

A Series Of 1st-Time Crypto Actions For The SEC

By **David Zaslowsky, Patrick Dennien and Ansley Schrimpf** (December 17, 2018, 1:33 PM EST)

When it comes to initial coin offerings and cryptocurrency, the U.S. Securities and Exchange Commission has consistently taken the position that it would apply existing, well-established securities law principles and that it would engage in vigorous enforcement to protect the investing public. And, in fact, the SEC's website has a page that tracks its ICO/digital assets enforcement actions.

But November was an especially aggressive month for the commission in terms of cracking down on unauthorized digital activities. More specifically, the SEC brought three actions that it described as "firsts": (1) its first enforcement action against an entity for operating as an unregulated national securities exchange; (2) its first cases imposing civil penalties solely for ICO securities offering registration violations; and (3) its first cases charging touting violations involving ICOs.

By highlighting these "firsts," the commission is sending a clear message. It is reinforcing its position that those engaged in digital asset businesses must comply with existing securities laws. And, the SEC is demonstrating that it will be using all of the tools in its toolkit to encourage such compliance.

The SEC Sets the Stage

In July 2017, the SEC issued its Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO.[1] The DAO report was the SEC's first clear public position that digital tokens can qualify as securities. In it, the commission made clear that it would apply long-standing securities principles regarding investment contracts to digital tokens. The well-established test for whether an investment contract is a security comes from the U.S. Supreme Court's decision in *SEC v. W.J. Howey Co.* and its progeny. *Howey's* three-part test requires "(1) an investment of money (2) in a common enterprise (3) with an expectation of profits produced by the efforts of others." The DAO report remains a significant touchstone for the commission in that it continuously makes reference (such as in the press releases in two of the cases discussed in this article) to the fact that the wrongful conduct took place after the issuance of the report, implying that it served as a form of "notice" to the general public.

SEC Chairman Jay Clayton then began 2018 by making the clearest signal yet that the SEC planned to impose itself over ICOs and digital token trading. In a Feb. 6, 2018, hearing before the U.S. House Committee on Banking, Housing, and Urban Affairs, Clayton testified, "[b]y and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws." The SEC would go on to make further statements as to when a token does not qualify as a security, but the commission's intent was clear — it had jurisdiction over ICOs and related trading.

The SEC also made clear that it was aware of the multiple ways in which digital tokens were replicating traditional security mechanisms. In March 2018, the SEC issued a public statement that online platforms must register as a national securities exchange or qualify as an exempt alternative trading system through Regulation ATS. Regulation ATS requires an ATS to, among other things, register as a broker-dealer, file a Form ATS with the commission to notice its operations, and establish written safeguards and procedures to protect subscribers' confidential trading information.



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In May 2018, the SEC followed a different tact in an effort to educate the public about the potential pitfalls in ICOs. It established a mock ICO website that touted an all too good to be true investment opportunity. The website featured several of the enticements that are common to fraudulent offerings, including a white paper with a complex yet vague explanation of the investment opportunity, promises of guaranteed returns, and a countdown clock that showed that time was quickly running out on the deal of a lifetime. Anyone who clicked on the "Buy Coins Now" button was taken instead to investor education tools and tips from the SEC and other financial regulators.

ICO Registration Violations

The first, and perhaps most significant, of the November "firsts" concerned charges against two companies that sold digital tokens in the form of ICOs. CarrierEQ Inc., aka Airfox, and Paragon Coin Inc. conducted ICOs in 2017, both of which were after the commission's warning in the DAO report that ICOs can be securities offerings. Airfox raised approximately \$15 million worth of digital assets and Paragon raised approximately \$12 million. Neither registered its ICO pursuant to the federal securities laws, nor did either qualify for an exemption to the registration requirements.

In the Airfox case, the order found that Airfox's AirTokens were securities under the Howey test. The AirToken offer constituted the offer and sale of investment contracts because investors purchased their AirTokens in exchange for other digital assets. Furthermore, AirToken purchasers had a reasonable expectation of profits from their investment in the Airfox enterprise because the company intended to use the proceeds of the AirToken offering to build an ecosystem that would create demand for AirTokens, which would increase the value of AirTokens. And, investors' profits were to be derived from the significant entrepreneurial and managerial efforts of others — specifically Airfox and its agents — who were to create the ecosystem that would increase the value of AirTokens and facilitate secondary market trading.

As the Airfox order concluded, Airfox's selling securities without a registration statement was a violation of Sections 5(a) and 5(c) of the Securities Act. The order in Paragon included similar findings and conclusions. In both cases, the SEC accepted the respondents' offer of settlement, which offers did not admit the findings.

The SEC's orders imposed \$250,000 penalties against each company and included undertakings by the companies to compensate harmed investors who purchased tokens in the illegal offerings. The companies also agreed to register their tokens as securities pursuant to the Securities Exchange Act of 1934 and file periodic reports with the commission for at least one year.

These cases are the strongest message yet that companies that issue securities through ICOs are required to comply with existing statutes and rules governing the registration of securities, or risk the consequences. As the SEC said at the time, "by providing investors who purchased securities in the ICOs with the opportunity to be reimbursed and having the issuers register their tokens with the SEC, the orders provide a model for companies that have issued tokens in ICOs and seek to comply with the federal securities laws."

Unregistered Digital Token Trading Platforms

The second significant action was the commission's first enforcement action against an entity for operating as an unregulated national securities exchange. The case was against Zachary Coburn, the founder of EtherDelta, a digital token trading platform. Coburn consented to the SEC's order and agreed to pay \$300,000 in disgorgement, \$13,000 in prejudgment interest, and a \$75,000 penalty.

Section 5 of the Exchange Act effectively makes it unlawful to operate an unregistered securities exchange. Section 3(a)(1) of the Exchange Act defines an "exchange" to include any organization that provides a marketplace or facilities for bringing together purchasers and sellers of securities. Further, Exchange Act Rule 3b-16(a) provides a test for whether a trading system qualifies as an "exchange." Specifically, the rule states that an organization is considered to be a marketplace if it: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, nondiscretionary methods under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

In its order, the SEC concluded that EtherDelta's trading system met the definition of "exchange." The SEC said that EtherDelta brought together orders by receiving and storing orders in tokens in its order

book and displaying the top 500 orders (including token symbol, size and price) as bids and offers on the EtherDelta website. EtherDelta provided the means for these orders to interact and execute through the combined use of the EtherDelta website, order book and preprogrammed trading protocols defined in the EtherDelta smart contract. These established, nondiscretionary methods allowed users to agree upon the terms of their trades in tokens.

The SEC noted also that Exchange Act Rule 3a1-1(a)(2) exempts from the definition of "exchange" organizations that properly comply with Regulation ATS. That was, however, of no help to EtherDelta, which took no steps to comply with Regulation ATS.

EtherDelta is not the first or only online cryptocurrency trading platform that has been taking advantage of the lack of enforcement by the SEC. Many legitimate and illegitimate companies have ignored regulatory compliance because the trading of digital tokens was well within the gray area of the law. The action against EtherDelta, as well as the increasingly public position of the SEC, shows that ignorance is no longer a viable strategy (for those who might have believed that it once was).

Improper Touting of Securities

The third significant enforcement action in November concerned celebrities DJ Khaled and Floyd Mayweather Jr., both of whom, according to the SEC, illegally promoted ICOs. Each of these cases also involved the commission's acceptance of an offer of settlement, without an admission by the respondents of the findings in the orders.

The order against Mayweather found that he failed to disclose promotional payments from three ICO issuers, including \$100,000 from Centra Tech Inc. (which the SEC sued in April) and \$200,000 in connection with two other ICOs. A post on Mayweather's Instagram account showed him holding a Centra Card at a shoe store with a caption saying that he was using it to spend bitcoin. In connection with another ICO, Mayweather posted on Instagram a prediction that he would make a large amount of money on the ICO.

Section 17(b) of the Exchange Act makes it unlawful for a person to publish a communication that describes a security if he receives consideration, without fully disclosing the receipt of such consideration and the amount. Mayweather violated Section 17(b) by touting three ICOs that involved the offer and sale of securities on his social media accounts, without disclosing that he received compensation from the issuer for doing so, or the amount of the consideration.

The case against Khaled was similar. The order said that he had more than 12 million Instagram followers (Mayweather had more than 21 million). Khaled made an Instagram post that showed him holding a Centra Card, with a caption that suggested purchasing Centra tokens, which he touted as a "game changer." Centra paid Khaled \$50,000 for this post, which he failed to disclose.

Without admitting or denying the findings, Mayweather and Khaled agreed to pay disgorgement, penalties and interest. Mayweather agreed to pay \$300,000 in disgorgement, a \$300,000 penalty and \$14,775 in prejudgment interest. Khaled agreed to pay \$50,000 in disgorgement, a \$100,000 penalty and \$2,725 in prejudgment interest. In addition, Mayweather agreed not to promote any securities, digital or otherwise, for three years, and Khaled agreed to a similar ban for two years.

According to the SEC, "[t]hese cases highlight the importance of full disclosure to investors. With no disclosure about the payments, Mayweather and Khaled's ICO promotions may have appeared to be unbiased, rather than paid endorsements." The SEC also warned that investors should be skeptical of investment advice posted to social media platforms. Indeed, in November 2017, the SEC issued a statement cautioning about making decisions based on celebrity endorsements.

Conclusion

In sum, November was a busy month for SEC enforcement. By highlighting its own "firsts," the SEC was sending the message that its actions will match its rhetoric and that it will be using all available avenues to crack down against those who abuse blockchain and smart contract technology at the expense of the investing public.

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[1] Release No. 81207 (Jul. 25, 2017).