

## SEC Charges “ICO Superstore” as Unregistered Broker-Dealer

***The settled order is the first SEC action charging a seller of digital tokens as an unregistered broker-dealer.***

On September 11, 2018, the U.S. Securities and Exchange Commission (SEC) announced a settled order instituting cease-and-desist proceedings and imposing remedial sanctions against TokenLot LLC (TokenLot), a self-described “ICO Superstore,” and its owners in connection with their sales of digital tokens to the general public through a website.<sup>1</sup> The SEC found that TokenLot and its owners acted as unregistered broker-dealers in violation of Section 15(a) of the Securities Exchange Act of 1934 (Exchange Act) and engaged in unregistered securities offerings in violation of Section 5 of the Securities Act of 1933 (Securities Act).

### A Logical Next Step in SEC Enforcement

The SEC has progressed incrementally from making statements about the application of federal securities laws to digital token offerings and trading to bringing enforcement actions that show the agency’s commitment to policing the cryptocurrency space. The SEC’s enforcement activity began on July 25, 2017, when the agency released a report of investigation under Section 21(a) of the Exchange Act concerning the public sale of Decentralized Autonomous Organization (DAO) digital tokens (the DAO Report).<sup>2</sup> In the DAO Report, the SEC announced its position that digital tokens are securities if they meet the definition of an “investment contract” under the test set forth in *SEC v. W.J. Howey Co.* The SEC also noted in the DAO Report that persons effecting transactions for others in such digital tokens may be required to register as a broker-dealer or exchange. But a report under Section 21(a) is not equivalent to an enforcement action, since the agency does not use the report to impose sanctions for alleged wrongdoing.

In December 2017, the SEC closed this gap with the announcement of the *Munchee* case.<sup>3</sup> In *Munchee*, the SEC found that the company’s token sale was an unregistered offering of securities, since the token purchasers had a reasonable expectation of obtaining profits generated by the efforts of the company’s management. As a result, the SEC found that *Munchee* had offered its tokens in violation of Section 5 of the Securities Act.

Since *Munchee*, the SEC has continued to bring a number of actions involving allegations of fraud in connection with digital token offerings. These fraud actions were mainly unremarkable as they concern old-fashioned Ponzi schemes and fraudulent offerings that happen to involve cryptocurrencies.

By contrast, *TokenLot* includes no allegations of fraud. *TokenLot*, like *Munchee*, is a message case meant to illustrate the application of the federal securities laws to the nascent cryptocurrency market.

## **TokenLot's Broker-Dealer Activity**

The SEC found that TokenLot acted as both a broker and a dealer. TokenLot acted as a broker by facilitating the sale of nine digital tokens as part of initial coin offerings (ICOs). TokenLot facilitated the token sales by marketing the tokens, by accepting investor orders and funds for payment, and by assisting with the transfer of tokens to investors upon receipt of payment. Acting as a broker, TokenLot received 5,800 purchase orders, of which 2,100 were executed. The SEC found that TokenLot received US\$112,000 in transaction-based compensation, which represented a percentage of the proceeds raised by the ICOs, subject to a guaranteed minimum commission.

The SEC also found that TokenLot acted as a dealer by selling the tokens of 145 different issuers after those issuers' ICOs had occurred, generating US\$232,000 in profits. TokenLot's secondary transactions took two forms. First, TokenLot regularly purchased tokens for its own account, often at a discount to the ICO price, and then immediately sold the tokens at a profit, or held the tokens in inventory. Second, TokenLot entered into pre-arrangements with certain issuers under which TokenLot would accept investor orders through TokenLot's website and forward the orders to the issuer. The issuer, in turn, would fulfill the orders with unsold tokens from an earlier ICO. TokenLot received compensation from the issuers as part of these arrangements.

In finding that these actions constituted unregistered broker-dealer activity, the SEC highlighted (i) TokenLot's solicitation of investors for securities transactions, and (ii) TokenLot's facilitation of initial securities offerings and secondary trading of securities. Interestingly, the SEC did not specifically address the question of whether the underlying digital tokens were securities. Rather, the SEC order simply stated that "the digital tokens issued in the ICOs and traded by [TokenLot] included securities."

Regarding solicitation, TokenLot advertised digital tokens available on its website through social media postings and forums, email newsletters, websites dedicated to digital assets, and paid internet advertising. The SEC noted that TokenLot received marketing fees from issuers in return for promoting the issuers' digital tokens on TokenLot's website.

As for facilitation, the SEC emphasized the central role that TokenLot and its website played in effecting sales. The website included a feature through which investors placed orders to buy specific digital tokens sold by TokenLot. Upon submission of orders, investor funds were transmitted to digital asset wallets controlled or maintained by TokenLot. After TokenLot received investors' funds, the digital tokens were transferred to the investors. In the case of secondary market sales, TokenLot sold digital tokens from its inventory as principal to investors. In the case of ICOs, digital tokens were transferred directly from issuers to investors; however, TokenLot received funds from investors and disbursed those funds to the issuers upon confirming that the investors had received digital tokens from the issuers.

## **The SEC's Unusual Remedies in the TokenLot Action**

The SEC broke new ground with the remedies it obtained from TokenLot and its owners. In addition to the usual panoply of relief (a cease-and-desist order, disgorgement, civil penalties and industry bars), the SEC order included an unprecedented undertaking by the Respondents. TokenLot and its owners agreed to retain an "independent intermediary," apparently akin to a receiver, with a specific mandate: to take control of TokenLot's remaining token inventory and "destroy" it within 30 days.

The TokenLot order does not specify how or why such destruction of tokens should occur, and is silent on the rationale for this unusual remedy. The order does not allege that the tokens in question were fraudulent or fictitious. It also does not discuss whether any other parties, such as the token issuers, have a property interest in the tokens that might be impacted by the order, nor does the order identify such parties or name them as relief-defendants. It is possible that TokenLot agreed to the undertakings in lieu of the SEC simply ordering disgorgement of TokenLot's inventory, which would have left the Commission as the party holding (or having to "destroy") the tokens. But these questions remain unanswered.

## Reading the Tea Leaves

The *TokenLot* action, while the first of its kind in the cryptocurrency space, treads what would be familiar ground in the traditional securities world. The usual badges of broker-dealer activity were present in the case: solicitation of securities transactions, facilitation of the execution and settlement of securities trades and receipt of transaction-based compensation. Based on the order, and assuming that at least some of the tokens sold through TokenLot's platform were securities, TokenLot operated as an unregistered broker-dealer.

Less clear, however, is the SEC's basis for concluding that the tokens sold through TokenLot's platform were securities. SEC Chairman Clayton has said previously that he has yet to see an ICO that is not a securities offering, so the agency may have taken the view that token sales that bill themselves as ICOs are securities offerings. The SEC did not take up the opportunity presented by this case to compare and contrast when different tokens should be considered securities, focusing instead on the nature of the broker-dealer activity relating to such tokens.

*TokenLot* further illustrates that the SEC's statements regarding its interest in regulating the cryptocurrency space have not been idle chatter. The SEC plainly views cryptocurrencies as an instance of pouring old wine into new bottles. The agency has looked skeptically on claims that ICOs are different than IPOs in substance, or that intermediaries who promote the trading of tokens in exchange for transaction-based compensation are distinguishable from traditional broker-dealers. In these ways, the SEC expects firms in the cryptocurrency space to use the well-established constructs of federal securities laws to evaluate their business activities to ensure those activities are legally compliant.

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**Endnotes**

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<sup>1</sup> The TokenLot Order is available at <https://www.sec.gov/litigation/admin/2018/33-10543.pdf>.

<sup>2</sup> The DAO Report is available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

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<sup>3</sup> The Muncie Order is available at <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.