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SEC Files First ICO Enforcement Action

By David W. Adams
and Edmund J. Zaharewicz

Virtual currencies bitcoin, etherium and others have gained significant notoriety, intriguing entrepreneurs and established businesses alike and prompting a wave of innovation particularly in the financial services industries, aka FinTech. Now, government regulators and enforcement agencies are not only taking notice, but taking steps to assert their jurisdiction and curb abuses.

Blockchain, the technology underlying bitcoin and most virtual currencies, has been lauded and criticized for its ability to offer relatively fast, inexpensive and nearly anonymous transactions. While blockchain technology has ushered in a new era of FinTech innovation, its rapid rise in popularity for raising investment funds has also drawn attention from several U.S. governmental agencies. Case in point: The U.S. Securities and Exchange Commission, which is charged with overseeing the U.S. securities markets.

Back on July 25, the SEC took particular notice of the white hot market for initial coin offerings, or ICOs, in which companies sell digital tokens or coins to raise money for various "projects." In particular, the SEC issued a "report of investigation" that found that digital tokens offered and sold by a "virtual" organization known as "The DAO" were securities and therefore subject to the federal securities laws."

The report cautions market participants that offers and sales of digital tokens or coins may be subject to the requirements of the federal securities laws. According to a senior SEC enforcement official, "The innovative technology behind these virtual transactions does not exempt securities offerings and trading platforms from the regulatory framework designed to protect investors and the integrity of the markets."

In a similar vein, SEC Chairman Jay Clayton stated, "We seek to foster innovative and beneficial ways to raise capital, while ensuring — first and foremost — that investors and our markets are protected." In short, market participants must be mindful of

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SEC Chairman Jay Clayton addresses The Economic Club of New York, in Manhattan in July. As to virtual currencies, Clayton has said, "We seek to foster innovative and beneficial ways to raise capita, while ensuring — first and foremost — that investors and our markets are protected."

and, to the extent applicable, comply with federal securities laws, notwithstanding their use of innovative technology.

Further indicating the SEC's concern with ICOs that involve securities offerings, its director of the Division of Corporation Finance stated, "Investors need the essential facts behind any investment opportunity so they can make fully informed decisions, and today's report confirms that sponsors of offerings conducted through the use of distributed ledger or blockchain technology must comply with the securities laws."

Interestingly, the SEC decided not to bring charges in connection with the ICO discussed in its July report, but rather opted to issue a warning to market participants. Nevertheless, the message was clear: The SEC won't let this market grow unchecked and operate outside traditional SEC supervision of securities markets. In an attempt to be as clear as possible, the SEC stated, "the federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology."

It is important to note that the SEC has not said that all ICOs involve an offer and sale of "securities." Rather, it will depend on the specific facts and circumstances and the economic realities of each transaction, generally through the application of the test described *SEC v. W.J. Howey*, a seminal case.

Fast forward to Sept. 29, when the SEC issued its first civil complaint against two companies and their founder for violating anti-fraud and registration provisions of the federal securities laws.

The SEC, via its New York Regional Office, claimed that the founder of the subject companies conducting two ICOs was selling unregistered securities and that the digital tokens or coins offered for sale didn't even really exist. According to the SEC's complaint, investors in REcoin Group Foundation and DRC World (aka "The Diamond Reserve Club") were led to believe they could expect sizeable returns from the companies' activities when the companies lacked any material operations.

The complaint alleges that the offering was designed to mislead investors. The SEC claims that the companies informed potential investors that each had teams of specialists working on the various projects and that the ICOs were backed by various investments in real estate and diamonds when no diamonds had been purchased and no real estate was owned or under contract.

Most commentators believe this will be the first of many regulatory actions intended to reign in abusive or non-compliant practices within the securities markets involving ICOs.

Indeed, securities practitioners have been closely watching the SEC after its July press release to see how quickly it would proceed with the first enforcement action against an ICO. The Sept. 29 enforcement action indicates that it will move quickly to stop misconduct involving ICOs.

The development of virtual currencies and the increasing popularity of ICOs are relatively new phenomena, and U.S. regulators have only recently begun to consider their regulatory implications. Because of the facts and circumstances analysis required to evaluate each potential ICO to determine whether it involves "securities" subject to the U.S. federal securities laws, together with the lack of specific SEC guidance, it will be difficult for companies to offer tokens that blur the line between virtual currency and security. The analysis may involve looking to other areas where the SEC has provided guidance through interpretive releases and no action positions with respect to investment contracts, such as real estate offerings and membership interests, understanding that they may not necessarily have any direct application to ICOs. In any event, anyone interested in using this form of financing will need to undertake careful planning and fully understand the nature of the regulatory risks it entails.

It is estimated that the exploding ICO market will have raised anywhere between $1 and $1.5 billion dollars by the end of 2017. While this is a small amount relative to the global securities marketplace, the rapid rise of this market is one reason regulators are looking carefully at ICOs. As such, it is in the best interest of any individual or company considering an ICO or investments in similar offerings to realize that using the blockchain doesn't exempt anyone from the federal securities laws and that, in addition to such laws, other state or federal laws may also apply to the particular transaction.

David W. Adams *chairs Carlton Fields' FinTech practice and focuses his practice on financial institutions, payment processors and emerging technology companies. He can be reached at dwadams@carltonfields.com and @GeorgiaLawDavid.*

Edmund J. Zaharewicz *counsels financial services companies on federal securities and state insurance matters, including InsurTech developments. He can be reached at ezaharewicz@carltonfields.com.*

ADAMS ZAHAREWICZ