SEC Settlement Decision Disrupts The Rise Of Free Tokens And Bounty Programs

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Initial Coin Offerings (ICOs) are back in the hot seat with one of the latest settlement decisions of the United States Securities and Exchange Commission (SEC).

In the settlement decision, the SEC found Tomahawk Exploration LLC's (Tomahawk) founder David Laurance in breach of U.S. securities laws as a result of his actions surrounding his proposed ICO of Tomahawkcoins (TOM). The SEC fined Laurance US$30,000 and barred him for life from acting as an officer or director of any issuer or participating in any offering. While this is not the first coin or token to face criticism from the SEC, the findings in this particular decision are interesting because they apply to coins that were freely distributed by the company through a "bounty program" rather than purchased by investors through an ICO.

Background

In the summer of 2017, Tomahawk sought to raise money to finance new oil exploration and drilling in California. After failing to raise the required capital through both private investments and public capital markets, Laurance turned to the cryptocurrency market and planned to issue TOM to raise the necessary capital.

Laurance launched a website and began advertising for an ICO to occur between July and August of 2017. He distributed information about the new coin offering and how TOM would be backed by the revenues generated by the oil exploration and development projects he planned to finance with the ICO. In addition to advertising about the upcoming ICO, Tomahawk began to promote a bounty program whereby individuals could complete online marketing, advertising and promotional tasks in return for "free" TOM. Several individuals participated in the bounty program by designing t-shirts, sharing articles and engaging with Tomahawk on social media. Eventually, over 80,000 TOM were distributed through the bounty program to participants that completed these tasks.

Why would a blockchain project give away free tokens?

An “airdrop” (i.e., the act of giving away free blockchain tokens) is an approach that was a common method of popularizing new cryptocurrencies during the formative years of blockchain technology. The idea is that a new blockchain project could gain recognition by piggybacking off another existing and more popular blockchain, such as Bitcoin. This was done by ‘gifting’ the new tokens for free into the wallet addresses that hold the more popular and valuable cryptocurrency.

The advantages to giving away digital currency for free can be quite significant. Some advantages of airdropping include: (i) growing the size of the coin’s market; (ii) building awareness of the new coin or ICO; (iii) helping with overall fundraising by creating publicity; and (iv) building the perception of value of the coin because people tend to give something more value if they own it.

The bounty program initiated by Tomahawk follows a more recent spin on the gifting of tokens. Many new blockchain projects utilize this method to help attract attention to their project and build publicity for upcoming ICOs.

Summary of SEC Decision

Despite failing to sell any TOM through its ICO, Tomahawk agreed in the settlement decision that “the distribution of TOM in exchange for promotional efforts pursuant to the bounty program constituted sales of securities”, and therefore Tomahawk had breached U.S. securities laws.

The analysis first applied the tests from the U.S. Supreme Court case, SEC v W.J. Howey Co. to determine that TOM did constitute a security. This was based on the premise that TOM value was based on the revenues from the oil projects that the coins were helping to finance, and that “the TOM tokens were offered in exchange for the investment of money or o**ther contributions of value** , including other digital assets”.

Most importantly from this settlement decision, the SEC addressed the uncertainty surrounding airdropping or gifting tokens or coins. Their analysis found that the distribution of TOM pursuant to the bounty program constituted a sale because it was a disposition of a security for value. Notably, the settlement decision provided that “[t]he lack of monetary consideration for “free” shares does not mean there was not a sale or offer to sale” for the purposes of U.S. securities law. Rather, “a ‘gift’ of a security is a ‘sale’ within the meaning of the Securities Act when the donor receives some real benefit”.[1]

The settlement decision then went on to further define “real benefit” to include online marketing, promotion of the ICO on blogs and other forums, and creating a public market. Ultimately, the analysis concluded that Tomahawk received value by issuing tokens through the bounty program which helped to generate interest in the ICO.

Significance

The settlement decision is significant because it provides an understanding of the SEC’s views regarding bounty programs in the blockchain industry.

In Canada, we expect the Canadian Securities Administrators to take a similar approach as the SEC regarding airdrops and bounty programs.

In CSA Staff Notice 46-308 – Securities Law Implications for Offerings of Tokens, the CSA had noted concerns about how a bounty program or similar program that offers free tokens or other benefits to persons who promote the offering through various channels (including social media, blogs or elsewhere on the Internet) could result in tokens being considered securities. This is because persons participating in this kind of program may have an incentive to make statements promoting the offering as an investment; for example, by suggesting the tokens have the potential to increase in value. The CSA's view is that these statements could create an "expectation of profit" which is one of the components of the Pacific Coast test which is a test used by the securities regulators in Canada to determine whether something is an investment contract, which is a type of security. For more information about the Pacific Coast test, read our bulletin from February 2018.

If you are planning to implement a bounty program or airdrop, we recommend you obtain the appropriate legal advice as the fact that the token is free is not a "silver bullet" around securities laws.

We encourage those involved in the Canadian blockchain community and other market participants to be mindful of applicable securities laws and to contact any member of BLG's Cryptocurrency and Blockchain Group if you require any assistance.

[1] See *SEC v Sierra Brokerage Servs., Inc.* 608 F. Supp. 2d 920, 940-43 (S.D. Ohio 2009).

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