The SEC and Digital Assets—A Busy Year End

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The end of the year has been a very busy time for the SEC in the digital asset space. From speeches to the issuance of joint statements to enforcement actions, there are many things to highlight, discuss and consider. This update summarizes the recent flurry of activity and emphasizes some key takeaways.

On November 16, 2018, the Division of Enforcement of the U.S. Securities and Exchange Commission (SEC) announced the settlement of administrative actions against two companies, Paragon Coin, Inc (Paragon) and CarrierEQ, Inc. (AirFox), that sold digital securities in tokenized form in initial coin offerings (ICOs). Although neither company admitted or denied the findings, the SEC found that their ICOs violated the registration requirements of Section 5 of the Securities Exchange Act of 1933 (Securities Act).[1]

Notably, these actions did not include allegations of fraud and, for the first time, the undertakings included registration of the tokens and a rescission option for ICO investors. As Stephanie Avakian, Co-Director of the SEC's Division of Enforcement, stated in press releases concerning AirFox and Paragon these "cases tell those who are considering taking similar actions that [the SEC] continue[s] to be on the lookout for violations of the federal securities laws with respect to digital assets … that [the SEC has made it clear that] companies that issue securities through ICOs are required to comply with existing statutes and rules governing the registration of securities." Jennifer Lette, an Assistant Director in the Division of Enforcement, stated at a December 12, 2018 DC Bar program that these two unrelated enforcement matters were brought together to send a clear message, noting that self-reporting and cooperation go a substantial way in mitigating the potential consequences.

The Paragon and AirFox actions represent the latest in a number of SEC enforcement cases against ICOs and digital asset companies since the SEC's 21(a) Report relating to the DAO on July 25, 2017, (DAO Report), cautioning market participants that offers and sales of digital assets by "virtual" organizations are subject to the requirements of the federal securities laws. AirFox and Paragon, however, represent a more aggressive approach to remedies than previous actions. Since the DAO Report, the SEC has launched numerous investigations, which have resulted in various entities and individuals being charged with having engaged in a variety of unregistered and fraudulent activities that violated the federal securities laws. These have included allegations of fraud in ICO offerings, one of which was filed on September 29, 2017, against an ICO promoter, Maksim Zaslavskiy. The SEC has also taken action to halt offerings that it believed should be registered as securities under Section 5 of the Securities Act, including the Munchee ICO, settled in December 2017 (Munchee Order).[2] As emphasized in the joint statement discussed below, the DAO Report and the Munchee Order suggest that digital assets offered and sold as investment contracts, regardless of the terminology or technology used in the transaction, are securities.[3]

On the same day the SEC announced the Paragon and AirFox settlements, the SEC's Divisions of Corporation Finance, Investment Management, and Trading and Markets (the Policy Divisions) issued a rare joint public statement on digital asset securities issuance and trading, affirming the positions taken in AirFox and Paragon, as well as other recent enforcement actions—Crypto Asset Management, TokenLot, and EtherDelta. The joint statement encouraged technological innovation that benefits investors and U.S. capital markets, but warned that "market participants must still adhere to our well-established and well-functioning federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain."[4] The AirFox and Paragon settlements and the joint statement are discussed in more detail below.

Recent SEC Enforcement Actions

AirFox

AirFox is a Boston-based business that sells mobile technology enabling customers of certain United States prepaid mobile telecommunications operators to earn free or discounted airtime or data by interacting with advertisements on their smartphones. Between August and October 2017, AirFox offered and sold digital tokens (AirTokens) through an ICO, which were issued and transferable on the Ethereum blockchain. Through this ICO, AirFox raised approximately $15 million in capital to finance its business and ecosystem. AirFox told investors that the new ecosystem would include the core functionality of AirFox's existing U.S. business and add new functionality, including the ability to transfer AirTokens between users, peer-to-peer lending, credit scoring, and, eventually, using AirTokens to buy and sell goods and services other than mobile data. In connection with the ICO, AirFox stated that AirTokens would increase in value and demand as a result of AirFox's efforts (including functionality not yet developed), and that AirFox would undertake efforts to provide investors with liquidity by making AirTokens tradeable on secondary markets. The SEC held that AirFox violated Section 5 of the Securities Act by offering and selling AirTokens without registering with the SEC or qualifying for an exemption to the registration requirements.

It is clear from the AirFox Order that the SEC focused on the substance, rather than the form, of AirFox's statements. For example, the SEC emphasized that certain statements in AirFox's offering materials, i.e., that the value of the AirTokens would increase as a result of AirFox's efforts and that AirFox would undertake efforts to provide investors with liquidity by making the AirTokens tradeable on secondary markets, supported the purchasers' reasonable expectation of an opportunity to profit from an investment in the AirTokens. In fact, although AirFox purported to require purchasers to agree they were buying the AirTokens for their utility, and not as an investment or a security, these statements appeared to be unpersuasive. The SEC identified the following additional elements as supporting the conclusion that AirTokens were investment contracts:

- During the primary offering, AirFox announced a reduction in the total supply of AirTokens and stated that the reduction was done to support secondary trading.
- AirFox established a social media bounty program to promote AirTokens, which paid promoters in AirTokens for participation.
- AirFox targeted marketing efforts towards digital asset investors and not anticipated users, and intentionally directed a presale prior to the public offering at "sophisticated crypto investors, angel investors and early backers of the project."
- The terms of sale purported to require purchasers to agree that they were buying AirTokens for their utility as a medium of exchange for mobile airtime, and not as an investment or a security, but at the time of the ICO, this functionality was not available. AirFox stated that proceeds of the ICO would be used to fund future development of the AirFox App and the AirToken ecosystem, leading investors to reasonably expect that AirFox and its agents would expend efforts on this development and increase the value of the AirTokens.[5]
- AirFox highlighted to investors that it planned to enter into agreements with digital asset exchanges to ensure trading on secondary markets.

The SEC imposed a $250,000 fine and required AirFox to reimburse investors who purchased AirTokens in the "illegal offerings," register the AirTokens as a class of securities pursuant to the Securities Exchange Act of 1934 (Exchange Act) and file periodic reports with the SEC for at least one year. Specifically, AirFox must undertake to (1) file a Form 10 to register under Section 12(g) of the Exchange Act the AirTokens; (2) maintain AirTokens as an asset class and make timely filings of all reports required under the Exchange Act; and (3) provide a claims notice and notify AirToken investors of their potential claims under Section 12(a) of the Securities Act, including the right to sue "to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if [the purchaser] no longer owns the security."[6] As explained below, it appears that the SEC's position is that the "consideration paid" in this context is the US dollar value of the digital assets (e.g., ETH or BTC) at the time of purchase.

Paragon

Paragon, an online entity, raised approximately $12 million worth of digital assets to develop and implement its business plan to add blockchain technology to the cannabis industry and work towards legalization of cannabis. As with AirFox, Paragon's ICO was intended to fund an "ecosystem" that was yet to be developed, including the acquisition of real estate for contemplated "ParagonSpace," co-working spaces by Paragon. Similar to AirFox, Paragon marketed its ICO to investors, with a whitepaper detailing the features of the token (PRG Tokens) alongside corresponding marketing and advertising, including a celebrity engaged by Paragon.

Although the form of marketing efforts and statements made by Paragon were different from AirFox, the facts cited in the Paragon Order are materially similar. Unlike AirFox, however, Paragon did not engage in a social media bounty program or actively reduce the supply of PRG Tokens. Rather, the Paragon whitepaper stated that the capped number of PRG Tokens would reduce the supply of tokens over time (e.g., as private keys are lost), which Paragon stated would "increase demand" and, therefore, the price per token. The Paragon whitepaper also pointed out that a Paragon-controlled reserve fund of PRG Tokens would be used to influence the price of PRG Tokens. The SEC also concluded that the risks highlighted in the whitepaper linked the future value of the PRG Tokens to the success of Paragon's efforts.

The SEC also imposed a $250,000 fine on Paragon and required it to take similar remedial actions as outlined above with respect to AirFox Order. These remedial actions are described in further detail below.

AirFox and Paragon—Registration and Rescission

Registration

The AirFox and Paragon Orders require registration of their respective tokens as securities under Section 12(g) of the Exchange Act, initially through filing a Form 10. (Form 10 is used to register a class of securities with the SEC for trading on a U.S. exchange.) By registering their tokens as securities, AirFox and Paragon will be subject to ongoing obligations, including filing periodic reports with the SEC. The registration process in Section 12(g) of the Exchange Act is likely to present expensive and difficult burdens for AirFox and Paragon. Of note, the undertakings in these two matters do not cure the violations of Section 5 under the Securities Act.

First, Form 10 will require, among other things, significant disclosures and information about AirFox and Paragon's businesses, applicable risk factors, finances (including audited financials), security (i.e., token) holders and legal information (e.g., pending litigation). How AirFox and Paragon will address these requirements remains to be seen. For example, the requirement for financial information will need to be aligned with nascent accounting practices for cryptocurrency. AirFox, Paragon and any other digital asset issuer seeking to register will presumably need to engage proactively with the SEC on these issues. To date, no registration statement for digital asset securities has been declared effective under the Securities Act, and neither have any digital asset offerings using Regulation A.[7] That being said, registrations under Exchange Act Section 12(g) using Form 10 automatically become effective 60 days after filing, regardless of any filing deficiencies; the SEC does not have to affirmatively declare them effective. AirFox and Paragon may be liable for any material misstatements or omissions, including potential personal liability for their directors and officers if any purchaser who exercises its rescission right relies on a misleading statement within their Form 10. (For example, potential liability under Section 18 of the Exchange Act.)

Second, once AirTokens and PRG Tokens registrations are effective, they will only be capable of trading on an Alternative Trading Systems (ATS) or securities exchange.[8] To date, there is a limited universe of ATSs that offer the trading of digital asset securities. As a result, AirTokens and PRG Tokens will be illiquid until trading infrastructure develops.[9] An additional limiting factor is that the participants on an ATS may be restricted to "accredited investors" or broker-dealers acting on behalf of non-accredited investors.

Third, as registered securities, AirFox and Paragon will be required to file annual reports (Form 10-K), quarterly reports (Form 10-Q) and current reports (Form 8-K). The AirFox and Paragon Orders require registration pursuant to Section 12(g) for a minimum period of one year, after which AirFox and Paragon can file a Form 15 to cease reporting, provided at that time they (1) have less than 300 holders, or (2) have less than 500 holders and total assets of less than $10 million.[10] Such restrictions, however, may run counter to AirFox and Paragon's intended goal of a decentralized user base for their ecosystems, and would depend on the number of holders who participate in the rescission process.[11]

It is worth noting that the definition of "security" in Section 2(a)(1) of the Securities Act includes an investment contract, and the SEC staff had presumably determined that as a consequence of the investment intent and other factors the tokens sold by AirFox and Paragon were investment contracts under the test established in *Howey* (the Howey Test).[12] Under different fact circumstances, the same token might no longer meet the Howey Test, and as such, would no longer meet the definition of a security within the meaning of either the Securities Act or the Exchange Act. This could result in a circumstance in which the same token would no longer be subject to the registration requirements of either act, thus rendering moot the need to register the tokens or rely on an available exemption. Although more clarity around mutability concepts would be needed to reach this conclusion, in theory, once there are no further efforts of others to be provided that serve as the requisite basis for a reasonable purchaser's expectation of profits, the tokens could be deregistered irrespective of the number of token holders outstanding or other requirements under the Exchange Act. Of course, the specific facts (e.g., decentralization, full functionality plus, etc.) necessary to determine that the Howey Test is no longer satisfied, have yet to be clarified by the SEC or the courts.

Rescission

The AirFox and Paragon Orders also require AirFox and Paragon to make an offer of rescission to the purchasers of their tokens, consistent with purchasers' rights under Section 12(a) of the Securities Act if securities are sold in violation of Section 5 of the Securities Act. Under Section 12(a), purchasers have a right to sue "to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon" if they return the platform tokens to the issuers. If the purchaser no longer owns the token, they have a right to sue for damages. The specific rescission process outlined in AirFox and Paragon require the issuers to disclose this right to purchasers through a claim form (the form of which requires SEC approval).[13]

Interestingly, the AirFox Draft Notice and Claim Form indicate that "[a]ll claims will be valued and paid in U.S. Dollars, based upon U.S. Dollar value of the consideration paid at the time of the purchase." Given the drop in the value of Ether and Bitcoin since the AirFox token offering (October 2017) and the Paragon token offering (October 2017), this could pose a real risk that neither company retains sufficient financial resources to satisfy these obligations assuming that these token sales comprised the bulk of the companies' previous fundraising efforts. Subsequent purchasers of the platform tokens do not have a statutory rescission right, and generally the rescission offer will need to be acted upon by purchasers within one year.[14]

Recent SEC and SEC Staff Comments

Joint Statement

On the same day the SEC announced the AirFox and Paragon settlements, the Policy Divisions released the joint statement, which stated that "there is a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities." The joint statement identified the following areas of activity the Policy Divisions look to in determining the obligations of market participants; (1) Offers and Sales of Digital Asset securities, (2) Investment Vehicles Investing in Digital Assets, and (3) Broker-Dealers and Securities Exchanges.

Division of Corporation Finance—Offers and Sales of Digital Asset Securities

The SEC has consistently emphasized to market participants that federal securities laws can apply when offering and selling digital assets. Since the release of the DAO Report, the SEC has taken action against violations of Section 5 of the Securities Act, as in the Munchee Order, as well as subsequent fraud-based cases. The AirFox and Paragon Orders represent the first time the SEC has imposed registration requirements under Section 12(g) of the Exchange Act and remediation requirements, as a condition of settlement of SEC administrative charges for violation of Section 5. The joint statement notes that "[w]ith 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."

Division of Investment Management—Investment Vehicles Investing in Digital Assets

The joint statement emphasized that the Investment Company Act of 1940 (Investment Company Act) establishes a registration and regulatory framework for pooled vehicles that invest in securities, which applies to the pooled investment vehicle and its managers, even when the securities in which it invests are in the form of digital assets.[15] The joint statement also noted that these investment vehicles and entities that provide investment advice with respect to digital asset securities must be "mindful of the registration, regulatory and fiduciary obligations" under the Investment Company Act and the Investment Advisers Act of 1940. The SEC's first action applying the investment management framework to the digital asset space was against Crypto Asset Management, when a hedge fund manager violated the registration provisions of the Investment Company Act.

Division of Trading and Markets—Trading of Digital Asset Securities

The SEC's Division of Trading and Markets oversees intermediaries, such as broker-dealers, transfer agents, entities providing central clearing and custodial services, and exchanges.

Broker-Dealers

Courts and the SEC have determined that a person needs to register as a broker-dealer if they "effect transactions in securities," including if they participate in such transactions at key points in the chain of distribution.[16] Common examples of broker-dealer conduct include taking, routing or matching orders, or facilitating the execution of securities transactions, receiving transaction-based compensation, as well as many other forms of involvement, including marketing and finding buyers. The SEC applied its traditional broker-dealer analysis in the TokenLot action, when it found that the company had engaged in broker-dealer activity with respect to digital assets, including securities, although notably the SEC Order did not specify which particular digital assets it determined to be securities or describe the basis for its determination. The TokenLot action is also notable because the SEC ordered some digital assets to be destroyed; by contrast, other federal agencies that have seized digital assets have treated them as property to be auctioned.[17]

Exchanges

The definition of an exchange under the Exchange Act is very broad.[18] On November 8, 2018, the SEC settled with Zachary Coburn, the founder of EtherDelta, for operating an unregistered securities exchange in violation of Section 5 of the Exchange Act. This action represented the first time the SEC took enforcement action against a digital asset exchange, which was smart-contract based and purported to be decentralized, solely for violations of Section 5 of the Exchange Act.[19] In the EtherDelta action, the SEC found that the EtherDelta website "had features similar to online securities trading platforms" and provided a marketplace for bringing together the orders of multiple buyers and sellers in "tokens that included securities." The SEC Order found that Coburn's conduct caused EtherDelta to operate as an unregistered national securities exchange. This conduct included the founding of EtherDelta, writing and deploying the EtherDelta smart contract to the Ethereum blockchain, and exercising complete and sole control over EtherDelta's operations.

SEC Chairman's Comments

Since the AirFox and Paragon settlements, SEC Chair Jay Clayton has made several public statements to address specific areas of concern and to strongly encourage compliance with the federal securities laws. He has emphasized that the novel technological nature of blockchain does not change the fundamental point that, when a security is being offered, federal securities laws must be followed.

Interview on CNBC—November 26, 2018

During a CNBC interview on November 26, 2018, Chairman Clayton stated: "if people are going to raise money using initial coin offerings, they either have to do so in a private placement, or they have to register with the SEC." Chairman Clayton began his interview by asking commentators to "separate securities from non-securities," and identified Bitcoin as the latter. "To the extent an ICO has been conducted offshore or pursuant to a private placement exemption," he stated that these types of offerings were exempt or excluded from the registration requirements of the federal securities laws.

Consensus Investment Conference—November 27, 2018

In remarks at the Consensus Investment Conference on November 27, 2018, Chairman Clayton stated that the settlements reached in AirFox and Paragon embodied the relevant concepts of registration and rescission, yet also stated that "people should understand that this was the remedy in this particular case but remedies in future cases may be different. Get your act together." This suggests that while AirFox and Paragon represent a path to compliance now, that path may become more difficult for issuers that are reticent or slow to proactively engage with the SEC.[20] He also reiterated that entrepreneurs who are starting a venture and funding it by issuing tokens should assume they are conducting a securities offering.

When prompted, however, Chairman Clayton did acknowledge the important concept of the potential "mutability" of a security (i.e., an instrument moving from being a security to a non-security, or vice-versa), a concept first raised in a speech by William Hinman, SEC Director of Corporation Finance, at the Yahoo Finance All Markets Summit: Crypto. Chairman Clayton analogized the concept of mutability to the producer of a new play soliciting investors and providing them tickets:

Chairman Clayton: "Let's say you're the producer of a play, a new play, and you get 15 people to invest in that play and you say [to the 15 people] 'your interest in this play is going to be a suite of tickets.' You haven't done it yet. You're giving them tickets in exchange for their interest in the play. Those tickets are securities. They [the 15 people] are taking those tickets back, waiting for the profits, it's like taking ten percent of the play."

[…] "Play gets done. It's up. You [the promoter] are long gone. Everybody has their tickets distributed and all you can exchange those tickets for is going to see the play—that's decentralized."

The hypothetical demonstrated the unique challenge of applying the Howey Test to digital assets and the importance of mutability. In Chairman Clayton's example, it is commonly understood that the suite of tickets are not inherently security instruments, they are simply tickets to a play. However, the facts and circumstances surrounding the manner of their offer, particularly the control over the enterprise by the producer and the investors' reliance on the producer, causes the suite of tickets to meet the definition of an investment contract. The fact that the investors are expecting a profit from the investment contract is not altered because the investment contract takes the form of tickets.

Interview with New York Times—November 29, 2018

In an interview with New York Times columnist Andrew Ross Sorkin on November 29, 2018, about cryptocurrency and the growing market impact of blockchain, Chairman Clayton made repeated references to the sanctity of the investor protection aspects of the federal securities laws, stating that "I'm not going to change the investor protection aspects of [the] offering rules or [the] trading rules just because there is a new technology." Chairman Clayton also referred to the producer of a play analogy again in acknowledging the potential of "mutability" and while declining to provide a bright line, referred to the idea of the play being "up and running."

Speech—December 6, 2018

In a speech in New York at the Municipal Securities Conference on December 6, 2018, Chairman Clayton again stated his position with respect to ICOs: "I believe that ICOs can be effective ways for entrepreneurs and others to raise capital. However, the novel technological nature of an ICO does not change the fundamental point that, when a security is being offered, our securities laws must be followed."

Senate Testimony—December 11, 2018

In testimony before the Senate Banking, Housing and Urban Affairs Committee on December 11, 2018, Chairman Clayton noted the significant amount of attention and resources focused on digital assets and ICOs, referenced the guidance provided by the Hinman speech, and stated his belief that the SEC has "taken a balanced regulatory approach that both fosters innovation and protects investors. For example, [SEC] staff meets regularly with entrepreneurs and market professionals interested in developing new and innovative investment products in compliance with the federal securities laws." In his testimony, Chairman Clayton also referred to the SEC's recent enforcement efforts and stated that he has asked the SEC's Division of Enforcement "to continue to police these markets vigorously and recommend enforcement actions against those who conduct ICOs or engage in other actions relating to digital assets in violation of the federal securities laws."

Where Do We Go From Here—Next Steps

To date, most of the SEC's enforcement actions in the digital asset arena have been settled matters. However, a November 28, 2018, order from the U.S. District Court for the Southern District of California in an SEC case against an alleged ICO promoter, BlockVest, LLC, and its principal, Reginald Buddy Ringgold III, for violations of Section 5 of the Securities Act could indicate the challenges the SEC faces as cases move through the courts.[21] In assessing whether a prima facie showing of a violation of federal securities laws had been established, Judge Gonzalo Curiel found that the plaintiff and defendant had presented "starkly different facts as to what the 32 test investors relied on," and accordingly, the court was unable to make a determination as to the first ("investment of money") and second ("expectation of profits") prongs of the Howey Test. As a result, given the disputed issues of fact and the absence of full discovery, Judge Curiel denied the SEC request for a preliminary injunction.[22] Importantly, however, BlockVest had not sold any coins to the public, had only one investor and its tokens had never moved past a test stage.

While the legal standard for a preliminary injunction is very different than for a civil trial, and not suggestive of the ultimate outcome of the case, certain statements within Judge Curiel's order reinforce the need to prove the facts and circumstances in each and every case. For example, Judge Curiel was unwilling to accept, without evidentiary support, that the availability of a website and whitepaper meant the 32 test investors actually reviewed those materials. In addition, Judge Curiel refused to accept the SEC's argument that an "offer" is sufficient to demonstrate a violation of Section 5 of the Securities Act, and reiterated that the threshold question was whether the offer involved a "security."

The activity of the last month and the recent AirFox and Paragon Orders appear to be part of a broader messaging effort by the SEC, which can be summarized as "if you finance a venture with a token offering, you should start with the assumption that it is a security."[23] However, despite public offers of engagement, to date, no digital asset offerings under Regulation A have been qualified, nor have any no-action letters relating to digital asset offerings been issued.

On November 28, 2018, SEC Commissioner Hester Pierce spoke at the Exchequer Club of Washington D.C. and acknowledged these questions within her personal remarks. Commissioner Pierce indicated that she thought that the SEC could do a better job at helping people think through the difficult legal issues surrounding token offerings, and that enforcement actions ought not be the means by which the SEC tells the marketplace what it is thinking. She also acknowledged the potentially unique issues that apply to token offerings, noting that while the same standards must be applied to crypto-issuers as others, the SEC should "resist the temptation to put up special roadblocks for issuers simply because crypto or blockchain is involved." Commissioner Pierce's tone is an encouraging one for industry participants who are seeking to proactively engage with the SEC on these questions, but it is important to remember that she represents only one vote among the five SEC commissioners.

These most recent SEC actions are still focused on token sellers that do not have full marketed functionality. In other words, the sellers relied on marketing the future features of their token projects, which the SEC pointed to as the efforts of others on which purchasers probably relied. While the Hinman speech referenced above gives us a glimpse of the bookends—pre-functional tokens must be sold in securities transactions at one end of the spectrum, and decentralized token projects are generally not securities at the other end of the spectrum—the middle stage where tokens are functional but not yet decentralized has not been addressed yet by the SEC or the courts. Since it generally takes some time for tokens to trade and be used for their intended purpose as non-securities and to reach decentralization, open issues concerning this middle stage and the conditions necessary to reach it have yet to be resolved, limiting the ability of practitioners to present a fully compliant road map to a new blockchain project.

Conclusion

It is unusual for an SEC Chairperson to focus so squarely on a specific area of concern in the market and to make clear the need for compliance with existing securities laws. The SEC is putting the digital asset industry on notice of its position through the Chairman's speeches, enforcement actions and joint statements by the Policy Divisions. The SEC is sending a consistent message that it believes many, if not most, of the digital asset offerings are in fact being sold as securities and that it expects full compliance with the existing securities regulatory framework. The SEC has articulated specific concerns and appears to be laser focused on this area of the market. While there are many outstanding questions and potential operational issues, it is clear that compliance with existing law is required. We strongly encourage industry participants, whether they are early in their process or believe they have regulatory exposure, to contact an experienced securities lawyer for advice navigating this complex area.

ENDNOTES

[1] See Section 5 of the Securities Act (regulating offers and sales of securities). Specifically, the SEC found that Paragon and AirFox violated Sections 5(a) and 5(c) of the Securities Act by offering and selling these securities without having a registration statement filed or in effect with the Commission or qualifying for exemption from registration with the Commission.

[2] For an analysis of the Munchee Order, see Perkins Coie' previous client alert.

[3] In addition to the Paragon and AirFox settlements this month, on November 29, 2018, the SEC announced settled charges against two celebrities, DJ Khaled and Floyd Mayweather Jr., for violating Section 17(b) of the Securities Act in connection with promoting ICOs via social media. Section 17(b) prohibits touting and publicity in connection with a securities offering without disclosing the consideration received in connection with the activity. The settlements included disgorgement and penalties, and are yet another example of the SEC's tools to combat federal securities laws violations in the digital asset space.

[4] Steven Peikin, Co-Director of the SEC's Enforcement Division, made a similar statement in the press release concerning AirFox and Paragon.

[5] According to AirFox, the prototype was "really just for the ICO and just for investment purposes so people know … how it's going to work" and "[did not] have any real users" at the time of the ICO.

[6] Section 12(a) of the Securities Act.

[7] In March 2015 the SEC adopted final rules to implement expanding Regulation A, an exemption from registration for public offerings into two tiers: Tier 1, for securities offerings of up to $20 million in a 12-month period; and Tier 2, for securities offerings of up to $50 million in a 12-month period.

[8] A platform that trades securities and operates as an exchange must register as a national securities exchange or operate under an exemption from registration, such as the exemption provided for an ATS under Regulation ATS. An entity seeking to operate as an ATS must register with the SEC as a broker-dealer and become a member of a self-regulatory organization (for example, the Financial Industry Regulatory Authority).

[9] We note that there are digital asset ATSs in the works but it is likely to be some time before a robust market for digital asset securities develops.

[10] Rule 12g-4 under the Exchange Act.

[11] Without speculating on the reason for such activity, we note that following the AirFox and Paragon announcement, both platform tokens saw an increase in trading volume on digital asset exchanges.

[12] In a 1946 U.S. Supreme Court decision, *SEC v. W.J. Howey Co.,* 328 U.S. 293 the Court held that a transaction is an investment contract, or security, if "a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."

[13] Since the Orders, an AirFox Draft Claim Form has been released. Token issuers should not attempt to use this form without consulting counsel. Any offer to purchase securities (which includes a rescission offer) would also need to be registered or exempt from registration under the Securities Act, so an issuer generally should not attempt to offer rescission as a remedy to the general public unless it is part of an approved settlement with the SEC. *See*, J. William Hicks, 7B Exempted Transactions Under the Securities Act of 1933 § 16.III.C (2018). Otherwise, the issuer risks doubling down on the original Section 5 violation of offering to sell unregistered securities without an exemption by offering to repurchase them.

[14] Claims under Section 12(a)(1) are subject to the one-year statute of limitations set forth in Section 13. Although not relevant for AirFox and Paragon, a claim also must be brought not more than three years from the first bona fide offer to the public. *LaCroy v. Dean Witter Reynolds, Inc*, 585 F. Supp 753 (E.D. Ark. 1984).

There is limited case law with respect to rescission offers, and while the SEC does not eliminate liability if a rescission offer is rejected, two circuit courts have held that purchasers who rejected rescission offers consequently waived their rights to a further action under federal securities laws. *Topalian v. Ehrman*, 954 F.2d 1125 (5th Cir. 1992); *Meyers v. C & M Petroleum Producers Inc.*, 476 F.2d 427 (5th Cir. l973).

[15] For a discussion of some questions that are relevant to registered investment companies that invest in certain digital assets, see SEC Staff Letter to ICI and SIFMA AMG: Engaging on Fund Innovation and Crypto-related Holdings.

[16] Generally, a broker-dealer is any person engaged in the business of effecting transactions in securities for their own account or the account of others. This analysis is one of facts and circumstances and the term "effect" has been construed broadly to encompass not only persons who are engaged directly in the offer or sale of securities, but also those who perform other than purely ministerial or clerical functions with respect to securities transactions. Broker-dealers must register with the SEC if they are physically present in the United States, or if, regardless of their location, they effect, induce or attempt to induce securities transactions with investors in the United States.

[17] The U.S. Marshalls Service has conducted several auctions of bitcoin seized by the FBI, DEA and IRS, the most recent in November 2018. The notice of sale can be found here.

[18] Section 3(a)(1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange … ." 15 U.S.C. § 78c(a)(1). Exchanges that seek to engage in certain traditional broker-dealer functions, such as outbound routing of orders from the exchange to other markets, have been required to register as broker-dealers to perform such activities. Such broker-dealers are generally considered to be acting as a facility to the exchange and, as a result, are often subject to both broker-dealer and exchange regulation.

[19] Section 5 of the Exchange Act makes it unlawful for any broker, dealer or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration.

[20] Within his comments, Chairman Clayton mentioned that it was important for any issuer when engaging with the SEC to tell the same story it tells to the SEC as to its investors, suggesting that the SEC is unlikely to appreciate any issuer who obfuscates and requires the SEC to allocate additional investigative resources.

[21] *SEC v. BlockVest*, 2018 U.S. Dist. LEXIS 200773 (S.D. Cal., 8CV2287-GPB(BLM), November 27, 2018) [SDP].

[22] In denying the SEC's request for a preliminary injunction, Judge Curiel also noted that the SEC had failed to demonstrate the reasonable likelihood that the wrong would be repeated. In this regard, Judge Curiel gave great deference to defendant's statement that they were no longer interested in pursuing an ICO. By agreeing to stop any pursuit of the ICO, Judge Curiel found that the SEC had failed to demonstrate a reasonable likelihood that the wrong will be repeated. Procedurally, this preliminary injunction analysis followed a temporary restraining order issued in early October 2018, halting the "offering."

[23] SEC Chairman Jay Clayton, Remarks at Consensus Investment Conference (November 27, 2018).

CONTACTS

Michael S. Didiuk
Keith Miller
Valerie Dahiya
Conor O'Hanlon
Anna C. Mourlam

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