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The US SEC asserts its regulatory enforcement power in the ICO space

In 2017, the US Securities and Exchange Commission ('SEC') formally asserted its regulatory enforcement power over the purchase and sale of cryptographic tokens, with action taken in this area including a report involving the initial coin offering ('ICO') of DAO tokens by 'The DAO,' and at the end of the year enforcement action against a number of organisations involved in ICOs. Jennifer Achilles, Kari Larsen and Michael Selig of Reed Smith discuss in detail how the SEC's approach to ICOs has evolved during 2017, and the lessons therein for cryptographic token issuers.

The SEC's first move came this past summer when it issued a report involving the ICO of DAO tokens by 'The DAO[1].' At the time of going to print, the SEC had since announced three enforcement actions involving ICOs. The SEC brought its first ICO enforcement action in September 2017 against Maksim Zaslavskiy for offering cryptographic tokens purportedly backed by non-existent diamonds and real estate[2]. Then, in December 2017, the SEC filed an enforcement action against PlexCorps[3], and instituted an administrative action against Munchee[4], both for offering tokens that allegedly qualify as unregistered securities. Shortly thereafter, SEC Chairman Jay Clayton issued a public warning to investors and market professionals about ICOs and the risks of investing in cryptocurrencies[5].

The SEC's framework for evaluating its regulatory power over these offerings is becoming clearer over time. Its statements and actions over the past six months provide insight into how the SEC will likely evaluate ICOs and their founders in 2018.

The DAO Report

As the number of ICOs skyrocketed in 2017 and significant amounts of capital poured into these new projects, the SEC turned its attention to cryptographic tokens. On 25 July 2017, it issued an Investigative Report (the 'Report') detailing its investigation of an ICO of tokens representing interests in 'The DAO,' a decentralised autonomous organisation.

The DAO was a for-profit entity created by Slock.it and Slock.it's co-founders. Through an ICO, The DAO offered 'DAO Tokens' to investors in exchange for Ether, a digital currency connected to the Ethereum blockchain. DAO Tokens granted the holders voting rights and entitlement to 'rewards' in exchange for their investments. The investors remained 'pseudonymous' meaning that the investors' Ethereum blockchain addresses functioned as their only identifying information. Following the ICO, persons could buy or sell DAO Tokens on the secondary market through digital asset exchanges. The DAO's primary form of business was investing in projects submitted by 'Contractors' who received a majority vote from DAO Token holders. Generally, only project proposals given the green light by The DAO's 'Curators' were voted on.

The SEC determined that the DAO Tokens offered by The DAO were unregistered and non-exempt securities. The SEC applied the *Howey* test (first articulated in a 1946 Supreme Court decision) to determine that the tokens were 'securities' under the federal securities laws. In *Howey*, the Supreme Court considered whether the offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor constituted an 'investment contract,' a form of security, sufficient to invoke the SEC's enforcement power[6]. The Court defined

The core of the SEC's legal analysis comes down to the 'solely through the efforts of others' prong of the *Howey* analysis.

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an 'investment contract' as a contract, transaction or scheme whereby a person:

- invests money;
- in a common enterprise, and
- is led to expect profits
- solely from the efforts of others (i.e., a promoter or third party).

In the Report, the SEC used *Howey* to reason that if a digital asset functions as an investment contract, it can be regulated as a security. The SEC relied on the prophylactic catch-all 'investment contract' definition to allow it to cast a broad net that captures as many "[n]ovel, uncommon, or irregular devices" as possible. The Report explains that "[w]hether or not a particular transaction involves the offer and sale of a security - regardless of the terminology used - will depend on the facts and circumstances, including the economic realities of the transaction." The core of the SEC's legal analysis comes down to the 'solely through the efforts of others' prong of the *Howey* analysis. Merely decentralising voting rights and the day-to-day choices of the issuer is insufficient to avoid a token being considered a security where others continue to perform critical managerial and entrepreneurial functions.

The DAO was essentially established to be capable of functioning independently from traditional forms of control, such as a Board of Directors. However, the SEC concluded that the efforts of the co-founders and Curators were critical to the operations of The DAO. The Curators played a 'critical' role in selecting the projects that investors were eligible to vote on and the co-founders stepped in to resolve network issues, such as responding to a cyber attack. Nevertheless, the SEC concluded that the voting rights provided to DAO Token holders were "limited" because they did not provide the holders with meaningful control due to the "perfunctory" nature of the voting on projects and the inability of the holders to communicate with one another due to wide geographic dispersion. Accordingly, the SEC determined that DAO Tokens were securities.

Exchanges that allow market participants to purchase and sell digital assets which qualify as securities are generally required to either register with the SEC as a national securities exchange or rely on an exemption from registration. As currently unregulated exchanges and new entrants begin to offer a wider variety of digital assets, they should consider whether SEC registration or exemptive relief under Regulation ATS will be necessary. Likewise, funds that seek to attract investors and manage digital or fiat currency trading and investing should consider the applicable state and federal regulatory issues applicable to their activities.

SEC v. Zaslavskiy

On 29 September 2017, the SEC brought its first enforcement action involving an ICO. The SEC alleges that Maksim Zaslavskiy and his companies, REcoin Group Foundation ('REcoin') and DRC World (also known as Diamond Reserve Club) ('DRC,' and together with ReCoin, collectively, the 'Companies'), sold unregulated securities in the form of cryptocurrencies, purportedly backed by assets that did not exist. According to the SEC's complaint, investors in the Companies were told they could expect sizeable returns from the Companies' operations, when the Companies had no real operations. As we have previously noted, an ICO that is premised on an increase in value of the token as a consequence of the profits of the issuers' business operations, more closely resembles the issuance of a security than an ICO in which the token is redeemable for goods or services.

REcoin was publicised as 'The First Ever Cryptocurrency Backed by Real Estate.' Investors were told by Zaslavskiy that REcoin had a "team of lawyers, professionals, brokers, and accountants" who would make real estate investments with the ICO proceeds. However, the SEC claims no personnel was hired or consulted to invest the raised funds. Additionally, the SEC alleged that Zaslavskiy and REcoin misrepresented that they had raised between $2 million and $4 million from investors, when only $300,000 had been raised.

Similarly, DRC was advertised as a cryptocurrency backed by investments in diamonds, with claims that individuals could purchase "memberships" in the company to obtain discounts with product retailers. The SEC alleges that Zaslavskiy and DRC had not purchased any diamonds and had not engaged in any business operations.

Through an emergency court order by a federal district court in Brooklyn, New York, the SEC froze the assets of Zaslavskiy and of the Companies on the basis that the defendants were likely violating the anti-fraud and registration provisions of the federal securities laws. The SEC is pursuing permanent injunctions, disgorgement, interest, and penalties against the Companies and Zaslavskiy. Additionally, the SEC is seeking to bar Zaslavskiy from participating in any offerings of digital securities in the future.

SEC v. PlexCorps

On 1 December 2017, the SEC's newly-created Cyber Unit filed a civil enforcement action in federal court against PlexCorps in connection with its ICO of the cryptocurrency 'PlexCoin,' also known as 'PLX.' On 4 December the Court granted the SEC's request for an emergency freeze on PlexCorps' assets. A press release by the SEC suggested that this would be the first in a series of cases to be brought by the SEC's Cyber Unit involving fraud in connection with distributed ledger technology and ICOs[7].

The PlexCoin White Paper written by PlexCorps characterises PlexCoin as "the new Bitcoin," and boasts that it is comparable to Bitcoin but with faster confirmation speeds[8]. Other cryptocurrencies, such as Litecoin and Dogecoin, offer this same advantage. Unlike Litecoin and Dogecoin, however, PlexCoin promised an extravagant investment return of 1,354% for pre-sale purchasers in "29 days or less." This statement, among other alleged

fraudulent misrepresentations, enticed thousands to purchase over $15 million in PlexCoins.

The PlexCorps enforcement action raises further questions on the contours of the SEC's enforcement power over cryptographic tokens in the wake of the SEC's recent and seemingly contradictory statements in other contexts as discussed in more detail below. Market participants interested in issuing or investing in cryptographic tokens should carefully consider the factors that might lead the SEC to characterise the currency or utility token as a security.

The PlexCoin White Paper

A cryptographic token issuer's white paper is where interested purchasers oftentimes begin their diligence of a digital asset. Satoshi Nakamoto introduced Bitcoin through a White Paper in 2008 and other cryptographic token issuers have followed this format as something of a tradition[9]. The document provides an overview of the use case or purpose for the token, the team behind it, and technical details. White papers typically do not follow the format of offering memoranda but may (and should) include legal notices, disclosures, and disclaimers.

The PlexCoin White Paper identifies PlexCorps as "a team of 53 people, men and women from all over the world who have a common goal: improving global financial services by simplifying the use of cryptocurrency in a manner that everybody can easily integrate it in their life." It advertises an "entourage" of experienced "specialists" from the financial, legal, and technology sectors. PlexCorps offers its PlexCoin as a viable replacement to Bitcoin, which was created in 2009, and, according to PlexCorps, "is already getting old." PlexCorps posits that "PlexCoin could become the main exchange cryptocurrency and the most used one in the world."

The White Paper characterises the ICO as "an unregulated means of crowdfunding" and contains a comprehensive overview of the "return on investment" for persons who purchase PlexCoin through ICO pre-sale. It notes that investors can "expect" a return on investment of various percentages depending on the "sale level" that they purchase the PlexCoins. For example, sale level 1 is the first 50 million PlexCoins, level 2 is the next 50 million, and so on. It stated that purchasers can expect the following returns:

Sale level 1: ROI after 29 days or less: 1,354%.
Sale level 2: ROI after 29 days or less: 629%.
Sale level 3: ROI after 29 days or less: 332%.
Sale level 4: ROI after 29 days or less: 200%.

The White Paper states that PlexCoin would be listed on cryptographic token exchanges following the ICO. The White Paper also contains details on the use of proceeds from the ICO, specifying that 70% of funds raised would be allocated to "market maintenance." In other words, PlexCorps plans to hold the funds and use them to buy back PlexCoin to "guarantee a steady increase of PlexCoin's value."

Significantly, the White Paper did not disclose that Dominic Lacroix, a recidivist securities law violator from Canada, ran the operation. The White Paper explains that the identity of PlexCorps' executives needed to be kept confidential because "[a]ny organization could then contact us, visit us and scrutinize our operations (and yours)! This is not what we want."

PlexCorps also did not disclose to US purchasers that a Quebec Tribunal determined that PlexCoin was a 'security' under the laws of Quebec and ordered PlexCorps to cease its PlexCoin related activities in July 2017.

'Cryptocurrencies' can be securities

While a cursory read through of the PlexCoin White Paper raises significant red flags, the SEC's choice to pursue this action rather than defer to the Department of Justice or a consumer protection agency is noteworthy. The SEC has previously taken the position that cryptocurrencies, such as Bitcoin and Ether, are forms of 'money,' but has never gone so far as to argue that these products are securities.

1. A decentralised autonomous organisation. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC Release No. 81207 (July 25, 2017).
2. SEC v. ReCoin Group Foundation, LLC, Complaint (Sep. 29, 2017), available at https://www.sec.gov/litigation/complaints/2017/comp-pr2017-185.pdf
3. SEC v. PlexCorps, Complaint (Dec. 1, 2017), available at https://www.sec.gov/litigation/complaints/2017/comp-pr2017-219.pdf
4. In the Matter of Munchee Inc., SEC Release No. 10445 (Dec. 11, 2017).
5. Chairman Clayton's Statement is available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11
6. SEC v. W.J. Howey Co., 328 U.S. 293 (Oct. 14, 1946).
7. The SEC's statement is available at https://www.sec.gov/news/press-release/2017-219
8. The PlexCoin White Paper is available at https://cdn01.plexcoin.com/Plexcoin_en.pdf
9. The Bitcoin White Paper is available at https://bitcoin.org/bitcoin.pdf
10. PlexCorps Complaint at ¶ 9.
11. See SEC v. SG Ltd., 265 F.3d 42 (1st Cir. 2001).
12. The SEC's Press Release is available at https://www.sec.gov/news/press-release/2017-227
13. See Howey, 328 U.S. 293.

The Munchee enforcement action is significant because it demonstrates that the SEC will intervene in ICOs where it believes the securities laws have been violated, even if there are no claims of fraud and the token has some use at issuance.

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Yet the SEC alleged in the PlexCorps complaint that, "PlexCoin Tokens are securities within the meaning of the U.S. federal securities laws[10]."

The key distinction that the SEC appears to draw between PlexCoin and Bitcoin is PlexCorps' marketing of the product as a cryptographic token that will appreciate in value based primarily on the efforts of the PlexCorps' "entourage." In contrast to other cryptocurrency white papers, the PlexCoin White Paper touted the experience of the PlexCorps core team and explained that 70% of the funds raised in the ICO would be used by PlexCorps to bolster the token's price. Accordingly, token issuers must be cognisant that the degree of control the issuer or foundation exercises over the value of the token is critical to the SEC's ability to categorise the token as a 'security.'

Related to the 'efforts of others' prong of the *Howey* analysis is the question of whether a 'common enterprise' exists. Some courts require a showing of 'horizontal commonality,' whereas others look for 'vertical commonality,' and some require both before an instrument can be considered a 'security[11].' Horizontal commonality involves the pooling of assets from multiple investors who all share in the profits and risks of the enterprise. Vertical commonality exists where the promoter's efforts affect the individual investors collectively (even if there is no pooling of funds or *pro rata* profits). It is generally the case that horizontal commonality will exist in the context of most ICOs because the value of the token is typically linked to its use case on a blockchain network, which requires others to support and use the network. However, many tokens have value independent of the efforts of any promoter and can exist independently of any company or foundation.

PlexCorps characterises PlexCoin as an investment that will increase in value based on the efforts of PlexCorps and its use of proceeds from the ICO, arguably demonstrating both horizontal and vertical commonality.

SEC v. Munchee

On 11 December 2017, the SEC halted the ICO of a California-based company, Munchee Inc. ('Munchee'). Munchee had been seeking to raise capital for its blockchain-based food review service by selling digital Munchee tokens, also known as 'MUN,' to investors. Munchee consented to the SEC's cease-and-desist order without admitting or denying the findings, and agreed to halt its offering and refunded the $15 million in funds it had collected from potential investors. As with the PlexCorps action, the SEC's administrative action against Munchee resulted from an investigation by the SEC's Cyber Unit.

The SEC determined that the MUN tokens were securities pursuant to Section 2(a)(1) of the Securities Act, despite their utility at the time of sale, because they were 'investment contracts' under the *Howey* test. According to the SEC, in the course of the offering, the company and other promoters emphasised that investors could expect that efforts by the company and others would lead to an increase in value of the tokens.

The company also emphasised that it would take steps to create and support a secondary market for the tokens. Accordingly, the SEC concluded that "[e]ven if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security. Determining whether a transaction involves a security does not turn on labelling[sic] - such as characterising an ICO as involving a 'utility token' - but instead requires an assessment of 'the economic realities underlying a transaction.'"

The Munchee enforcement action is significant because it demonstrates that the SEC will intervene in ICOs where it believes the securities laws have been violated, even if there are no claims of fraud and the token has some use at issuance. In the press release announcing the Munchee settlement, Stephanie Avakian, co-director of the SEC Enforcement Division, said, "We will continue to scrutinize the market vigilantly for improper offerings that seek to sell securities to the general public without the required registration or exemption. In deciding not to impose a penalty, the Commission recognized that the company stopped the ICO quickly, immediately returned the proceeds before issuing tokens, and cooperated with the investigation[12]."

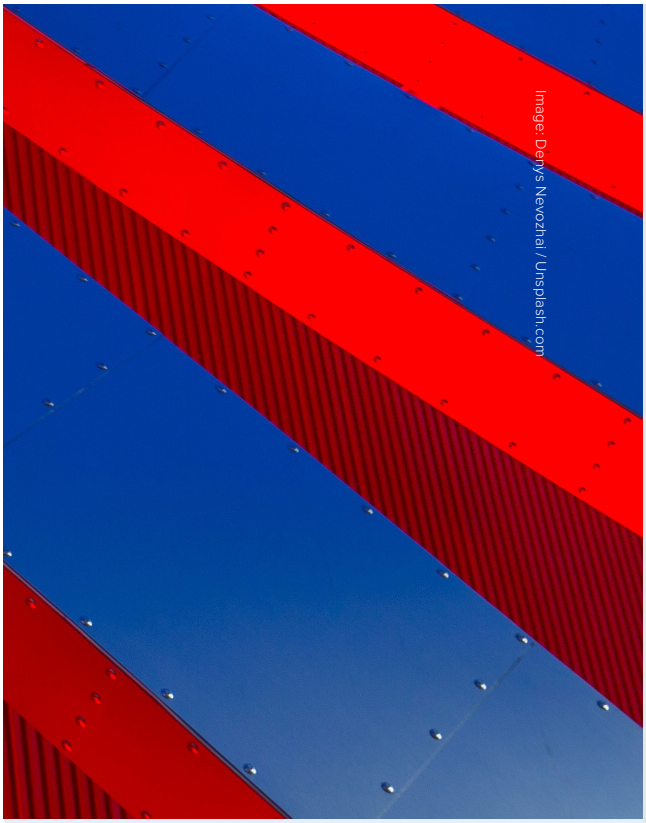
Image: Denys Nevozhai / Unsplash.com

Chairman Clayton's statement

SEC Chairman Jay Clayton released a statement on cryptocurrencies and ICOs on 11 December 2017. While Chairman Clayton's statement catalogues the risks attendant to ICOs, it also notes that ICOs "can be effective ways for entrepreneurs and others to raise funding." The statement makes clear that the SEC distinguishes between cryptocurrencies and security tokens, but that tokens labeled as 'cryptocurrencies' may nevertheless qualify as securities depending "on the characteristics and use" of the product. Echoing the statements in the Munchee settlement order, the Chairman noted that even functional utility tokens are not safe harbored from qualifying as securities. The SEC will consider the facts and circumstances regarding each token issuance to determine whether such products qualify as 'investment contracts,' and therefore securities, under the *Howey* test[13]. Clayton cautioned that no ICOs are registered with the SEC to date.

Conclusion

In 2018, the SEC will likely continue to take a broad and expansive view of its own regulatory powers to allow it to review ICOs for compliance with the securities laws and bring enforcement actions against perceived violators.

Aspiring cryptographic token issuers must exercise caution in drafting their white papers and related materials to include appropriate risk disclosures and notices in all token sale materials, and to avoid making material mis-statements and omissions.

CFPB delays the effective date of the final rules on prepaid accounts

The US Consumer Financial Protection Bureau ('CFPB') issued its final rules on prepaid accounts ('the Prepaid Rule') on 25 January 2018 amending Regulation E, which implements the Electronic Fund Transfer Act, and Regulation Z, which implements the Truth in Lending Act, which includes extending the effective date of the final rules by one year to 1 April 2019. The CFPB stated that it is sensitive to the concerns raised by industry commentators about needing more time to implement the rule, especially where they are making changes to packaging for prepaid cards sold in stores.

"The one year delay is welcome," said Linda C. Odom, Partner at K&L Gates. "The industry needs a significant amount of time between the Prepaid Rule becoming final and its effective date. It easily takes a year to develop and launch a prepaid card program, and almost that long to significantly modify an existing program, so having this additional time is crucial. With more time, the industry will be able to launch a whole new range of innovative prepaid card programs."

Through the issuance of the final rules the CFPB has finalised modifications to several aspects of the prepaid rule published in the Federal Register on 22 November 2016 and amended on 25 April 2017, including with respect to error resolution and limitations on liability for prepaid accounts where the financial institution has not successfully completed its consumer identification and verification process; and regarding the application of the rule's credit-related provisions to digital wallets that are capable of storing funds.

"The CFPB received comments from a cross-section of industry participants, many of which pushed for a further extension of the effective date so they would have time to review any changes to the Prepaid Rule and coordinate with internal and external parties to implement compliance plans and changes. We also understand that the CFPB recognised that the changes made in the error resolution requirements would require specific disclosures," explains Odom.

The CFPB's 2016 prepaid rule put in place requirements for treatment of funds on lost or stolen cards, error resolution and investigation, upfront fee disclosures, access to account information, and overdraft features if offered in conjunction with prepaid accounts, with the latest changes aimed amongst other things at providing greater flexibility for credit cards linked to digital wallets.

"In finalizing the Prepaid Rule, the CFPB made a number of amendments to address industry comments, including those concerning the Rule's application to certain business models and industry practices, which have largely been viewed favorably so far. The real measure of the industry's response to the new rules, however, will be demonstrated by the launch of new products taking advantage of the rules (e.g., hybrid cards), or the lack thereof," concludes Odom.