

# Regulators Continue to Scrutinize Initial Coin Offerings

December 29, 2017

As reported in the most recent issue of Expect Focus, the SEC issued an investigative report in July cautioning market participants that distributed ledger (blockchain) technology-based offers and sales of digital "tokens" or "coins" in a so-called initial coin offering (ICO) may be subject to federal securities laws, depending on the circumstances. Subsequently, the SEC and other regulators have continued to scrutinize ICO-related activities. In August, the SEC staff issued several trading suspensions on certain issuers of microcap stock who made claims regarding their investments in ICOs or touted coin/token related news. In a related SEC investor alert, the staff warned investors to "be especially cautious" of warning signs of possible ICO-related fraud. According to the staff, such signs include situations where a company claims that its ICO is "SEC-compliant" without explaining how or purports to raise capital through an ICO described in vague or nonsensical terms or with undefined technical or legal jargon. In September, the SEC brought its first enforcement action involving an ICO against a purported businessman and two companies. The complaint alleges that the companies' marketing materials contained several misstatements asserting that the ICO would invest the proceeds into real estate and diamonds when, in fact, no real estate or diamonds had been purchased. The SEC alleged that the defendants attempted to "skirt the registration requirements of the federal securities laws." In November, a New York federal judge entered a preliminary injunction freezing the businessman's assets. September also saw the SEC announce new enforcement initiatives aimed at cyber-related misconduct. The initiatives include a newly-created "Cyber Unit" which will specifically target securities violations "involving distributed ledger technology and initial coin offerings," among other types of cyber-related misconduct. In December, the Cyber Unit made headlines by charging two individuals and a Canadian company with securities fraud and the unlawful offer and sale of unregistered securities called "PlexCoin" in connection with a purported ICO. The unit also obtained an emergency asset freeze to stop the alleged ICO fraud, which had raised up to \$15 million from thousands of investors by falsely promising a 13-fold profit in less than a month. According to the chief of the Cyber Unit, this first Cyber Unit case contained "all of the characteristics of a full-fledged cyber scam and is exactly the kind of misconduct the unit will be pursuing." In October, the Commodity Futures Trading Commission published a "A CFTC Primer on Virtual Currencies" as part of its LabCFTC initiative. Launched in May, LabCFTC is designed to promote responsible FinTech innovation by making the CFTC more accessible to innovators, and to

serve as a platform to inform the CFTC's understanding of new technologies. The primer describes the CFTC's jurisdiction as being "implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce." While acknowledging the SEC's investigative report findings that digital tokens sold in ICOs may be securities, the primer states "[t]here is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances." In November, the SEC staff issued a public statement warning celebrities and others that ICO endorsements may be unlawful if the digital tokens or coins sold are securities and they do not disclose the nature, source, and amount of compensation paid in exchange for the endorsement. The staff's statement also cautioned investors to conduct research before investing in ICOs, noting that investors should understand whether a promoter's endorsement "is truly independent or a paid promotion." In December, the SEC issued a cease-and-desist order against a company conducting an ICO to raise capital to improve and create an "ecosystem" around an existing phone app. The company represented to investors that the sale of its "utility tokens" did not pose a significant risk of implicating federal securities laws. The SEC disagreed and contacted the company, which promptly terminated the ICO and returned all of the investors' funds. In light of these remedial efforts, the SEC did not seek to impose any civil penalties. Finally, in a recent speech, SEC Chairman Jay Clayton highlighted concerns over the lack of information about many online platforms that list and trade virtual coins or tokens offered and sold in ICOs. The Chairman followed these remarks with a public statement in December discussing the SEC's commitment to "vigorously" police ICOs and encouraging investors to consider the risks involved with these investments. The Chairman's statement further expressed his own view that the majority of ICO offerings directly implicate federal securities laws.

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