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SEC imposes penalties and provides path to compliance for unregistered ICOs and digital asset exchanges

By Daniel McAvoy and Brian Becker

For the first time, the Securities and Exchange Commission (SEC) has imposed civil penalties, disgorgement of profits, mandatory registration and other sanctions on digital asset market participants that unlawfully promoted sold, or exchanged securities after the issuance of the DAO Report. Three recent SEC enforcement actions have indicated that the SEC is not only concerned with unregistered offerings of securities in initial coin offerings (ICOs), but also intends to bring enforcement actions against issuers, promoters and exchanges that are unlawfully dealing in securities under federal securities laws absent fraudulent activity. Moreover, the SEC has provided a possible path to non-enforcement for ICOs that were unregistered sales of securities. But the SEC's approach to regulating ICOs was brought into question by a recent federal court case in which the SEC's motion for a preliminary injunction to enjoin Blockvest, LLC (Blockvest) from conducting its ICO was denied.

Enforcement Actions Against ICO Issuers

On November 16, 2018, the SEC released two cease-and-desist orders against the ICO issuers commonly known as AirFox and Paragon, each of whom issued utility tokens in what the SEC had contended were unregistered offerings of securities under the Securities Act of 1933, as amended (the Securities Act). AirFox and Paragon's unlawful conduct occurred after the SEC released its investigatory report on The DAO in July 2017 (the DAO Report), specifying how the SEC would apply the "Howey" test to determine whether a digital asset is a security. The SEC ordered AirFox and Paragon to, among other things: (i) register their ICO tokens under the Exchange Act by filing a Form 10 and all ongoing Exchange Act periodic reports, (ii) pay a civil penalty of $250,000 to the SEC and (iii) grant tokenholders a right of rescission and give notice of that rescission right and their right to sue AirFox or Paragon for rescission damages—the negative delta between purchase price and sale price, plus statutory interest on that amount.

The AirFox and Paragon orders were not the first SEC enforcement actions against ICO issuers. In December 2017, absent any sign of fraud, the SEC released a cease-and-desist order to Munchee Inc. (Munchee) to stop its ICO which the SEC found to be an unregistered offer and sale of securities. However, in not imposing a fine or requiring undertakings from Munchee, the SEC acknowledged

that Munchee had stopped its ICO after being contacted by the SEC and returned to investors the proceeds received from the offering.

With the AirFox and Paragon orders, the SEC for the first time provided a possible roadmap for ICO issuers to cure a prior defective unregistered issuance. This would require registering the tokens under the Exchange Act, filing delinquent periodic reports, offering rescission damages to investors and notifying investors of their right to bring such a rescission action.

Enforcement Action Against Promoters

The SEC released two orders on November 29, 2018, against two prominent stars—the former biggest draw in the sport of boxing, Floyd Mayweather Jr. and music superstar DJ Khaled, for the unlawful promotion of securities through ICOs without disclosing the compensation received for such promotion. In September 2017, after the release of the DAO Report, Mayweather and Khaled used social network accounts to promote the ICOs of two issuers the SEC had found offering securities without registration or an exemption from registration. Neither star disclosed that he would receive compensation in connection with their promotions. Under Section 17(b) of the Securities Act, it is unlawful for a person to promote the sale of securities and receive compensation without fully disclosing the expectation and amount of compensation. Accordingly, the SEC concluded that Mayweather and Khaled violated Section 17(b) of the Securities Act for promoting two separate ICOs, ordering each of them to pay mid-six figures in disgorgement and penalties. While the SEC did not seek penalties for acting as unregistered broker-dealers because there were much more obvious violations, there is a distinct possibility that such a promoter could be deemed an unregistered broker-dealer.

Enforcement Action Against Digital Asset Exchange

On November 8, 2018, the SEC issued a cease-and-desist order pertaining to the operation of the online platform EtherDelta, which permitted placing buy and sell orders for digital assets on the secondary market. The SEC found that EtherDelta's founder, Zachary Coburn, had violated Section 21C(a) of the Securities Exchange Act by knowingly causing EtherDelta to operate an unregistered securities exchange in violation of Section 5 of the Securities Exchange Act. The SEC ordered, among other things, (i) disgorgement of $300,000, plus prejudgment interest of $13,000, (ii) payment of a civil penalty of $75,000 to the SEC and (iii) to cease and desist the operations of EtherDelta.

Federal Court Case Involving Blockvest, LLC

On November 27, 2018, the United States District Court for the Southern District of California denied the SEC's motion for a preliminary injunction enjoining the ICO of Blockvest, LLC (Blockvest). The Southern District held that there was a disputed issue of material fact regarding the information that the purchasers of Blockvest's tokens relied upon prior to making an investment in Blockvest's ICO, and therefore, the Southern District could not conclude whether the digital assets Blockvest offered were securities under federal securities laws. The Blockvest case involved an unusual set of facts, in which Blockvest alleges that the "investors" in its ICO were closely related parties to its founder who provided money to Blockvest with the understanding that Blockvest's digital platform would only be tested for adequate functionality, and no tokens were actually released to the testing participants. The Blockvest case is significant in that it is the first in which a court declined to accept the SEC's assertion that any ICO with a sale of tokens for capital-raising purposes constitutes offer or sale of securities.

Future Landscape for ICOs

As it has done before, the SEC made clear with these enforcement actions that many digital assets sold in ICOs and traded on purported exchanges fall within the purview of federal securities laws. On one hand, this means increased time and costs accompany regulatory compliance for market participants. On the other hand, this also means that there are clearer paths to regulatory compliance that ICO issuers and exchanges may follow. For example, ICO issuers of assets the SEC deems to be security tokens may avail themselves of Regulation D, Regulation S or Regulation CF (private placement rules), although these require compliance with the strictures of those regimes. In addition, secondary markets then may qualify as an alternative trading system (ATS), which would allow them to operate with certain restrictions while imposing a less restrictive regulatory regime than a securities exchange registered under the Exchange Act.

As the digital asset industry continues to evolve, many additional questions will need to be answered by the SEC and the federal courts to decide whether and when digital assets should be classified as securities.

For more information on the content of this alert, please contact your regular Nixon Peabody attorney or:

— Daniel McAvoy at **dmcavoy@nixonpeabody.com** or 212-940-3112
— Brian G. Becker at **bbecker@nixonpeabody.com** or 585-263-1028