

## SEC Ends 2018 Signaling Its Approach to Regulating the Cryptocurrency Markets

***Recent actions reinforce the SEC's commitment to applying traditional securities markets regulation in the cryptocurrency markets.***

The US Securities and Exchange Commission (SEC, or the Commission) recently issued a public statement<sup>1</sup> and announced five settled orders instituting cease-and-desist proceedings that shed light on how the SEC will continue to apply “the well-established and well-functioning federal securities law framework” to the nascent cryptocurrency markets. These orders — one against a token exchange, two against token issuers, and two against promoters — clarify the SEC’s approach for:

- Determining whether token transactions constitute unregistered securities offerings or unregistered broker-dealer or exchange activity
- Resolving unregistered token offerings

The Commission’s recent actions also signal the potential next frontier for SEC enforcement as the new year begins.

### First Token Exchange Enforcement Action

On November 8, 2018, the SEC instituted and settled a first-of-its-kind enforcement action against Zach Coburn, founder and former owner of EtherDelta, a token trading platform, for operating an unregistered exchange in violation of the Securities Exchange Act of 1934, as amended (Exchange Act) (EtherDelta Order).<sup>2</sup> According to the EtherDelta Order, 3.6 million buy and sell orders for tokens were executed on EtherDelta from July 2016 to December 2017.<sup>3</sup> The SEC noted that approximately 3.3 million of these tokens were traded after the SEC’s publication of the DAO Report on July 25, 2017,<sup>4</sup> which warned that digital assets that are securities must be traded on a registered securities exchange or through a broker-dealer.<sup>5</sup>

Exchange Act Rule 3b-16(a) provides that a platform falls within the definition of a national securities exchange if it both:

- Brings together the orders for securities of multiple buyers and sellers
- Uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade<sup>6</sup>

The SEC concluded that EtherDelta met these criteria by operating a website that offered buyers and sellers access to the EtherDelta order book, which received and stored orders, and displayed the top 500 firm bids and offers (including token symbol, size, and price). The SEC concluded — without providing an analysis — that at least some of the tokens traded on EtherDelta were securities under the *Howey* test (*i.e.*, the purchaser invested money with a reasonable expectation of profit from the managerial or entrepreneurial efforts of others). The SEC also noted that EtherDelta’s website automatically executed user trades through a “smart contract” designed and maintained by Coburn that self-executed protocols for validating trades and directing the Ethereum blockchain to be updated as a result thereof. In addition, the SEC noted that EtherDelta charged users a trade service fee equal to a percentage of the trade volume. Based on these findings, the SEC ordered Coburn to cease and desist from committing or causing any violations and future violations of Section 5 of the Exchange Act, and Coburn agreed to pay US\$300,000 in disgorgement, US\$13,000 in prejudgment interest, and a US\$75,000 penalty.<sup>7</sup>

Market participants — especially those operating trading platforms — should study the SEC’s analysis in the EtherDelta Order to understand what factors may lead the SEC to conclude that a particular platform should be registered as a securities exchange, a broker-dealer, or alternative trading system.

## Airfox and Paragon — Resolving Unregistered ICOs?

On November 16, 2018, the SEC issued cease-and-desist orders concluding the initial coin offerings (ICOs) conducted by Carriereq, Inc. (Airfox)<sup>8</sup> and Paragon Coin, Inc.<sup>9</sup> (Paragon) were unregistered securities offerings conducted in violation of the Securities Act of 1933, as amended (Securities Act).

### Airfox

According to the SEC order, as of August 2017, Airfox sold mobile technology that allowed mobile customers to earn free or discounted airtime or data by interacting with advertisements.<sup>10</sup> Between August and October 2017, Airfox raised US\$15 million through an ICO to support the development of an application (Airfox App) that would pay “AirTokens” to customers for viewing advertisements (Airfox ICO).<sup>11</sup> Although Airfox intended for the Airfox App to be used by cell phone owners in developing countries, the Airfox ICO was open to and attracted investors from the United States.

The SEC concluded that the Airfox ICO was an unregistered securities offering because the AirTokens constituted “investment contracts.”<sup>12</sup> To support this conclusion, the SEC focused on whether investors expected profits that would result or derive from Airfox’s efforts. The SEC found that Airfox marketed AirTokens as investments and primed investors’ profit expectations by:

- Increasing token value by limiting the supply of AirTokens
- Outlining how AirTokens would increase in value
- Promising AirTokens would be tradeable on secondary markets in the future
- Announcing an agreement to enable trading in advance of the Airfox ICO<sup>13</sup>

Because the Airfox ICO occurred before the completion of the Airfox App, the value of AirTokens depended on Airfox’s efforts to finish and launch the app. Airfox also encouraged speculation by marketing the Airfox ICO to “sophisticated crypto investors, angel investors and early backers of the AirToken project,” rather than potential AirToken users — *i.e.*, individuals with prepaid cell phones in developing countries<sup>14</sup> — and instituting a “bounty” program to pay seasoned ICO marketers to promote the Airfox ICO in exchange for a percentage of total AirTokens sold.<sup>15</sup>

## Paragon

In the second SEC action, the Commission noted that from August to October 2017, Paragon sold US\$12 million worth of “PRG Tokens” in an ICO to capitalize on Paragon’s development of blockchain-based products and services for the cannabis industry (Paragon ICO).<sup>16</sup> As with the Airfox ICO, the SEC determined that the Paragon ICO was an unregistered securities offering because PRG Tokens constituted investment contracts. The SEC highlighted that Paragon marketed PRG Tokens as an investment and primed investors’ profit motive by:

- Conducting a discounted presale
- Marketing Paragon’s plans to inflate PRG Token value by restricting supply and maintaining a reserve fund to ensure price stability
- Publicly stating in its whitepaper, on blogs, and on social media that PRG Tokens would increase in value as they would be tradeable on secondary markets.<sup>17</sup>

Further, while stating that PRG Tokens would be usable for purchasing cannabis related goods or services through the Paragon “ecosystem,” the SEC found that Paragon’s marketing materials emphasized that the “utility, liquidity and trading price of PRG Tokens” depended on Paragon’s efforts to create a future “ecosystem.”<sup>18</sup>

## Remedial Actions of Airfox and Paragon

To resolve their respective violations of the Securities Act, both Airfox and Paragon agreed to register their tokens as securities under Section 12(g) of the Exchange Act (the 1934 Act Registration), timely file reports required by Section 13(a) of the Exchange Act for at least one year,<sup>19</sup> and administer a claims process under the supervision of Commission staff. The “Claims Process” would offer token purchasers either:

- A refund of their investment, plus interest, in exchange for the applicable tokens in their possession
- Payment of damages for tokens they purchased but no longer own

The SEC orders also required Airfox and Paragon to pay penalties of US\$250,000.

## Impact on Token Issuers and ICO Investigations

In these cases, the US\$250,000 fines imposed by the SEC may be the least costly of the issues facing Paragon and Airfox. Registration of the tokens as securities under the Exchange Act and compliance with its requirements and ongoing reporting is an expensive endeavor. Moreover, given that the tokens will now unequivocally be treated as securities, those same tokens may not be exchanged on their respective networks, unless the networks are registered as intermediaries (*i.e.*, a broker-dealer or exchange). They also may not be traded in the US on cryptocurrency exchanges unless those exchanges are themselves registered with the SEC or subject to an appropriate exemption. As a result, purchasers may conclude that the tokens are unlikely to retain their value and that they are better off seeking immediate compensation through the Claims Process.<sup>20</sup> It is also difficult to see how these platforms will survive these “remedial” steps, given that the above measures undercut the fundamental nature of their networks.

## SEC Actions Against Celebrity ICO Promoters

On November 29, 2018, the SEC instituted and settled the two cease-and-desist orders against celebrity promoters of ICOs — Floyd Mayweather and Khaled (better known as DJ Khaled). Both agreed to settle charges for violating the Securities Act by using social media to promote ICOs for tokens that constituted securities.<sup>21</sup>

According to the SEC order, during the summer of 2017, Mayweather used social media to promote three securities that were being offered and sold in ICOs, without disclosing that he received approximately US\$300,000 in exchange.<sup>22</sup> His marketing efforts mainly consisted of posts regarding the issuer's product and his expectation to profit from participating in the ICOs.<sup>23</sup> Similarly, the Commission determined that on September 27, 2018, Khaled promoted a security that was being offered and sold in a securities offering without revealing the \$50,000 he was paid to make such post. Each order specifically noted that the promoter's marketing efforts occurred after the publication of the DAO Report, which "warned ... that virtual tokens or coins sold in ICOs may be securities, and those who offer and sell securities in the United States must comply with the federal securities laws."<sup>24</sup> As a result, the SEC concluded that both Mayweather and Khaled violated Section 17(b) of the Securities Act, which broadly requires that persons advertising securities offering must disclose the fact or amount of consideration they are receiving in exchange.

To settle their respective violations, Mayweather and Khaled agreed to pay disgorgement, prejudgment interest and civil money penalties totaling US\$614,775.67<sup>25</sup> and US\$152,727.72,<sup>26</sup> respectively. Mayweather further agreed not to accept payment from any issuer, underwriter, or dealer to promote or publicly describe any security being sold for a period of three years from the date of the order,<sup>27</sup> while Khaled agreed to the same restriction for a period of two years.<sup>28</sup>

## **Joint Public Announcement by Divisions of the SEC**

On November 16, 2018, the SEC's Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets (the Divisions) released a joint public statement that provided supplemental guidance on Airfox and Paragon, as well as other recent enforcement actions regarding secondary trading of tokens that constitute securities (Security Tokens) and investment in Security Tokens by investment vehicles<sup>29</sup> (the Public Announcement). The timing of these orders and the Public Statement, as described below, suggests a coordinated effort to provide additional guidance to the cryptocurrency community, possibly in response to the market's growing frustration with the Commission's approach of regulating piecemeal through enforcement actions that address one aspect of securities regulation at a time.<sup>30</sup>

### **Offers and Sales of Tokens that Constitute Securities**

The Public Announcement demonstrated that the SEC staff are considering future approaches in the cryptocurrency market, particularly for token issuers that conducted an unregistered offering of Security Tokens. Before Airfox and Paragon, the Commission had not brought any enforcement actions that mapped out a way forward for non-compliant issuers, other than to order the violators to cease and desist their violations, pay civil penalties, and accept any other sanctions the Commission imposed. In the Public Announcement, however, the agency suggested that the Airfox and Paragon actions provide a roadmap for token issuers looking to remediate prior non-compliance so that token purchasers have sufficient information to determine whether to accept the non-compliant issuer's offer for recompense.<sup>31</sup> While this path protects investors in ICOs, it would likely put an end to many network projects.

### **A Functional Approach to Identifying Exchanges and Broker-Dealers**

The Divisions acknowledge that blockchain and distributed ledger technologies have created new ways to buy, sell, and trade assets electronically. However, concern remains that many platforms deploying this technology to facilitate trading of, or transactions in, Security Tokens have not registered with the SEC as required, absent an exemption. The Public Announcement reaffirms the SEC's functional approach to identifying platforms and systems that constitute an exchange or broker-dealer governed by the Exchange Act. This approach focuses on assessing the actual activities occurring on the platform or

conducted by the entity rather than how an entity characterizes itself, its platform, system, technology, or the activities occurring thereon.

For example, the Divisions note that a platform participant's initiation of an offer to buy or sell a token will be considered for purposes of determining whether a platform is an exchange irrespective of whether the platform calls such activity an "order." Similarly, a central system receiving orders for future processing will be considered the "bringing together of buyers and sellers" for purposes of the exchange analysis regardless of the name of such system. Furthermore, the Divisions reiterated that an entity using proprietary accounts to buy and sell tokens that constitute securities may be acting as a "dealer," requiring registration under federal securities laws. Lastly, the Public Announcement serves to remind parties involved in secondary token sales that they are responsible for determining whether such tokens are securities.

### **The Next Enforcement Frontier**

The recent enforcement actions and Public Announcement reinforce the SEC's commitment to applying traditional securities markets regulation where appropriate in the cryptocurrency markets. The SEC enforcement cases to date have covered most, but not all, of the facets of the primary and secondary markets for cryptocurrencies. A footnote in the Public Announcement states that entities in the cryptocurrency markets should consider whether their activities may implicate the registration requirements for transfer agents and clearing agencies. This suggests that the agency may be targeting platforms that perform the functions of a transfer agent or clearing agency for future enforcement action. Given US investors' demand for cryptocurrencies, as well as for the plentiful supply of international cryptocurrency offerings and trading markets, the SEC is likely to investigate whether foreign entities have by their activities subjected themselves to the federal securities laws.

No matter where the SEC goes from here in regulating the cryptocurrency markets, it will clearly maintain an aggressive enforcement posture.

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**Endnotes**

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<sup>1</sup> Press Release, US Securities and Exch. Comm., Statement on Digital Asset Securities Issuance and Trading (Nov. 16, 2018), [https://www.sec.gov/news/public-statement/digital-asset-securities-issuance-and-trading#\\_edn19](https://www.sec.gov/news/public-statement/digital-asset-securities-issuance-and-trading#_edn19) (the Public Announcement).

- <sup>2</sup> Order Instituting Cease-and-Desist Proceedings pursuant to Section 21C of the Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order (Nov. 8, 2018), <https://www.sec.gov/litigation/admin/2018/34-84553.pdf> (EtherDelta). Although not discussed in this *Client Alert*, on September 11, 2018, the SEC announced a settled order instituting cease-and-desist proceedings and imposing remedial sanctions against TokenLot LLC and its owners in connection with their sale of digital tokens to the general public through a website. In the order, the SEC found that TokenLot acted as an unregistered broker in connection with nine ICOs by accepting investor orders and payments and transferring tokens to investors upon receipt of payment, and also acted as an unregistered dealer when selling the tokens of 145 different issuers after those issuers' ICOs had occurred. For more information, please refer to *Client Alert* 2395, SEC Charges "ICO Superstore" as Unregistered Broker-Dealer (Oct. 19, 2018), <https://www.lw.com/thoughtLeadership/SEC-charges-ICO-superstar-unregistered-broker-dealer>; Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (Sep. 11, 2018), <https://www.sec.gov/litigation/admin/2018/33-10543.pdf> (the TokenLot Order).
- <sup>3</sup> EtherDelta, para. 4.
- <sup>4</sup> *Id.*
- <sup>5</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Rel. No. 81207 (Jul. 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf>; for more information, please refer to Client Alert 2187, SEC: Certain Initial Coin Offerings Are Securities Offerings (Jul. 27, 2017), <https://www.lw.com/thoughtLeadership/SEC-certain-initial-coin-offerings-securities>.
- <sup>6</sup> EtherDelta, para. 24 (citing 17 CFR 240.3b-16(a)).
- <sup>7</sup> EtherDelta, Section IV(A) – (C).
- <sup>8</sup> Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Penalties and Cease and Desist Order (Nov. 16, 2018), <https://www.sec.gov/litigation/admin/2018/33-10575.pdf> (Airfox Order).
- <sup>9</sup> Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Penalties and Cease and Desist Order (Nov. 16, 2018), <https://www.sec.gov/litigation/admin/2018/33-10574.pdf> (Paragon Order).
- <sup>10</sup> Airfox Order, Section III.
- <sup>11</sup> *Id.*
- <sup>12</sup> See SEC v. W.J. Howey Co., 328 U.S. 293 (1946).
- <sup>13</sup> Airfox Order, para. 10, 11, 12 and 23.
- <sup>14</sup> Airfox Order, para. 16 (quoting an August 2017 blog post of Airfox).
- <sup>15</sup> Airfox Order, para. 15.
- <sup>16</sup> Paragon Order, Section III.
- <sup>17</sup> See Paragon Order, para. 6, 21, 24, 25, 31, 34, 42, 43.
- <sup>18</sup> Paragon Order, para. 3, 34, 35 36.
- <sup>19</sup> While these platforms could still possibly become sufficiently decentralized to no longer be considered to be engaging in securities transactions, the Exchange Act registration seems likely to inhibit that process. For more information regarding when tokens may no longer be considered securities, please refer to *Client Alert* 2336, A Path Forward for Consumer Tokens (Jun. 27, 2018), <https://www.lw.com/thoughtLeadership/lw-a-path-forward-for-consumer-tokens>.
- <sup>20</sup> It is currently unknown if, or how many, purchasers have availed themselves of the Claims Process instituted by Airfox and Paragon as the SEC has not published the monthly reports that Airfox and Paragon are required to file regarding the claims received and paid. Interestingly, the price trends of AirTokens and PRG Tokens have diverged since November 16, 2018; the price of PRG Tokens has increased from approximately US\$0.043 to approximately US\$0.12, while AirTokens no longer appear to be available for trading and, according to Etherscan, the last transfer on Airfox's blockchain took place in late November 2018.
- <sup>21</sup> Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order (Nov. 29, 2018), <https://www.sec.gov/litigation/admin/2018/33-10578.pdf> (Mayweather Order); Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order (Nov. 29, 2018), <https://www.sec.gov/litigation/admin/2018/33-10579.pdf> (Khaled Order).
- <sup>22</sup> Mayweather Order, para. 1.
- <sup>23</sup> See e.g. Mayweather Order, para. 6a (quoting Mayweather's Instagram and Facebook posts, "[s]pending bitcoins ethereum and other types of cryptocurrency [...] Join Centra's ICO on September 19<sup>th</sup>"); paragraph 9 (quoting Mayweather's Instagram post, "... I'm gonna make a \$hit t\$on of money on August 25<sup>th</sup> ... I'm gonna make a \$hit t\$on of money on August second on the [...] ICO").
- <sup>24</sup> Mayweather Order, para. 10.

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<sup>25</sup> Mayweather Order, section IV(B).

<sup>26</sup> Khaled Order, section IV(B).

<sup>27</sup> Mayweather Order, para. 12a.

<sup>28</sup> Khaled Order, para. 9a.

<sup>29</sup> In addition, on September 11, 2018, the SEC instituted and settled cease-and-desist proceedings against Crypto Asset Management, LP (Manager), the managing member of a pooled investment vehicle formed for the purpose of investing in digital assets (the Fund), and Timothy Enneking, the founder and sole principal of the Manager (together with Manager, the Respondents). According to this order, the SEC found that the Respondents caused the fund to operate unlawfully as a unregistered investment company. In the Public Announcement, the SEC reiterated the findings (and message) of the order that “investment vehicles that hold digital asset and those who advise others about investing in digital asset securities, including managers of investment vehicles, must be mindful of the registration, regulatory and fiduciary obligations under the Investment Company Act and the Adviser Act.” For more information, please refer to the Order Instituting Administrative and Cease-and-Desist Proceedings, pursuant to Section 8A of the Securities Act of 1933, Section 203(e), 203(f), and 203(k) of the Investment Adviser Act of 1940, and Section 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (Sept. 11, 2018), <https://www.sec.gov/litigation/admin/2018/33-10544.pdf>.

<sup>30</sup> See e.g. JD Alois, “Attorney on SEC & Crypto Asset Marketplaces: ‘By Not Allowing Intermediaries They Are Stifling Innovation’” (Nov. 7, 2018), <https://www.crowdfundinsider.com/2018/11/140977-attorney-on-sec-crypto-asset-marketplaces-by-not-allowing-intermediaries-they-are-stifling-innovation/>.

<sup>31</sup> See The Public Announcement (“[t]he registration undertakings are designed to ensure that investors receive the type of information they would have received had these issuers complied with the registration provisions of [the Securities Act] ... prior to the offer and sale of tokens in their respective ICOs. With the benefit of the ongoing disclosure provided by registration under the Exchange Act, investors who purchased the tokens from the issuers in the ICOs should be able to make a more informed decision as to whether to seek reimbursement or continue to hold their tokens”).