

Blockchain Update: SEC Order Interrupts the Munchee ICO

SEC issues cease-and-desist order two days into the Munchee ICO, a sign the Commission is inching toward a new regulatory framework for ICOs.

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This past September, when the Securities and Exchange Commission (SEC) brought fraud charges against Maksim Zaslavskiy in relation to two initial coin offerings (ICOs), there was very little head scratching; it was patently obvious that Zaslavskiy's real estate venture and diamonds club membership were empty facades. At the time, even those adamantly opposed to SEC meddling tended to regard this crackdown as a necessary and salutary step—the SEC protecting investors, not interfering with innovation and growth.

The recent Munchee Inc. cease-and-desist order, however, does not offer the same moral and regulatory assurance. This time, buyers and sellers alike are made to wonder to what extent a utility token's functionality will determine its classification by the SEC. If pre-sale tokens, often sold at early-bird discounts with limited to no functionality at the time of sale, have been the stock-and-trade of many successful ICOs in 2017, will they be the subject of increased regulatory constraint in the year ahead?

Though the *Munchee* Order appears to mark new ground, it is consistent with the SEC's actions of late. Indeed, when understood alongside the *DAO* Report and in light of SEC Chairman Jay Clayton's recent comments, the *Munchee* order is part of a natural progression towards a new regulatory framework for tokenized offerings. The *Howey* test, which was articulated in a 1946 Supreme Court Case, will serve as the basis for this new framework. Here, regardless of whether the issuance is called a digital/utility/app token, the SEC considers it an investment or securities contract if the ICO sponsor represents a "common enterprise" and investors are "*led to expect* [emphasis ours] profits solely from the efforts of the promoter or third party."

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To understand the SEC's analysis more fully, the nuances of the Munchee ICO are worth exploring. It's a cautionary tale, with many implications for entrepreneurs and investors alike.

Where the Munchee ICO broke bad

Marqueed as "Yelp meets Instagram," the Munchee ICO was based on a plan to develop the existing Munchee App, which allows users to rate and share their dining experiences, upload images of menu items, and interact with other local or far-flung foodies. According to their website, the new decentralized and tokenized Munchee "ecosystem" would incentivize users and reviewers to contribute content in exchange for MUN tokens distributed over the Ethereum blockchain. Once functional, MUN tokens could be cashed in at participating restaurants, with potential profits culled from ad revenue. But the value of MUN tokens would remain immaterial (at best) until the ICO-financed ecosystem was operational.

At the time the ICO went live, its tokens were pre-functional, their utility speculative. If actual value would at some point be imputed to MUN tokens, this would be a byproduct of the Munchee team's app development and the participation of third-party restaurants and reviewers. For this reason, two days into the ICO, and on track to sell all 500 MUN units, the SEC's Cyber Unit and Complex Financial Instruments division intervened. And when Munchee immediately complied with the cease-and-desist order, the SEC opted not to pursue legal action.

Never mind if the world really needed a "Yelp meets Instagram," or whether the relative enthusiasm around the Munchee ICO had more to do with the crypto goldrush of late and less to do with its viability as a business model. The point here is that this was not an uncommon architecture for an ICO, not to mention the fact that Munchee already had an app available in the United States and an existing user base, to boot. Other ICOs have tiptoed past the SEC with fewer legs to stand on. But that may not work anymore.

As the SAFT Project white paper predicted, pre-functional token offerings are akin to, if not the equivalent of, securities contracts. In the SEC's estimation, Munchee erred by issuing tokens with neither

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transactional value nor profit-potential until its team reconfigured the app, users contributed appealing content, a growing number of restaurants agreed to participate or advertise through the app's interface, and demand existed for MUN tokens on secondary markets. Investors, however, appeared to have no role in the evolution of this ecosystem. Still, they were led to believe the efforts of others would ultimately make the MUN token trade profitable.

The extent to which investors were primed to expect future profit is the first thing emphasized in the *Munchee* Order. The second thing, which wasn't perhaps on the radar of most crypto enthusiasts, was the role an ICO's marketing approach could play into an SEC investigation. But it's not so surprising; the two issues are closely intertwined. Typically, in the months before an ICO is launched, the sponsoring business will develop a white paper, which may take the form of a material document or a website. The white paper provides background on the market, details about the product or service, the capital objectives, the timeframe and number of tokens that will be issued, and an overview of the developers' team.

In Munchee's case, their white paper was available on their website, but the real marketing campaign played out on industry forums like Reddit and BitcoinTalk.org, where members of the Munchee team extolled the virtues of a "Yelp meets Instagram" ecosystem. What they did not do, according to the SEC at least, was make a good faith effort to market MUN tokens to current app users, to restaurants and bloggers—that is, to the very people on whom the token's functionality would ultimately depend. Instead, they courted investors. And when they weren't actively promoting the profit-potential of MUN tokens themselves, they were sharing and retweeting endorsements from would-be investors.

As the SEC saw it, this behavior provided further evidence that Munchee had led investors to believe that people other than investors would drive future profits. This, coupled with the MUN token's pre-functionality, is precisely where the rubber met the regulatory road for Munchee.

Key takeaways for future ICO developers

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In a year when judges have cited presidential tweets as evidence of intent, there's something strangely apropos about the SEC's probing analysis of Munchee's social media output. But the lesson for future ICO developers is not to avoid discussing their projects with investors online; after all, the ability to leverage web technology to promote ICOs to a broad, global pool of investors is a key component of a startup's marketing. Rather, ICO developers need to carefully consider the legal challenges ahead if they intend to appease the SEC. They should take pains to make sure their public pronouncements aren't misleading with respect to a token's utility at the time of the launch and upon the project's completion.

At the same time, they need to make sure their marketing efforts aren't misdirected, that they're not targeting investors exclusively at the expense of important network participants. They might even consider putting the brakes on their ICO, at least until true functionality is established. Or, if they've already launched or completed their ICOs, they need to get seasoned legal counsel to help them navigate the securities issues. Otherwise, in 2018, they risk having a project suspended indefinitely or their business hamstrung by an SEC injunction.

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