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Client Alert

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Securities Regulators Expand Oversight of ICO Market and Digital Currency

The Initial Coin Offering (ICO) market exploded in 2017 with almost $4 billion of investment. Securities regulators in the United States have responded first with a series of public warnings and, more recently, by bringing enforcement actions against promoters of ICOs and other digital currency investments. We survey some of the recent regulatory developments in this rapidly evolving field.

SEC Guidance – DAO Report

As we first reported in our August 2017 client alert, the Securities and Exchange Commission (SEC) zeroed in on the ICO market when it issued its report of investigation concerning The DAO and its sale of DAO Tokens (the DAO Report). An ICO is a form of financing technique in which a company (typically one operating in the digital currency space) seeking to raise seed money makes a "token" available for sale, and the token gives the purchaser some future right in the business or other benefit.

The SEC applied its traditional *Howey* test to conclude that the DAO Tokens were investment contracts, and thus securities, for purposes of the federal securities laws. Importantly, the SEC concluded that the *Howey* test was met because the promoters' efforts were essential to the enterprise and DAO Token holders' control rights were limited. As securities, such tokens are subject to SEC oversight, which includes the requirement that every offering of securities either be registered with the SEC or find an appropriate exemption from registration.

We noted that although the SEC declined to bring any formal action against the promoters, the DAO Report drew a line in the sand for holders of similar tokens. The DAO Report placed the token market on official notice that US federal securities laws apply to the offer and sale of tokens that qualify as securities, including securities issued as tokens on blockchains in ICOs in exchange for cryptocurrencies. Without a valid exemption from registration, both the issuer and those who participate in the unregistered offer and sale of digital securities may be deemed to be violating US federal securities laws.

SEC Enforcement – Munchee

Since the summer of 2017, the SEC has brought several enforcement actions against promoters of ICOs. A number of these actions involved old-fashioned Ponzi schemes masquerading as token offerings. But at least one action has involved a token issuer where no allegations of fraud were made. On December 11, 2017, the SEC issued a cease-and-desist order against Munchee Inc. after finding that the company's ICO involved unregistered offers and sales of securities in violation of Section 5 of the Securities Act of 1933.

Munchee sought to raise $15 million for its blockchain-based food review and social platform by selling to users digital tokens that could be used to buy and sell goods and services through an iPhone app. Munchee and others promoting the ICO told investors that the tokens could be expected to increase in value as the company implemented improvements to the app and said that the company would work to support a secondary market for the tokens. Drawing on the DAO Report, the SEC concluded that the tokens were securities, and Munchee was in violation of the federal securities laws by conducting

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unregistered offers and sales. After being contacted by the SEC, Munchee halted its ICO and refunded investors' money before any tokens were delivered. Due to Munchee's cooperation and its quick action to end the ICO and return funds, the SEC chose not to impose a penalty.

NASAA

The SEC may get most of the press, but it is not the only securities regulator in the United States. Each of the states retains authority to police fraud in the offer and sale of securities and, absent a good exemption, may also pursue claims for the unregistered offering of securities in their states. The North American Securities Administrators Association (NASAA) serves as a kind of trade association for the various state securities regulators. It advocates on their behalf, acts as a kind of clearinghouse for state regulators and seeks to promote consistency in regulation across the states.

On January 4, 2018, NASAA issued a statement entitled "NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution." This statement provides an overview of risks associated with investing in an ICO and ominously warns investors that NASAA has identified "cryptocurrency-related investment products as emerging investor threats for 2018."

In a somewhat unusual move, the three sitting SEC commissioners issued a joint statement commending the NASSA statement. The commissioners also cautioned the investing public that:

> Unfortunately, it is clear that many promoters of ICOs and others participating in the cryptocurrency-related investment markets are not following [securities] laws. The SEC and state securities regulators are pursuing violations, but we again caution you that, if you lose money, there is a substantial risk that our efforts will not result in a recovery of your investment.

State Enforcement – Texas

Illustrating the role that states play in securities enforcement, the Texas State Securities Board (the Board) recently brought two emergency administrative actions against digital currency businesses. On December 20, 2017, in an emergency cease and desist order involving a Dubai-based business, a resident of Maryland and a resident of California, the Board alleged that an online offering of a digital currency product violated the registration and disclosure provisions of the Texas Securities Act. In a similar emergency cease and desist order issued on January 4, 2018, against United Kingdom-based BitConnect, the Board alleged securities fraud and other violations of Texas law in connection with "an open source, all-in-one Bitcoin and crypto-community platform designed to provide multiple investment opportunities."

These cases serve as good reminders that the Board, like most state securities regulators, has the power to summarily issue ex parte cease and desist orders, without the need to appear before a judge and without the requirement that the defendant be granted prior notice. The SEC does not possess this power, which allows the states to move with great speed when they have identified an ongoing violation. Of course, Texas is not alone in its desire to police the ICO market, and many other states have recently warned residents about the risks of investing in digital currency and indicated their intent to enforce state law when an ICO is involved.

CFTC

Having concluded in 2015 that digital currency is a commodity subject to its oversight and jurisdiction, the Commodity Futures Trading Commission (CFTC) has also been actively enforcing its rules against certain operators of digital currency businesses. In fact, on December 15, 2017, the CFTC issued a Proposed

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Interpretation concerning its authority over retail commodity transactions in virtual currency. On October 17, 2017, the CFTC issued its "Primer on Virtual Currencies". The document provides a thorough overview of the digital currency market and the CFTC's approach to regulation, highlighting recent enforcement cases against digital currency businesses. Notably, it discusses the SEC's guidance in the DAO Report and concludes:

- There is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.

- The CFTC looks beyond form and considers the actual substance and purpose of an activity when applying the federal commodities laws and CFTC regulations.

In most situations, a given financial product subject to SEC or CFTC jurisdiction is either deemed a security or a commodity; the analysis is usually binary. Here, however, the CFTC is declaring that tokens can exist in a kind of quantum state as both a security and a commodity.[1] Thus, although the CFTC has not yet targeted the ICO market for enforcement, we anticipate that its enforcement efforts in this market will accelerate in 2018.

FINRA

The Financial Industry Regulatory Authority (FINRA), the self-regulatory organization that oversees US broker-dealers, released its 2018 regulatory and examination priorities on January 8. Evidencing growing concern about the role broker-dealers play in the sale of ICOs and digital currency, FINRA observed that:

> Digital assets (such as cryptocurrencies) and initial coin offerings (ICOs) have received significant media, public and regulatory attention in the past year. FINRA will closely monitor developments in this area, including the role firms and registered representatives may play in effecting transactions in such assets and ICOs. Where such assets are securities or where an ICO involves the offer and sale of securities, FINRA may review the mechanisms—for example, supervisory, compliance and operational infrastructure—firms have put in place to ensure compliance with relevant federal securities laws and regulations and FINRA rules.

Private Plaintiffs

Perhaps seeing blood in the water, the private tort bar has aggressively been initiating litigation against parties involved in token offerings. In some cases, these lawsuits cite the DAO Report for the proposition that promoters of an ICO offered securities to investors without registration, which triggers a right of rescission for which purchasers of the offered token are entitled to receive a refund of the purchase price, often with statutory interest. In other cases, plaintiffs have also alleged securities fraud as part of the offering and sought monetary damages.

[1] There is precedent under the Dodd-Frank Act for so-called "mixed swaps" that are subject to joint SEC and CFTC regulation, and pursuant to the Act the agencies have promulgated joint regulations on these instruments. But to date, we have not seen this kind of coordination on the topic of ICOs.

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Next Steps

In an effort to structure around the growing body of regulatory pronouncements concerning ICOs and digital currency, some promoters have tried to restructure their products as so-called “utility” tokens that grant the holder the right to a good or service, as opposed to a pure financial return. While even SEC Chairman Jay Clayton believes doing so is theoretically possible, he also warned that tokens “and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law.” Plaintiffs in private litigation in ICOs similarly make the argument that tokens inherently have no prelaunch utility and are entirely dependent on the efforts of the issuer and its promoters to successfully develop and launch a functional network or ecosystem in which they will someday have value. Accordingly, participants in the growing ICO marketplace should consider the impact of the state and federal securities laws carefully before proceeding to solicit investors.

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