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Cryptocurrencies and ICOs: An SEC enforcement perspective

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Cryptocurrencies and initial coin offerings are in vogue, and the Securities and Exchange Commission is hot on their trail.

Cryptocurrencies are digital assets designed to enable purchases, sales and other financial transactions in a secure and pseudonymous matter. Cryptocurrency transactions are recorded on the blockchain, a form of distributed ledger technology.

It is estimated that over 2,000 cryptocurrencies have come into existence in the last decade, with a combined market capitalization at the end of 2017 of over $200 billion. Of these, the best known are bitcoin and Ethereum, which as of November 2017 had market capitalizations of $107.5 billion and $30.2 billion, respectively.

Bitcoin futures are trading on the Chicago Board Options Exchange and the Chicago Mercantile Exchange, while Nasdaq has announced that it is investigating launching cryptocurrency futures.

Coinciding with the surge in market interest in cryptocurrencies, so-called initial coin offerings, or ICOs, have become a popular way for blockchain-focused startups to raise capital. According to online ICO marketing platform Coinschedule, ICOs raised $3.7 billion in 2017.

The SEC has also taken notice of these developments, out of a stated concern that there is substantially less investor protection in cryptocurrency and ICO markets than in traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.

In recent months, the commission has made clear its position that offers and sales of digital assets are subject to the requirements of the federal securities laws. In addition, the SEC has taken enforcement action as described below and signaled that its enforcement division will continue to police this area vigorously.

The agency has also raised questions concerning how funds holding substantial amounts of cryptocurrencies and related products would satisfy the requirements of the federal securities laws applicable to mutual funds.[1]

WHAT ARE ICOS?

With an ICO, a startup offers its own digital tokens to help fund the development of a network project, in exchange for government currency or other cryptocurrencies. The startup will issue a white paper explaining the project that the ICO is intended to fund.

Many of the white papers have very limited information about the use of funds and the timeline for development. The tokens can provide access to the startup's services or applications (utility tokens) or equity interests (securities tokens) that can be traded on the secondary market through online trading platforms.

Many ICOs are marketed not just to potential end users of the network services or applications but also to cryptocurrency investors attracted by the potential for the tokens to increase in value or to otherwise profit from the tokens based on the efforts of others.

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In the SEC's view, these are key hallmarks of a security and a securities offering. But few, if any, ICOs have been registered with the SEC, and many unregistered ICOs have not complied with SEC registration exemptions.

In late 2017, the ICO market saw the introduction of "simple agreements for future tokens," or SAFTs. In a SAFT, no prefunctional token is created or sold; rather, what is sold is the right to acquire fully functional tokens in the future following launch of the startup's network. After such launch, the tokens would be "utility tokens," with the intention that they not be considered securities.

SAFTs were designed to address the regulatory uncertainty as to the status of tokens under the federal securities laws. While a SAFT is an investment contract and therefore a security (the offer of which would be made pursuant to a registration exemption), its structure is intended to avoid delivery of the digital token at a time when it is prefunctional and therefore at greater risk of running afoul of the *Howey* test (addressed below).

However, in light of the positions taken by the SEC in the ICO space, a number of questions remain as to the criteria the SEC will apply in determining that a utility token is not a security.

THE DAO REPORT

The SEC's first major action addressing ICOs was its July 2017 report on an investigation into The DAO, a decentralized autonomous organization.[2] The report describes it as "a 'virtual' organization embodied in computer code and executed on a distributed ledger or blockchain."

According to the report, The DAO's founders promoted DAO tokens to investors, promising that The DAO would be decentralized and autonomous, i.e., run by investors. Token holders were to vote to fund projects to create products or services that they could later use or charge others for using.

However, the white paper issued by The DAO's promoters said a group of "curators" selected by The DAO's founders would determine which project proposals would be submitted to a vote.

The SEC's report concluded that DAO tokens are securities under the Securities Act and that their offer and sale must therefore be registered with the commission unless a registration exemption applies.

In reaching this conclusion, the SEC applied the analytical framework set forth by the U.S. Supreme Court in the seminal case of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and its progeny, which hold that an "an investment contract" is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

First, the SEC explained that investors' use of Ether (a virtual currency used on the Ethereum blockchain) is an investment of "money" that creates an investment contract under *Howey*.

Second, the agency said investors had a reasonable expectation of profits because The DAO's objective was to fund projects for profit.

Third, it said investor profits depended on the managerial efforts of The DAO's founders and curators. The founders and curators held themselves out to be experts and exercised significant control over the project proposals. In contrast, token holders lacked meaningful control because they were anonymous and dispersed, and their voting abilities were limited by the curators' selection of project proposals.

The DAO report confirms that those participating in unregistered offerings of digital tokens that constitute securities may be liable for violations of the federal securities laws. In addition, trading platforms providing for trading in these securities must register unless they are exempt.

SEC ENFORCEMENT

The SEC has initiated several enforcement actions since publication of the DAO report.

In the first action, brought in September 2017 in the U.S. District Court for the Eastern District of New York, the agency charged a businessman and two companies with defrauding investors in two ICOs (REcoin Group Foundation and DRC World) that were purportedly backed by investments in real estate and diamonds.

The defendants allegedly fabricated the existence of their respective business operations and made unsubstantiated promises of outsized returns to investors.

The second action was an administrative proceeding that involved a legitimate startup company called Munchee, which had an app that was built around a crowd-sourced restaurant review concept.

Munchee decided to raise $15 million in capital to improve its existing app and recruit users to eventually buy advertisements, write reviews and buy and sell goods and services using Munchee tokens.

In connection with its offering, Munchee described how the tokens would increase in value as a result of its efforts and said the tokens would be traded on secondary markets.

In an enforcement order issued Dec. 11, 2017, the SEC applied the *Howey* analysis and determined that:

- Investors paid Ether or bitcoin to purchase their tokens.
- Investors had a reasonable expectation of profits from their investment in the Munchee enterprise.
- Investors' profits were to be derived from the significant entrepreneurial and managerial efforts of Munchee and its agents.

Accordingly, the SEC concluded that the tokens were securities because they qualified as investment contracts. It explained that simply launching the underlying product or service in nascent form would not avoid the possibility that the SEC might treat the tokens as securities.

In addition, the SEC noted that "[e]ven if [the] tokens had a practical use at the time of the offering, it would not preclude the token from being a security."

Munchee agreed to halt the ICO and agreed to a settlement and cease-and-desist order in which it did not admit or deny the SEC's findings. The company also refunded investor proceeds. Because Munchee stopped the ICO quickly and cooperated with the investigation, the SEC did not impose a penalty.

In its most recent action, announced Jan. 30, the enforcement division obtained a court order in the U.S. District Court for the Northern District of Texas halting an allegedly fraudulent ICO by Dallas-based AriseBank. The ICO targeted retail investors using social media, a celebrity endorsement and other wide dissemination tactics to raise $1 billion in capital to fund what it claimed to be the world's first "decentralized bank."

WELCOME TO THE MAINSTREAM

In an October 2017 speech, Stephanie Avakian, co-director of the SEC's enforcement division, announced the creation of a new cyber unit, which will focus on, among other cyber-related issues, the use of ICOs to raise capital.

The new unit's concern is that "the popular appeal of virtual currency and blockchain technology can be an attractive vehicle for fraudulent conduct."

In December SEC Chairman Jay Clayton issued a statement expressing his views on ICOs and cryptocurrencies. Clayton discussed the DAO report and made clear that attempts to highlight utility characteristics of a proposed ICO do not, by themselves, alter the SEC's position that — in appropriate contexts and depending on the facts and circumstances — such offerings represent investments of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

In other words, merely calling a token a utility token or structuring it to provide some utility does not prevent the token from being deemed a security.

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.

And though Clayton recognized that not all cryptocurrencies are securities, he asserted that, before launching a cryptocurrency or related product, promoters must either comply with the securities law requirements or demonstrate that the cryptocurrency or product is not a security.

In a subsequent speech Jan. 22, Clayton affirmed that the SEC expects market professionals, especially gatekeepers (securities lawyers, accountants, underwriters and dealers) to "act responsibly and hold themselves to high standards" in advising promoters of ICOs.

Furthermore, he warned that he has instructed SEC staff "to be on high alert for approaches to ICOs that may be contrary to the spirit of our securities laws and the professional obligations of the U.S. securities bar."

The SEC appears to have little doubt that ICOs and cryptocurrencies, in appropriate contexts, are subject to the requirements of federal securities laws. As cryptocurrencies continue to gain market traction, the agency will continue to bring enforcement actions against promoters that attempt to defraud investors.

Startups seeking to raise funds for legitimate blockchain projects would be well-advised to consult counsel on how to structure their offerings so as to qualify for available registration exemptions and thereby avoid enforcement action for violation of the federal securities laws.

NOTES

[1] It should be noted that the Commodity Futures Trading Commission has oversight and jurisdiction over virtual currencies and virtual currency futures markets and has been actively engaged in this area. In addition, the Financial Industry Regulatory Authority has put its broker-dealer members on notice that it will be monitoring their business, compliance and supervisory practices with respect to digital currencies and ICOs. Increased scrutiny and enforcement activity is expected as well by state securities regulators. A discussion of the foregoing regulatory agencies' initiatives in the area of digital currencies and ICOs is beyond the scope of this article.

[2] Sec. & Exch. Comm'n, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), http://bit.ly/2uySAZs.

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