these entrepreneurial efforts and their actual and marketed link to the value of the companies' tokens, the Commission found that investors reasonably expected to profit from the efforts of Airfox and Paragon.

Airfox and Paragon's scenario is similar to many emerging companies in the blockchain community. The company needs capital to expand functionality within its application. So, the company will publish a "whitepaper" and offer digital tokens to potential investors to finance development. In its whitepaper, the company will assure investors the token is marketed primarily for its utility, but will represent that the token could rise in value based upon the application's popularity in the marketplace. The company may also promise to ensure the creation of a secondary market for the token. In this situation, Airfox and Paragon serve as clear warnings from the Commission that the token is a security under the *Howey* test and the DAO Report.

2. Based on the first lesson, you should seek to qualify for an exemption or register any offer or sale of your tokens pursuant to the Securities Act.

In most circumstances, this will entail complying with the rules promulgated under amended Regulation A or Regulation D of the Securities Act. Rule 506(b) under Regulation D is the safe harbor relied on in most traditional venture capital financings because it offers the benefits of federal preemption of state law (subject to certain limited exceptions), doesn't contain a dollar threshold, and doesn't impose a significant disclosure burden on the issuer if all of the purchasers qualify as accredited investors. It has not been well-suited for some emerging companies in the blockchain community, however, because it produces a restricted security, meaning, among other things, that a non-affiliated investor cannot resell its token for at least one year, and limits the ability of an issuer to market its offering of digital tokens.

Unlike an offering under Regulation D, an offering conducted under amended Regulation A shares some key features of registered public offerings. Before offering securities under amended Regulation A, an issuer must file an offering statement on Form 1-A with the Commission, which includes an offering circular that is distributed to investors. The Commission will review and comment on an issuer's Form 1-A, and this review process must end in the qualification of the Form 1-A before any sales can be made. Amended Regulation A also requires issuers to file periodic reports with the Commission on a semi-annual basis after the offering is complete.

Although this process is more expensive and time consuming than an offering conducted under Regulation D, amended Regulation A allows an issuer to: (A) sell securities that are not restricted securities, meaning the securities are freely tradable by non-affiliates; (B) "test the waters" by communicating with potential investors about their interest in the offering, subject to certain restrictions; and (C) gain federal preemption of state "blue sky" laws in certain offerings. Additionally, for certain offerings, amended Regulation A grants a conditional exemption to the registration requirements of Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act"), which lightens the burden of an issuer's financial reporting obligations immediately after the offering is complete.

Whether a company chooses to rely on Regulation D, amended Regulation A or another exemption largely depends on its stage of development and capital needs. For a mature company with significant capital needs, an offering conducted under amended Regulation A probably makes the most sense. By contrast, Regulation D is likely the better choice for a start-up company with more limited capital needs.

3. Finally, Airfox and Paragon offer a roadmap of how the Commission is likely to address an unregistered and non-exempt offering of digital tokens.

According to the Commission, the penalties imposed in the Airfox and Paragon orders provide "a model for companies that have issued tokens in ICOs and seek to comply with the federal securities laws." In each order, the Commission required the Company to register its digital tokens under Section 12(g) of the Exchange Act and to file periodic reports under Section 13(a) of the Exchange Act for at least one year. Additionally, the companies were required to pay a $250,000 fine and give investors the option to rescind their investment through a process that involved timely notifying each investor of its potential claims under the Securities Act.

Based on these penalties and the Commission's comments, the Commission appears most interested in ensuring full disclosure to potential investors in digital tokens. Under the federal securities laws, as the Commission's orders reflect, full disclosure involves registering the securities under the Exchange Act and timely filing periodic reports. This process imposes a financial reporting obligation on issuers that most start-up companies (and perhaps even companies in later stages of their growth cycle) will be ill-equipped to handle.

Given the magnitude of these penalties, any issuer who offers or sells digital tokens without giving serious consideration to federal and state securities laws is running a high risk. For assistance in determining whether

your particular offering qualifies for an exemption or should be registered, feel free to contact Hunter Threet, or any member of Baker Donelson's Corporate Finance and Securities Group.