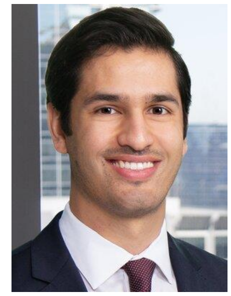
How Crypto Cos. Can Take Advantage Of 'Mini-IPOs'

By **Juan Antonio Solis and James Harrigan** (November 25, 2024)



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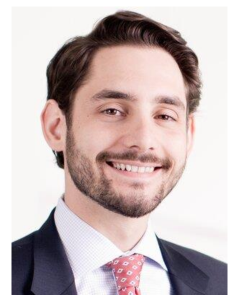

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Over the past couple of years, the U.S. Securities and Exchange Commission has intensified its enforcement efforts against the cryptocurrency industry, with actions against Binance, Coinbase and Kraken underscoring the agency's view that most tokens are securities — especially those used to raise capital.

Wells notices sent to Crypto.com and Immutable in late August and Nov. 1., respectively, reveal that regulatory attention is only ramping up, pressuring token issuers to explore alternative ways to raise funds.

Despite the SEC's sweeping view that most tokens are securities, its stance is not going untested. As last year's SEC v. Ripple Labs Inc. decision in the U.S. District Court for the Southern District of New York demonstrates, courts may not always agree with the SEC's position about initial coin offerings and registration requirements, leaving a level of uncertainty for the industry's regulatory landscape.

Commonly called a "mini-IPO," Regulation A offers companies, especially new companies and startups, the benefits of broader access to capital and increased liquidity if they meet certain requirements and qualifications that are less burdensome than full registration. For its part, Regulation D provides multiple ways to raise unlimited capital through private security offerings to certain accredited investors.

While these exemptions are commonly used outside the blockchain industry, there is increased interest in, and successful application of, both exemptions for token offerings, serving as a blueprint for future offerings.

Regulation A and Regulation D

Section 5 of the Securities Act prohibits the offer or sale of securities unless the offer or sale is registered with the SEC or is made pursuant to a valid exemption. The most promising exemption for public sales of securities in the U.S. is Regulation A, which was expanded in March 2015 as part of the Jumpstart Our Business Startups Act into two different tiers — Regulation A and A+ — with varying eligibility and compliance requirements.

Tier 1 offerings are capped at $20 million over a 12-month period. Under Tier 1, there are no special qualifications for investors and no limits on the amounts of securities that any investor may purchase — subject to the monetary cap. But Tier 1 offerings must comply with state blue sky laws, meaning they must also be registered or otherwise qualified in any state in which the securities will be offered or sold — or subject to an exemption at the state level.

Tier 2 offerings are capped at $75 million over a 12-month period. Investors in Tier 2 offerings must either be accredited — they must meet certain wealth and income thresholds, or other measures of financial sophistication — or they can only invest 10% of their annual income or net worth, taking spousal income into account.

Unlike Tier 1, Tier 2 offerings preempt state registration and qualification requirements, but issuers remain subject to state law enforcement and antifraud regulations. Tier 2 offerings may also still be subject to filing fees in the states where the issuer intends to offer the securities.

In April 2021, Exodus Movement Inc. — a noncustodial crypto wallet provider — became the first crypto company to make a token offering under Regulation A+. Exodus raised $75 million by selling its native Exit tokens, each of which represented one share of Exodus common stock. Just days after the SEC qualified Exodus' offering statement, more than 4,000 investors purchased Exit tokens in this first-of-its-kind offering.

Regulation D provides a safe harbor under the Section 4(a)(2) exemption from registration in Rules 504 and 506. Securities purchased pursuant to Regulation D offerings are restricted for purposes of Rule 144 under the Securities Act — meaning for private companies they are generally not freely tradable for at least one year.

Known as a "limited offering," Rule 504 provides an exemption from registration for companies that offer or sell up to $10 million in securities in a 12-month period. And like in Tier 1 offerings under Regulation A+, Rule 504 offerings are also subject to state blue sky laws. Unlike Rule 506, Rule 504 issuers are not subject to specific disclosure requirements.

Rule 506 lays out two paths for a private placement transaction to reach exempt status: the traditional 506(b) offering and a general solicitation 506(c) offering. Both allow a company to raise an unlimited amount of capital through a security offering.

Rule 506(b) says that a company's offer or sale of securities is exempt from registration if (1) the company does not generally solicit or advertise to market the securities, and (2) the company sells the securities to no more than 35 nonaccredited investors who must — alone or through a representative — have sufficient financial sophistication to evaluate the risks of the investment.

If the securities are available to nonaccredited investors, the company must also disclose certain information, including financial statements. There is no limit on the number of accredited investors or the amount of funds that may be raised under this private placement exemption.

General solicitation offerings under Rule 506(c) allow issuers to broadly and generally advertise the offering if all purchasers are accredited investors. The issuer must take reasonable steps to verify the investors' accredited status, such as by reviewing documentation like W-2s, tax returns, and bank or brokerage statements, or obtaining written confirmation through certain preapproved agents — like broker-dealers or lawyers — that reasonable steps were taken to verify the investors' status.

In 2018, Aspen — formerly known as AspenCoin — became the first token to be issued by a real estate investment trust as part of an equity offering under Rule 506(c) of Regulation D. The token represented equity in the historic St. Regis Hotel in Aspen, Colorado, which ultimately raised $18 million through the Aspen token offering.

The offering was limited to accredited investors, who underwent a mandatory know-your-company/anti-money laundering process to verify their status as accredited investors. Because the offering was made under Rule 506(c), the purchased securities were subject to a one-year lock-up period, after which they became available for secondary trading on an alternative trading system.

Not to be ignored in all this is Section 12(g) of the Securities Act, which kicks in whenever an issuer has more than $10 million in assets and the class of securities is "held of record" by at least 2,000 persons or at least 500 nonaccredited investors.

Of Section 12(g)'s exclusions, the only one that potentially applies here is outlined in Section 12g5-1(a)(7), which makes the term "held of record" inapplicable to securities issued under Tier 2, but only if the issuer (1) is required to file and is current in its periodic reports under Regulation A, (2) engages a transfer agent regarding the securities, and (3) either has a public float under $75 million, or if the public float is zero, generated less than $50 million in annual revenue. Section 12(g) also triggers annual (Form 10-K), quarterly (Form 10-Q) and ongoing (Form 8-K) reporting obligations.

Process and Requirements

Offerings under Regulation A and Regulation D require certain filings with the SEC.

Regulation A issuers must file Form 1-A, an offering statement that requires disclosure of, among other information, the offered securities, material risks, use of proceeds, business overview, beneficial ownership information and two years of financial statements. Issuers that qualify may not begin to actually sell their securities until the SEC has qualified the offering statement. Form 1-A has many similarities to a full registration statement on Form S-1, and the SEC will undertake a detailed review and comment process before qualifying Form 1-A.

Regulation D issuers must file Form D, a notice of sale of securities, with the SEC no later than 15 days after the first sale of securities. Form D requests the names and addresses of the company's promoters, executive officers, and directors, as well as brief background information about the offering. Form D itself, however, does not require a significant level of detail about the offering, and can be prepared with negligible cost and burden.

Reporting obligations also attach to Regulation A+ offerings. Tier 1 requires providing information about the sale and termination of the offering (called an exit report), while issuers conducting Tier 2 offerings are subject to ongoing disclosure obligations — including annual (Form 1-K), semiannual (Form 1-SA) and current (Form 1-U) reports. In addition to the Form 1-A and ongoing reporting requirements, Tier 2 issuers must also audit their financial statements, which for many small and startup crypto companies can be a challenge.

Although Regulation D offerings do not have ongoing reporting obligations, Rule 506(b) offerings require disclosures to nonaccredited investors that are substantially similar to Regulation A disclosures. This includes detailed financial information and the requirement to make themselves available to answer prospective investors' questions.

In practice, most issuers will not sell to nonaccredited investors if only to avoid these requirements. But even when the requirements do not apply, the anti-fraud provisions of the federal securities laws still require the issuer to provide investors with all material information about the issuer and the offering.

Restrictions

As with any securities offering, there are limitations. For instance, exemptions under

Regulation A+ and Regulation D contain certain disqualifying events that could prevent someone from issuing securities under either exemption. These bad-actor disqualifications include criminal convictions and previous findings of securities fraud, and they apply not only to the issuers but also to underwriters, directors and other significant shareholders.

Additionally, all securities transactions — including those made under any exemption — are also subject to the anti-fraud provisions of the federal securities laws. Not unlike public statements made by companies with a class of securities registered under the Exchange Act, private companies that conduct securities offerings under Regulation A+ or Regulation D exemptions are responsible for false or misleading statements made to potential or actual investors.

For example, on May 16, 2023, the SEC charged 10 companies with alleged infractions of Regulation A+ offerings, which included selling shares at different prices under the same offering and failing to update financial statements.

Also, for those exemptions that are subject to blue sky laws — Tier 1 under Regulation A+ and Rule 504 — each state in which the securities are offered will have its own requirements that may apply to the offering.

As mentioned earlier, the securities offered under Regulation D are restricted, meaning they cannot be publicly resold by a private company for at least one year unless the offering is registered or one of certain limited exceptions applies. This can present a challenge, especially to those crypto companies with business models that rely on the free transferability of their tokens — such as governance tokens.

Conclusion

There are many reasons why Regulation A and Regulation D are attractive to blockchain companies. Regulation A permits issuers to test the waters and gauge investor interest before or after filing an offering statement. There are also no restrictions on the resale of securities under either type of Regulation A offering.

The SEC further allows issuers that have not previously sold securities pursuant to qualifying offering statements to submit a draft offering statement to the SEC for nonpublic review.

Regulation D provides a path to offer securities with reduced cost and in less time than full registration, and in some situations the ability to raise an unlimited amount of capital without needing to register the offering.

Pursuing an exemption, however, is not without unique challenges. A development-stage or blank-check company, for example, is unlikely to qualify for Regulation A+. And while Regulation D contains no limitation on the amount of capital that can be raised in some circumstances, the restrictions around accredited investors can significantly narrow the pool of capital, and the yearlong lock-up period may be unworkable for business models that rely on free secondary trading.

We know where we are: The SEC has stated time and again its position that most cryptocurrencies are securities, and regulators have backed up those statements with recent enforcement actions against large, highly sophisticated crypto companies. While courts may disagree with the SEC's views in specific cases, if not registered or subject to an exemption, initial coin offerings can run the risk of becoming a target for regulators.

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