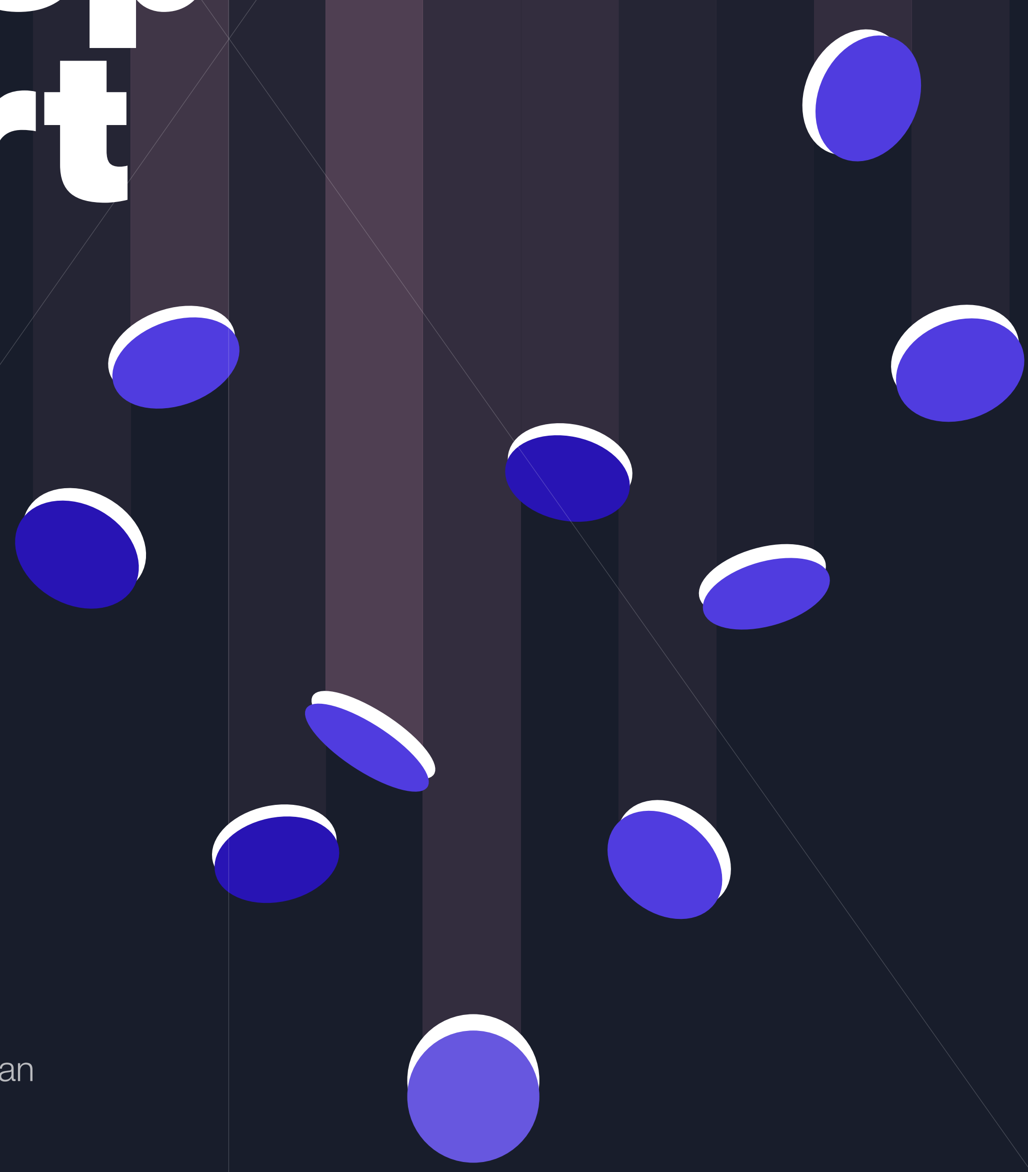
Republic / crypto

Republic Airdrop Report

by **Jed Halfon**



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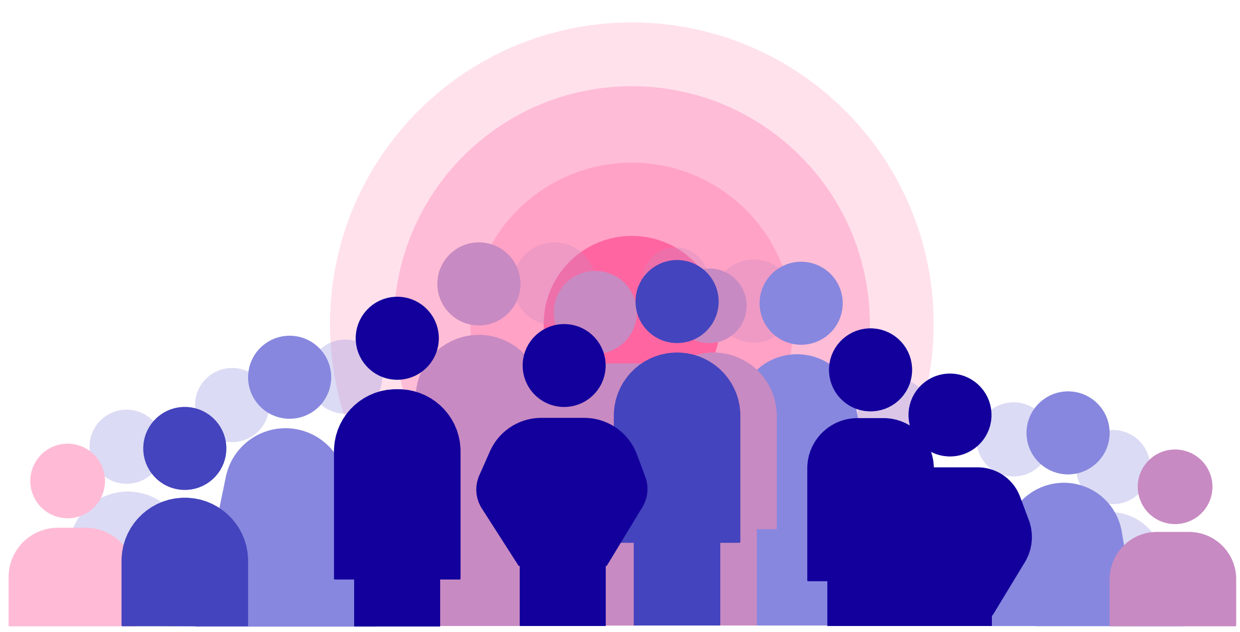
Abstract

Token distributions have taken many shapes over the last year. One of the most well-known approaches for broadly distributing tokens is known as an airdrop. An "airdrop" is simply the giving away of a digital asset free of a monetary exchange. Until now, projects have had varying degrees of success with their approaches, with many being launched without deference to US securities regulations. Even so, airdrops stand to be a unique competitive business tool in the new digital economy, and Regulation Crowdfunding offers a compelling, compliant, and viable path to execution. In this report we discuss the: (1) arguments in favor of airdrops and their shortcomings, (2) main types of airdrops we have seen, (3) alternative use cases for airdrops, and (4) legal and technical framework Republic is using for its new airdrop product.

Why Airdrop Tokens

There are many potential benefits to conducting an airdrop, among them: (i) increasing awareness and public exposure of a tokenized product or network, (ii) decentralizing networks, and (iii) bootstrapping new networks or communities.

I. Awareness and Exposure



Airdrops have the potential to increase a project's visibility and public exposure. The crypto industry has become extremely competitive; making your token shine is challenging. Giving away tokens thrusts access to your product directly into the "hands," or wallets, of consumers and can grab their attention. In fact, this same strategy has worked well with non-crypto products.

Paypal famously offered $20 worth of in-network credit to early users that could only be transferred to other Paypal users.[1] There are also few out there who haven't succumbed to the allure of a five-dollar gift card from Starbucks. Recently, Robinhood also offered free randomized stocks of up to $500 in value for newly referred registered users.[2] Data on the conversion rate from these methods is somewhat scarce, but it is safe to say these campaigns increased product awareness and had an impact on consumer adoption.

While giving something away for free can increase product visibility, most of the successful products and services we use today did not use handouts to convert initial customers. On the rare chance they did, it is likely that the giveaways were part of campaigns of sustained engagement. The most successful marketing campaigns require continuous engagement and multiple points of contact.[3] Incidental possession of a project's token may not offer enough exposure to convert users.[4]

In order to increase public awareness and engagement, airdrop issuers should think of an airdrop as one tool in a larger toolkit. It's a single point of contact in a broader strategy of sustained, varied, and diverse engagement.[5] Additionally, dropping tokens that provide access to easily accessible or understandable products (e.g. coffee, common stock, etc.) may more efficiently drive awareness.

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[1] Visakan Veerasamy, PayPal's Referral Program: A Legendary Growth Hack, REFERRALCANDY BLOG (Jan. 23, 2016), https://www.referralcandy.com/blog/paypal-referrals/ (last visited Jan. 7, 2019).

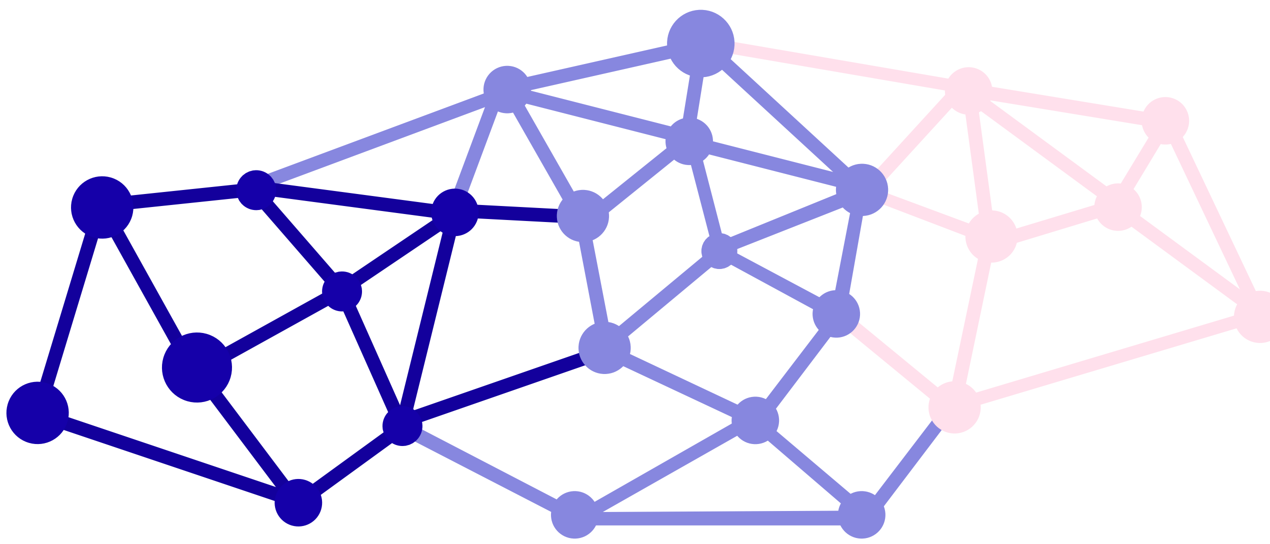
[2] Invite Your Friends, Get Free Stocks, ROBINHOOD HELP CENTER, https://support.robinhood.com/hc/en-us/articles/360001214643-Invite-Your-Friends-Get-Free-Stocks (last visited Dec. 18, 2018).

[3] Lambrecht, Anja, and Catherine Tucker. "When Does Retargeting Work? Information Specificity in Online Advertising." Journal of Marketing Research, vol. 50, no. 5, 2013, pp. 561–576.

[4] The case can be made that incidental ownership of a new asset still allows for sustained engagement even if the point of contact is singular. Given that the crypto markets are so volatile, owners of an asset may be more inclined to continuously check the price and performance of an asset in their custody. This does not seem like it will provide for meaningful engagement, but is certainly one way of converting a single point of contact into a kind of self-imposed interest.

[5] Sustained engagement in the past was difficult as many airdrops were given to pseudonymous addresses. The ability to retarget may change overtime as addresses and accounts become more integrated with other activities.

II. Decentralization



Airdrops can be an effective way of decentralizing ownership of a network, a core value of the crypto ecosystem.[6] Measuring decentralization is notably difficult.[7] There is no consensus as to what "decentralization" is, let alone at what threshold a network is considered decentralized.[8] Widely dispersing an asset in an airdrop can be a good way of facilitating "decentralization of ownership." Decentralized ownership through an airdrop can help achieve more equitable distribution of wealth, a goal championed by many crypto projects including Access Network, M-PESA, etc. Others have made the case that decentralized ownership can diversify stakeholders,[9] something needed to keep miners interested and networks strong.

Decentralization also diversifies user bases, allowing a network to avoid relying too heavily on any one group of users. Ownership of crypto assets is currently very concentrated.[10] There are many reasons for this.

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[6] Spencer Bogart, The Long Game in Crypto: Why Decentralization Matters, MEDIUM (Apr. 25, 2018), https://medium.com/@Bitcom21/the-long-game-in-crypto-why-decentralization-matters-fd681ff5ed0 (last visited Jan. 7, 2019).
[7] Jackson Palmer, Are We Decentralized Yet? ARE WE DECENTRALIZED YET, arewedecentralizedyet.com (last visited Jan. 7, 2019).
[8] Myles Snider, Why Decentralization Matters: A Response, MEDIUM (Apr. 27, 2018), https://medium.com/multicoin-capital/why-decentralization-matters-a-response-6b4b9a31367f (last visited Jan. 7, 2019).
[9] Balaji S. Srinivasan, Quantifying Decentralization, NEWS.EARN.COM (Jul. 27, 2017), https://news.earn.com/quantifying-decentralization-e39db233c28e (last visited Jan. 7, 2019).
[10] Jackson Palmer, Are We Decentralized Yet?, ARE WE DECENTRALIZED YET, arewedecentralizedyet.com (last visited Jan. 7, 2019).

For one, securities laws in the U.S. continue to limit who can make most early stage investments to those considered accredited investors. The crypto industry itself was, until only recently, dominated by a small group of early adopters. It's easy to forget that the industry was mostly obscure and marginalized until only a year ago. Even for assets that have taken center-stage and had their ownership diluted over time, it's likely that they suffer from a re-concentration of ownership from "weak hands" into "strong hands."[11] It's much more difficult to hold a volatile asset when real world financial constraints weigh heavily on personal finances. These forces have, in part, limited the ability for networks to decentralize their ownership.

While airdropping tokens to numerous owners can help decentralize ownership, significant ownership of digital assets requires more than possession of a nominal amount. At the very least, meaningful ownership of a digital asset requires: (i) awareness of ownership of the asset, (ii) appreciation of the use or value of the asset, (iii) reasonable accessibility to the asset, and (iv) the ability to derive meaningful usage or minimal value from the portion owned.

Some have likened ownership of a crypto asset to the ownership of bearer bonds.[12] This is a helpful comparison for understanding how to best structure an airdrop. A bearer bond is a debt instrument whose bearer, or owner, holds all rights and interests in the instrument. Imagine your Grandma Sue gave you an old fashioned 1920s bearer bond for your 13th birthday. In order to "own" the bond, a couple of things would have to happen. You'd have to be aware that you'd received it. Even if you were aware of its existence, you likely wouldn't take the prerequisite steps to take care of the bond unless you thought it had some value. Like crypto assets, bearer bonds are very fragile - they are often a single piece of thick paper stock that is easy to damage or lose. You'd need to appreciate what the asset was and what it could do for you in order to properly safeguard it.

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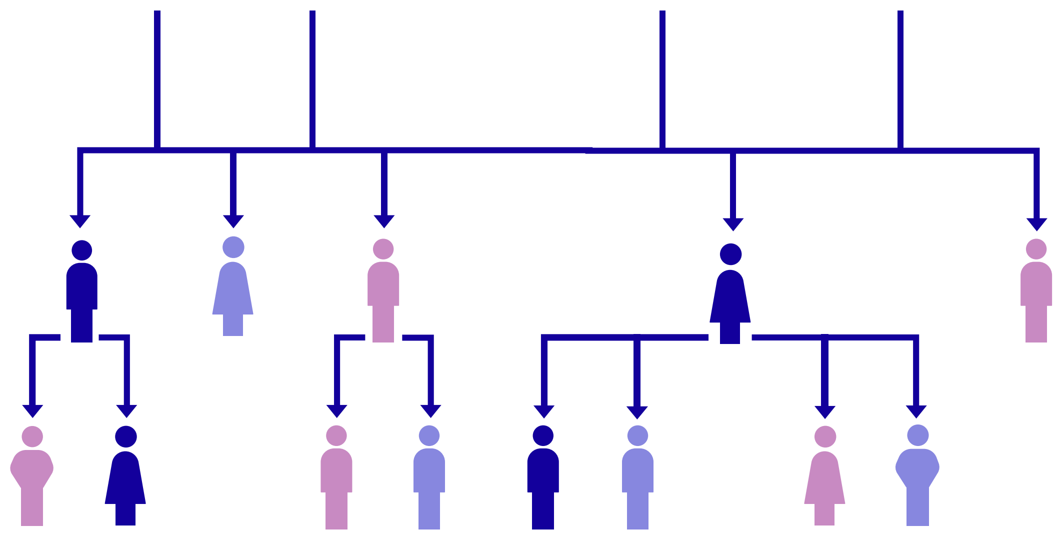
[11] Nic Carter, The Dark Underbelly of Cryptocurrency Markets, MEDIUM (Sept. 3, 2018), https://medium.com/s/the-crypto-collection/a-glimpse-into-the-dark-underbelly-of-cryptocurrency-markets-d1690b761eaf (last visited Jan. 7, 2019).
[12] See Gabriel Shapiro, Tokenizing Corporate Capital Stock, ZERO LAW (Oct. 28, 2018), gabrielshapiro.wordpress.com/2018/10/28/2/ (last visited Jan. 7, 2019).

You'd have to also remember where you put the asset and have it accessible at vital points in the lifecycle of the asset (dividends, distributions, votes, etc.). Lastly, the bond would have to be redeemable for either sufficient utility or, on its own, for sufficient market value[13] that would justify the steps needed to redeem it. It's possible that the issuer of the bond might not pay a coupon to holders if the payment is too small. For purposes of decentralization, true ownership requires some meaningful "piece of the pie".

In this sense, giving away small amounts doesn't necessarily decentralize a project in any meaningful way. The most successful airdrops aiming to decentralize ownership will build in mechanisms to ensure that recipients are "owners" and users in the practical sense. They may also consider dropping larger amounts to smaller groups of recipients to ensure holders have a more vested stake in the success of the asset. An issuer contemplating an airdrop could also consider dropping even larger amounts to persons of interest, turning potential strategic allies into incidental stakeholders with sufficient assets to care.

[13] Binance allows users to trade nominal amounts of most tokens on their site into BNB. The ease with which you can trade out of less liquid tokens decreases the likelihood that receipt of smaller drop amounts will have staying power.

III. Bootstrap a Network



Airdrops can be a good way of bootstrapping a network. Because of network effects[14], a product or service becomes more valuable to its existing users the more people use it.[15] Many crypto projects have a floor of usage that, if not met, will prevent the product from providing basic functionality. For a cloud computing network, there must be a minimum demand threshold of computing power in order for users to provide computing resources. For payment networks, there must be enough people willing to accept the currency for it to have any practical usage and value.

Many crypto projects have struggled to create this base level of activity. In September of 2018, Civic announced that it would use a third of its token supply, valued at roughly $43 million at the time of the announcement, to pay for new users and specifically "drive network effects."[16] Even for the few crypto projects that have led the pack by creating usable products as of the date of this report, many have had minimal usage.[17]

[14] For purposes of this paper, we are mostly concerned with direct and indirect network effects, as they are the most relevant to projects in their earliest stages.

[15] Kyle Samani, On the Network Effects of Stores of Value, MULTICOIN CAPITAL (May 9, 2018), https://multicoin.capital/2018/05/09/on-the-network-effects-of-stores-of-value/ (last visited Jan. 7, 2019).

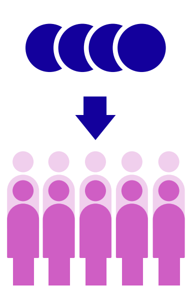
[16] Brady Dale, Civic to Spend $43 Million in Tokens to Boost User Numbers, COINDESK (Sept. 5, 2018), https://www.coindesk.com/civic-to-spend-43-million-in-tokens-in-aggressive-user-expansion (last visited Jan. 7, 2019).

[17] Matthew Beedham, Blockchain's 'Killer' DApps Can't Keep Users Interested, THE NEXT WEB (Aug. 20, 2018), https://thenextweb.com/hardfork/2018/08/20/dapps-userbase-drop-blockchain/ (last visited Jan. 7, 2019).

Augur, perhaps one of the most complex early projects, only had ~$2mm in total open interest on its prediction markets in November of 2018.[18]

In this sense, airdropping tokens to potential users of a network can incentivize early participation which can help with early network effects. Of course, the gap between receiving a token and participating in a meaningful way that helps build out a network is wide. To achieve participation, the recipients would have to be "owners" in the sense mentioned above and also translate that ownership and awareness into active participation. The most successful airdrops aimed at bootstrapping networks will offer tokens that are immediately and easily usable. Issuers may consider dropping tokens that will be otherwise burned if not redeemed within the network or within a certain period of time, adding pressure to use the token.

IV. Types of Airdrops We've Seen



1. Network Drop

In a network drop, an issuer drops tokens indiscriminately to an entire given network. This is one of the most common types of airdrops.[19] An issuer queries a network for a list of addresses meeting any specification they desire. For example, in the past, issuers gathered a list of all Ethereum addresses with a minimum a balance of 0.1 ETH and dispersed their token to those addresses. OmiseGo used this methodology for their airdrop in 2017.[20]

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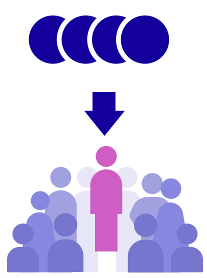
[18] David Floyd, US Elections Push Augur's Total Ether Bets Over $2 Million, COINDESK (Nov. 6, 2018, 13:00 UTC), https://www.coindesk.com/us-election-pushes-total-augur-bets-over-2-million (last visited Jan. 8, 2019).

[19] Katalyse.io, What Are 'Airdrops' in Crypto World?, MEDIUM (Feb 15, 2018), https://medium.com/the-mission/what-are-airdrops-in-crypto-world-a345725c75e0 (last visited Jan. 7, 2019).

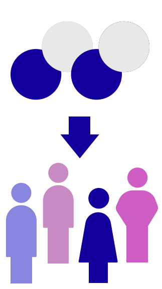
[20] OmiseGo (OMG) Token Distribution, BITFINEX (Dec. 30, 2017), https://www.bitfinex.com/posts/omg-distribution (last visited Jan. 7, 2019).

Others have also dropped tokens to partner networks. Ontology, which is building an infrastructure layer for the NEO blockchain and shares some of the NEO team, offered an airdrop of 0.2 ONT tokens per every 1 NEO an individual held.[21] In this sense, they were able to leverage the network of a former project to bootstrap their own.



2. Smart or Precision Drop

In a "smart"[22] or "precision drop"[23] an issuer drops tokens to a targeted class. This approach has become more popular lately.[24] The type of target class varies, as issuers can drop to a specific (i) class of people, like engineers, mathematicians, doctors etc., or (ii) class of actors, e.g. to those who are willing to carry out some action.[25] Handshake used this latter method earlier this year by opening a "faucet"[26] from which they gave away HNS tokens to active developers or community members. Users had to verify that they either had a Freenode IRC account, that was created prior to a specific date, or a GitHub account that met a certain list of requirements.



3. Exchange Drop

In an exchange led airdrop an exchange selects which token to distribute and drops those tokens into some or all of the exchange users' wallets. Putting an asset in a position that is a few clicks away

[21] Erin Gorsline, NEO Airdropping ONT Tokens to Community: Here's How to Get Some, COIN CENTRAL (Feb. 28, 2018), https://coincentral.com/neo-will-drop-ont-to-the-community-tomorrow-heres-how-to-get-some/ (last visited Jan. 7, 2019).

[22] KAnnaliese Milano, Say Hello to SmartDrops: The New Way to Give Away Free Crypto, COINDESK (Aug. 6, 2018), https://www.coindesk.com/say-hello-to-smartdrops-the-new-way-to-give-away-crypto-money (last visited Jan. 7, 2019).

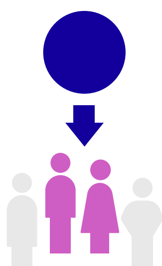
[23] David A. Johnston, The Smartdrop Model, MEDIUM (Jul. 2, 2018), https://medium.com/@DJohnstonEC/the-smartdrop-model-859888916d94 (last visited Jan. 7, 2019).

[24] Rahul Nambiampurath, Introducing SmartDrops: An Efficient Alternative to Cryptocurrency Airdrops, BTCMANAGER.COM (Aug. 7, 2018), https://btcmanager.com/introducing-smartdrops-an-efficient-alternative-to-cryptocurrency-airdrops/ (last visited Jan. 7, 2019).

[25] Harrison Hines, Token Foundry Standards, TOKEN FOUNDRY (Jun. 24, 2018), https://blog.tokenfoundry.com/token-foundry-standards/ (last visited Jan. 7, 2019).

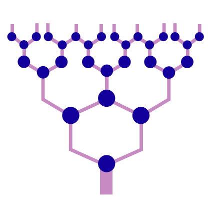
[26] Pete Rizzo, Handshake Revealed: VCs Plan to Give Away $100 Million in Crypto, COINDESK (Aug. 2, 2018), https://www.coindesk.com/handshake-revealed-vcs-back-plan-to-give-away-100-million-in-crypto (last visited Jan. 7, 2019).

from trading naturally increases the chances someone will buy or sell the asset. Many exchanges have done this including Binance,[27] KuCoin[28] and Bittrex[29]. These types of airdrops are often timed to coincide with exchange listings for tokens.[30]



4. "You Get What You Pay For" Drop

In an opt-in airdrop the issuer creates the order for an airdrop to take place, but leaves it up to individuals to pay for the transaction fees and execute those orders. This drop was debuted by the team at OpenRelay, an 0x relayer, to drop Embiggen token.[31] The was quite unique in that it appears to have been the first airdrop that was completely free to the issuer. The OpenRelay team first queried the Ethereum blockchain for unique active addresses and then created a 0x order for each of these addresses (~27 million). However, the orders were only initiated once a user went to their website, logged into their wallets, and initiated the transaction themselves, thus incurring the transaction fee themselves. This is an interesting way of deflecting transaction costs and also catering to a more crypto native audience.



5. Merkle Mining "Drop"

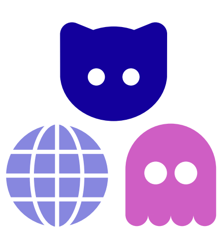
Merkle Mining,[32] coined by the team at Livepeer, is not quite an airdrop in the traditional sense, but is a method for effectively distributing tokens to

[27] Binance Distributes ADD and MEETONE, Updates Stance on Airdrops and Forked Coins, BINANCE (Jul. 3, 2018), https://support.binance.com/hc/en-us/articles/360006657132-Binance-Distributes-ADD-and-MEETONE-Updates-Stance-on-Airdrops-and-Forked-Coins (last visited Jan. 7, 2019).
[28] LOC Token Official Blog, KuCoin Airdrop Distribution is Completed + KuCoin Listing Update, MEDIUM (Aug. 14, 2018), https://medium.com/@LockChainCo/kucoin-airdrop-distribution-is-completed-kucoin-listing-update-ca73c20e6353 (last visited Jan. 7, 2019).
[29] Julian Yap, Statement on Ignis [IGNIS] airdrop to Nxt [NXT] holders, BITTREX (Dec. 20, 2017), https://bittrex.zendesk.com/hc/en-us/articles/115003571832-Statement-on-Ignis-IGNIS-airdrop-to-Nxt-NXT-holder (last visited Jan. 7, 2019).
[30] Binance Supports Ontology (ONT) Airdrop for NEO Holders, BINANCE (Feb. 26, 2018), https://support.binance.com/hc/en-us/articles/360001183332-Binance-Supports-Ontology-ONT-Airdrop-For-NEO-Holders (last visited Jan. 7, 2019).
[31] Austin Roberts, Embiggen Airdrop, OPENRELAY (Jun. 3, 2018), https://blog.openrelay.xyz/embiggen-airdrop/ (last visited Jan. 7, 2019).
[32] Doug Petkanics. "Introducing the MerkleMine." Livepeer Forum, 30 Apr. 2018, forum.livepeer.org/t/introducing-the-merklemine/204 (last visited Jan. 7, 2019).

help build a community. In order for Livepeer Token (LPT) to be distributed, a user with an eligible Ethereum address had to visit the Livepeer website and follow the instructions to “claim tokens”. By initiating the transaction to claim tokens in their wallet, they are simultaneously submitting merkle proofs[33] for 20 random Ethereum addresses. For each of these proofs, 2.4 LPT was generated. This 2.4 LPT is then split between the caller address (person who initiated the transaction) and one of the random 20 Ethereum addresses.

V. What’s In the Realm of Possibility

Airdrops are a competitive tool of the new digital economy. In addition to offering the benefits mentioned above, below are some alternative applications for airdrops.



1. Digital Collectibles

Airdropping digital collectibles (“DCs”) or non-fungible tokens (NFTs) can be a good way of growing the interest in and value of a class of collectibles. The DC ecosystem is complex.[34] It includes a broad range of assets from CryptoKitties to video game skins, and even unique digital land plots. DC projects face many of the same issues as early stage crypto projects. They need to reach a critical mass of users for engagement to be relevant, valuable, and competitive. However, DCs have a different “engagement threshold.” For many mainstream networks, a user needs

[33] A merkle tree is a data structure designed to efficiently store information by hashing data in one direction. A merkle proof is a way of verifying that any piece of data belongs in a given merkle tree.

[34] For a helpful explanation of some of the legal complexities of issuing and trading DCs, see: James Gatto, Legal Issues with Blockchain-Based Crypto Games and Collectibles, SHEPPARD MULLIN (May 2018), https://www.sheppardmullin.com/media/article/1718_Blockchain-Issues-for-Interactive-Entertainment-Companies-Article-0518.pdf (last visited Jan. 7, 2019).

to be “actively engaged” in order to provide meaningful value and help bootstrap the network. They may need to carry out some work or give back to the network, or purchase some product within the network. For DCs, hype, discussion, and attention is often enough engagement to be considered meaningful and active.

“Usage” of collectibles varies from project to project. Airdropping DCs can help bootstrap networks and garner interest in a project. There are some aspects of DCs and DC projects that make uniquely suitable for airdrops, including the following:

A. Asymmetrical Upside to Users: A recipient of an airdropped DC may receive asymmetrical appreciation in the value of the asset they receive. In a normal airdrop, the asset price correlates directly with the success of the network. In an airdrop of DCs, the value of the dropped asset could be greater than or less than the value of the other DCs given away. It’s difficult to know what characteristics of each DC will be deemed of value as the network matures. It’s also difficult to anticipate what feature or characteristic will be deemed scarce or desirable. In this sense, receiving a “free” DC can be more appealing. It’s the equivalent of receiving a lottery ticket from a newly minted lottery company. If the lottery company has some traction and there’s enough buy-in, you may receive a huge upside from the dropped lottery ticket, even though other dropped tickets may eventually have little to no value.

B. Liquidity: Liquidity for DCs is currently very limited. DC trading mostly takes place on certain types of exchanges and marketplaces, often ones where other traditional assets are not traded.[35] Investors will be less likely to quickly trade away DC assets, which in part solves for the “free money” problem[36] of airdrops and increases the chances of longer engagement.

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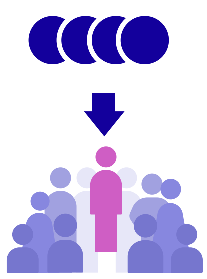
[36] Kyle Samani, A New Model for Token Distribution, MULTICOIN (Nov. 9, 2018), https://multicoin.capital/2018/11/09/new-models-for-token-distribution/ (last visited Jan. 7, 2019).

[35] Pawel Chudzinski, Mapping the Emerging Non-Fungible Token Landscape, MEDIUM (Jun. 15, 2018), https://medium.com/point-nine-news/mapping-the-emerging-non-fungible-token-landscape-ee56f0d1079f (last visited Jan. 7, 2019). We do not comment on the legality of such exchanges or marketplaces.

C. DC Creation: some collectibles rely on “breeding”[37] of two DCs together, resulting in an additional DC being produced. Supply is virtually infinite with breeding DCs, since a new asset can always be created by breeding two. If properly structured to incentivize breeding, an airdrop could help early DC networks quickly diversify and vary their collectible bases.



2. Algorithmic Stable Coins

Algorithmic stablecoins can use airdrops to help bootstrap their networks.[38] Algorithmic stable coins, or those using a seigniorage share model, use elastic money supplies and various incentives to create tokens with a price peg. Many projects like Basis,[39] Maker,[40] Carbon[41] and Kowala,[42] chose to start with a USD pegged token. In theory, the price can be pegged to almost anything.

One of the most critical junctures for an algorithmic stable coin is the initial launch. It’s at this point that liquidity will likely (if the network succeeds) be at its lowest. There will be less demand for whatever secondary incentive token is offered. Ensuring that algorithmic stable coins have healthy and consistent upward and downward pressures is vital for maintaining the peg.

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[37] CryptoKitties, Getting started with CryptoKitties Part Two: Buying and Breeding, MEDIUM (Apr. 16, 2018), https://medium.com/cryptokitties/getting-started-with-cryptokitties-part-two-buying-and-breeding-792502e54a4d (last visited Jan. 7, 2019).
[38] SpankChain, BOOTY is Officially (air)Dropping Friday, October 5th!, MEDIUM (Oct. 4, 2018), https://medium.com/spankchain/booty-is-officially-air-dropping-friday-october-5th-75fd770ca546 (last visited Jan. 7, 2019).
[39] Salil Deshpande, Basis: a Price-stable Cryptocurrency with an Algorithmic Central Bank, NOTEWORTHY (Apr. 18, 2018), https://blog.usejournal.com/basis-a-price-stable-cryptocurrency-with-an-algorithmic-central-bank-bd702eeb5e68 (last visited Jan. 7, 2019).
[40] The Dai Stablecoin System, MAKER (Dec. 2017), makerdao.com/whitepaper/ (last visited Jan. 7, 2019).
[41] Connor Lin et al., Carbon: A Price-Stable Cryptocurrency for Next-Generation Payments, CARBON (Apr. 3, 2018), https://www.carbon.money/whitepaper.pdf (last visited Jan. 7, 2019).
[42] Eiland Glover & John W. Reitano, The Kowala Protocol: A Family of Distributed, Self-Regulating, Asset-Tracking Cryptocurrencies, KOWALA, https://www.kowala.tech/pdf/kowala-protocol-white-paper.pdf (last visited Jan. 7, 2019).

Stable coins are also, arguably, less capable of having "multiple lives" or "second chances". While the technical framework is vital, there must be enough trust in the product to drive enough meaningful adoption.[43] There must not only be trust in the algorithm driving the stabilizing feature, but also trust that the market as a whole will exist, and trust that there will be enough third-party interest in the product as well.

Issuers can consider airdropping their pegged tokens to incentivize usage. Issuers can view this as an additional way of adding stability, especially in the project's earliest phases. To maintain healthy networks in the early stages, there were rumors that projects like Basis planned to create a "stability fund"[44] to simply trade the tokens against themselves.[45] Dropping the actual pegged token (some projects use two or three tokens) is, outside of transaction costs, generally free of charge to the issuer, i.e. the issuer doesn't have to give up any market share of the underlying product to do so. While a fund that is tasked with maintaining early liquidity in a network could easily run out of money, dropping (or slowly dripping) tokens can provide a sustained counterweight to market pressures.

3. Competitive Airdrops

Networks or companies seeking to gain a competitive edge can use airdrops to their advantage. The decentralized business environment has largely been untested to date.[46] One of the greatest struggles will

[43] Jonathan Moed, With the Rise of Stablecoins, Can Crypto Finally Realize Its Potential?, FORBES (Oct. 31, 2018), https://www.forbes.com/sites/jonathanmoed/2018/10/31/with-the-rise-of-stablecoins-can-crypto-finally-realize-its-potential/#3d8d5e235cc6 (last visited Jan. 7, 2019).
[44] Basis Report, INTELLIGENT TRADING, 7 (Aug. 20, 2018), https://intelligenttrading.org/wp-content/uploads/ITF_Basis_Analysis_Aug_20_2018.pdf (last visited Jan. 7, 2019).
[45] Preston Byrne, Basecoin (aka the Basis Protocol): the worst idea in cryptocurrency, reborn, PRESTON BYRNE (Oct. 13, 2017), https://prestonbyrne.com/2017/10/13/basecoin-bitshares-2-electric-boogaloo/ (last visited Jan. 7, 2019).
[46] Jed Halfon, No More Candy And Balloons: Airdrops, Or Digital Asset Giveaways, Are Coming, FORBES (Oct. 1, 2018), https://www.forbes.com/sites/jedhalfon/2018/10/01/no-more-candy-and-balloons-airdrops-are-coming/#7c7e24964c11 (last visited Jan. 7, 2019).

inevitably be that open sourced projects are just that, open to the public. The codebase, the guts of the company, are out there on display for all to see. It is therefore very easy to just copy code and fork an entire network. When this happens, networks will seek ways to distinguish themselves and attract users, mining power, and activity to their likely very similar network. [47] [48]

In these instances, tokens can be airdropped to strategic holders. For example, let's say there was a decentralized version of the popular dating app Tinder. Let's call this version "Tinder1." Competitors could airdrop extra tokens to the most liked person on an open-source Tinder1 to incentivize them to move over to "Tinder2". The new network would be mostly the same, except this individual would own a larger chunk of network value in Tinder2. In a more hostile environment, tokens could also be sent to addresses that "burn"[49] the tokens of a given network, e.g. burning Tinder1 tokens in exchange for an equal or greater stake in Tinder2.[50] To date, most of the open source competition has happened among payment tokens and at the protocol layer. True competition for dApp market share has trailed behind because successful dApps have proven to be exceptionally difficult to build. As these projects do start rolling out products, competition will inevitably[51] follow.

[47] Pete Rizzo, Bitcoin Cash Hard Forks in Bid to Ease Mining Difficulties, COINDESK (Nov. 13, 2017), https://www.coindesk.com/bitcoin-cash-hard-forks-blockchain-bid-ease-mining-difficulties (last visited Jan. 7, 2019).

[48] Julia Magas, Opposing Bitcoin ABC and Bitcoin SV Factions' Debates Grow Heated as the Bitcoin Cash Hard Fork Draws Closer, COIN TELEGRAPH (Nov. 13, 2018), https://cointelegraph.com/news/opposing-bitcoin-abc-and-bitcoin-sv-factions-debates-grow-heated-as-the-bitcoin-cash-hard-fork-draws-closer (last visited Jan. 7, 2019).

[49] Burning a token means making it unspendable. This can be done through any number of methods, including sending the tokens to an address whose private key is generally unknowable. For example, many seeking to burn ethereum based tokens send them to the Ethereum genesis address, because it is impossible to replicate the private keys for this address. See: Brady Dale, Crypto Startups are Destroying Millions or Coins and Investors Love It, COINDESK (Aug. 23, 2018 at 8:00 UTC), https://www.coindesk.com/crypto-startups-are-destroying-millions-of-coins-and-investors-love-it (last visited Jan. 9. 2019).

[50] Andy Bromberg, What the First Token Hostile Takeover Could Look Like, MEDIUM (Mar. 16, 2018), medium.com/@andy_bromberg/what-the-first-token-hostile-takeover-could-look-like-c40be3ccb6b5 (last visited Jan. 7, 2019).

[51] Kyle Samani, Aggregation Theory, Thin Protocols, and Recentralization: Augur Edition, MULTICOIN (Aug. 8, 2018), https://multicoin.capital/2018/08/08/aggregation-theory-thin-protocols-and-recentralization-augur-edition/ (last visited Jan. 9, 2019).

VI. Regulation Crowdfunding Airdrops

In 2017 and 2018 numerous airdrops were launched without much deference to U.S. securities laws. Whether or not a given token is considered a security is outside the scope of this report, but we can safely assume many of the tokens airdropped in the past would be considered securities if reviewed by the SEC and other regulators.[52] This means that airdropping tokens requires an issuing company to comply with federal securities laws, or find themselves subject to censure and possible bans from offering digital assets in the future.[53] Regulation Crowdfunding ("Reg CF") is uniquely positioned to offer an effective, compliant, and cost-efficient way to airdrop tokens.

The fact that a security is given away for "free" does not necessarily exempt it from securities regulations. Section 3(a)(11) of the Exchange Act defines an "offer" of securities as "an attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value (emphasis added)."[54] In 1999, a series of enforcement actions were brought against companies that gave away "free stock" without registering with the SEC or qualifying for a registration exemption.[55] In these matters, the SEC pointed out that value was provided to the issuing companies by the recipients of the securities in the form of publicity, traffic, and general interest in the businesses, thereby constituting a sale and making the giveaways qualify as offerings of securities.[56]

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[52] Jay Clayton, Chairman, Sec. and Exchange Comm'n, Statement on Cryptocurrencies and Initial Coin Offerings, SEC.GOV (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 (last visited Jan. 7, 2019).

[53] Violating Sections 5(a) and 5(c) of the Securities Act by offering and selling securities without having a registration statement filed or in effect with the Commission or qualifying for an exemption from registration with the Commission. See SEC Rel. No. 2018-280 (Dec. 12, 2018), https://www.sec.gov/news/press-release/2018-280 (last visited Jan. 7, 2019).

[54] Exchange Act of 1934, 15 U.S. Code § 78c, as amended.

[55] SEC Rel. 99-83 (July 22, 1999), https://www.sec.gov/news/headlines/webstock.htm (last visited Jan. 7, 2019).

[56] The release points out that: "In each of the four cases, the investors were required to sign up with the issuers' web sites and disclose valuable personal information in order to obtain shares. Free stock recipients were also offered extra shares, in some cases, for soliciting additional investors or, in other cases, for linking their own websites to those of an issuer or purchasing services offered through an issuer. Through these techniques, issuers received value by spawning a fledgling public market for their shares, increasing their business, creating publicity, increasing traffic to their websites, and, in two cases, generating possible interest in projected public offerings." Id.

The recent ruling in Tomahawk echoed this sentiment and characterized a bounty program that distributed Tomahawkcoins (TOM) for "free" to those willing to market the Tomahawak ICO, as an illegal offer and sale of securities.[57] The bounty program was similarly designed to "foster the company's economic interest."[58] As discussed in previous sections of this report, there is value[59] to be gained by a company from conducting an airdrop of their tokens, and it seems that the SEC would deem this value as sufficient to meet that necessary prong of the definition of an offer under Section 3(a)(11).[60]

The SEC has, on multiple occasions, made it clear that nearly all tokens are considered securities.[61] As stated before, all offerings of securities within the U.S. or to U.S. citizens must be registered with the SEC or must qualify for an exemption from the registration requirements. The Reg CF registration exemption allows issuers to easily distribute tokens to a broad audience of U.S. and foreign citizens, accredited and unaccredited investors alike, while falling under a clear safe harbor from registration.

Reg CF is extremely flexible. An airdrop issuer can run several campaigns a year and even concurrent[62] campaigns.[63] A Reg CF airdrop can take place alongside a 506(c)

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57 For purposes of this discussion, we do not view the distinction between an airdrop and a bounty as a meaningful one. Both tend to offer up private securities in exchange for some perceived value received by the issuer. In the case of a bounty program, the issuer tries to better control the "type of value" received by participants by demanding a unique task or action.

58 Tomahawk Exploration LLC, Exchange Act Release No. 83839 (August 14, 2018).

59 The court added that "The distribution of TOM pursuant to the Bounty Program constituted sales under Section 2(a)(3) of the Securities Act, which applies to "every disposition of a security or interest in a security, for value." The lack of monetary consideration for "free" shares does not mean there was not a sale or offer for sale for purposes of Section 5 of the Securities Act. Rather, a "gift" of a security is a "sale" within the meaning of the Securities Act when the donor receives some real benefit. See SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp. 2d 923, 940–43 (S.D. Ohio 2009), aff'd, 712 F.3d 321 (6th Cir. 2013) at 7. See also Sierra Brokerage, 608 F. Supp. 2d at 940 ("where a 'gift' disperses corporate ownership and thereby helps to create a public trading market it is treated as a sale")" at 8.

60 In determining whether an investment contract exists, the investment of "money" need not take the form of cash. See, e.g., Uselton v. Comm. Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) ("[I]n spite of Howey's reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract.").

61 Jay Clayton, Chairman, Sec. and Exchange Comm'n, Statement on Cryptocurrencies and Initial Coin Offerings, SEC.GOV (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 (last visited Jan. 7, 2019).

62 For example, a company could issue two classes of securities using Reg CF at the same time, running one campaign that sells traditional equity or convertible notes, and another that offers tokens.

63 Reg CF allows issuers to hold "concurrent" offerings so long as they are conducted through the same intermediary, a funding portal or a broker dealer (Reg CF Rule 100(a)(3)).

private placement as well. Reg CF also does not require fiat payment to be offered as consideration for the security offered[64] and allows flexibility regarding the "payment mechanism."[65] This opens the door for issuers to be creative and demand a range of alternative forms of considerations, from social media promotion to in network activity and support.

There are many misconceptions about Reg CF. Some of the most common misconceptions that initially give potential airdrop issuers pause include:

Contamination:

Distributing my token in an exempt Reg CF securities offering guarantees that my token will forever be considered a security.

Some view selling an asset in a securities offering and using a securities instrument wrapper as potentially "contaminating" the legal character of the underlying asset forever.

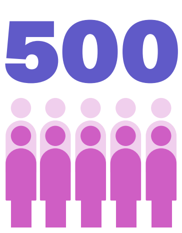
We find this categorical point of view to be without merit. For one, that would empower Reg CF, and any other securities offering exemption, with the ultimate power! The power to change the legal character of any type of asset under the sun simply by selling or offering it in a certain manner. If someone were to have an offering of bananas (or the right to bananas),[66] and they were to describe and offer up those

[64] Because a funding portal cannot receive any funds, it would be required to direct investors to transmit money or other consideration directly to a "qualified third party" that has agreed in writing to hold the funds for the benefit of the investors and the issuer and to promptly transmit or return the funds to the persons entitled to such funds." Crowdfunding, Exchange Act Release No. 33-9974; 34-76324 (Oct. 30, 2015), at 233. (emphasis added).

[65] "The statute does not limit or require a particular payment mechanism, and we are not imposing such a restriction because we believe that the rules should provide reasonable flexibility regarding the payment mechanisms intermediaries employ." SEC Rel. No. 33-9974; 34-76324 (Oct. 30, 2015), at 231.

[66] The drafters note that we already have commodity markets where the instruments used to exchange raw goods such as oil and peaches are considered securities, but the items are not.

bananas in a proper offering memorandum, go solicit and receive investments through a broker dealer and ultimately file a Form D, we could hardly say that those bananas themselves would forever be, until the day they turned brown and rotted away, securities. Similarly, SEC Director Hinman's remarks in June seemed to support this view. In his speech he suggested that Ethereum, in its current state, would not be considered a security, and noted that the analysis of the legal character of each offering and token would be a "facts and circumstance" analysis. Hinman's comments further suggested that the facts and circumstances surrounding the offering and the character of the underlying asset may change, noting that "I would like to emphasize that the analysis[67] of whether something is a security is not static and does not strictly inhere to the instrument" (emphasis added).[68] Additionally, the analysis can evolve as the success of the project's reliance on initial adopters shifts and the project becomes more decentralized.[69]



Holders of Record:

Distributing my token to more than 500 unaccredited investors will force me to become a public reporting company.

In general, an issuer must register a class of equity securities pursuant to Section 12(g)(1) of the Exchange Act if on the last day of its most recent fiscal year, those securities have 500 or more unaccredited holders of record. However, the securities can exceed the 500 unaccredited limit by exempting all those who acquired the security through a Reg CF, if the issuer (i) engages a registered transfer agent, (ii) makes all filings required under Reg CF, and (iii) has assets under $25mm at the end of each fiscal year.

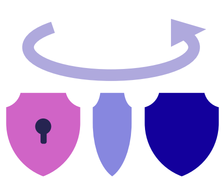
[67] Id.

[68] Id.

[69] Id. Hinman adds, "But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created?"

Items 1 and 2 above are not overly burdensome; transfer agents often charge less than $100 a month to retain, and the annual filing requirements, which include filing a Form C-A, are not particularly onerous.[70]

Item 3 initially gives issuers more pause. However, Section 12(g) of the Exchange Act, which determines when a company must become a public reporting company, is concerned solely with "equity securities." [71] This means that securities (or tokens) that don't provide privileges and rights like a claim on the residual, voting rights, information rights or the like in the issuing entity, likely do not qualify as qualifying securities under Section 12(g) of the Exchange Act. As we've seen, the range of rights that tokens afford is wide. From utility tokens to governance tokens, there are many types of tokens that provide rights and privileges that do not comport with the traditional framework of equity securities.



Secondary Trading:

The tokens distributed in an airdrop are not useful because their ability to be freely traded is prohibited for one year.

Some express concern that tokens received in a Reg CF structured airdrop (or traditional Reg CF fundraising campaign) are subject to a one-year lock-up resale period, similar to the trading restrictions securities sold in a private Reg D offering are subject to.[72] This is not necessarily the case. Securities sold in a Reg CF offering can be transferred *immediately,* subject to blue-sky restrictions that also apply

[70] Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers, SEC.GOV (May 13, 2016), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#2 (last visited Jan. 7, 2019).
[71] 17 CFR § 240.12g-1 Registration of securities; exemption from section 12(g) of the Exchange Act.
[72] 17 CFR § 230.144

to all restricted securities, after the sale, and before the one year period is up, to accredited investors or back to the issuer, so long as blue sky restrictions are met. [73] Similar blue sky restrictions may also apply to secondary trading of securities sold under a Regulation A offering, making a Reg CF offering a more cost-effective alternative for reaching retail token holders. While that doesn't allow for full range of use within the first year after distribution, this is a substantial improvement over the costs of a registered securities offering to retail investors, which no token has ever completed successfully.

Conclusion

A Reg CF structured airdrop campaign is likely the most cost-effective way of distributing private securities to both accredited and unaccredited investors. While airdrops are in many ways extensions of formerly used marketing tools, there are elements of airdrops that are native to crypto. The ease and low cost of mass distributions, the fractionalization of shares, and the ability to weave a drop into a competitive fork all make airdrops a truly unique tool of the new digital economy. The crypto industry is nascent and the use-cases for airdrops will likely evolve, but they remain a compelling tool of engagement and growth, and Reg CF is well positioned to support them.

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[73] 17 CFR § 227.501