Akin®

SEC Division Director Provides Long-Awaited Guidance on Initial Coin Offerings

Jun 15, 2018

Reading Time : **6 min**

By: Peter I. Altman, Jason Daniel, Olivier De Moor, Sebastian Rice, Christopher Staton Spicer

What prompted this?

While BTC's larger market capitalization (roughly double that of ETH) and 2017 bull run made it a prime target for scammers, fraudsters and potential market manipulation, ETH's more recent launch, and the centralized nature of that launch, has fueled speculation that the SEC could deem it a security. However, up until recently, the SEC had provided only limited guidance for determining whether coins, such as BTC and ETH, would be treated as securities. In January, SEC Chairman Jay Clayton gave a warning to companies rushing out Initial Coin Offerings (ICO) to try and boost their share price, cautioning against a one-size-fits-all approach to digital token regulation. In a May congressional hearing, co-directors of enforcement Steve Peikin and Stephanie Avakian repeated the SEC's guidance that whether a coin offering constitutes a securities offering depends on the "facts and circumstances" of each case.

What does it mean?

While the remarks made clear that, over the counter, ETH and BTC transactions are unlikely to constitute a securities transaction, Hinman was equally clear that the SEC would be putting substance over form when scrutinizing offerings. A coin offering could be considered a security offering at the initial launch, notwithstanding its name or the existence of a secondary market, but the reverse could also be true—an investment contract could, over time, become a commodity as its engineers and initial sponsors lose control over its value and marketing. While the design of cryptocurrencies varies significantly, a core feature distinguishing them from securities offerings is the use of distributed ledger technology to shift both control and profiteering away from founders toward users, investors, miners and ledger (or "node") operators. ETH's supporters have argued that, even if its launch could be

considered an unregistered securities offering, its current broad ownership means that no one entity or individual drives its value. The SEC appears to have agreed, with Hinman citing their decentralized trading as the key driver of his opinion.

"[S]trictly speaking," Hinman noted, "the token, the coin, whatever the digital information packet is being called, all by itself, we don't think is a security . . . central to determining whether a security is being offered, however, is how it's being sold, and the reasonable expectation of purchasers." His comments invoked the role of oranges in the seminal case of *Securities and Exchange Commission v. W. J. Howey Co.*, where the Supreme Court held that an offer of a land sales and services contract constituted an "investment contract" within the meaning of the Securities Act of 1933, even if the underlying value of the property being conveyed, a series of citrus groves, was based on the value of a commodity (oranges). 328 U.S. 293 (1946). In the end, Hinman concluded that "the way in which [a digital asset] is sold as part of an investment to non-users by promoters to develop an enterprise can be, and to that extent most often is, a security, because it evidences an investment contract."

Hinman's statements align with the cases brought to date by the SEC, which have primarily focused on fraud in the ICO space. In December, the SEC's Cyber Unit filed a first-of-its-kind criminal complaint against the operators of "PlexCoins," an alleged ICO scam targeting investors with promises of outsized returns. See *SEC v. PLEXCORPS et al.*, No. 17-cv-7007 (E.D.N.Y.). This was quickly followed by other actions targeting unregistered ICOs making fraudulent promises of retailer and bank backing. See *SEC v. Titanium Blockchain Infrastructure Services, Inc., et al.*, No. 18-CV-4315 (C.D. Cal.); *SEC v. Sohrab et al.*, No. 18-CV-02909 (S.D.N.Y.). The SEC's apparent decision to leave policing of the cryptocurrency cash and futures markets to the CFTC and law enforcement suggests that its focus on ICO scams is likely to continue or increase.

While the SEC is a leader in shaping regulation of cryptocurrency, it is certainly not the only player. In the past year, enforcement actions involving cryptocurrency have been brought by the Department of Justice and numerous agencies, including the CFTC and state agencies. For instance, last October, the U.S. Attorney's Office in the Eastern District of New York brought a criminal action against Maksim Zaslavskiy alleging securities fraud conspiracy in connection with unregistered initial coin offerings, and, notably, the SEC also filed charges against Zaslavskiy. In January, the Massachusetts Securities Division sued to stop an offshore company and its founder from launching an unregistered ICO. In March, District Court Judge Jack Weinstein of the Eastern District of New York entered a preliminary injunction at the CFTC's

request against the alleged operator of a fraudulent cryptocurrency advisory service, specifically identifying the concurrent oversight from the SEC in regulating digital currencies. In April, then New York Attorney General Eric Schneiderman sent inquiry letters to 13 virtual currency exchanges requesting operational disclosures. See *CFTC v. McDonnell*, 287 F.Supp.3d 213, 222-23 (2018); see also *CFTC v. My Big Coin Pay Inc. et al.*, No. 18-cv-10077 (D. Mass) [Dkt. No. 70] at 7 (citing McDonnell for proposition that virtual currencies are "commodities").

Where do we go from here?

While cryptocurrency exchange operators may breathe a sigh of relief, companies considering ICOs and their counsel will focus on the following list of factors that Hinman believes are indicative of a third party driving expectations of an investment return:

- Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?
- Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe that such efforts will be undertaken and may result in a return on their investment in the digital asset?
- Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?
- Are purchasers "investing," that is, seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?
- Does application of the Securities Act protections make sense? Is there a person or entity on which others are relying that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?

- Do persons or entities other than the promoter exercise governance rights or meaningful influence?

Additionally, Hinman offered the following list of factors that would indicate that a token is not being offered as a security, but rather as a consumer item:

- Are independent actors setting the price, or is the promoter supporting the secondary market for the asset or otherwise influencing trading?
- Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?
- Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred in only amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?
- Are the assets marketed and distributed to potential users or the general public?
- Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?
- Is the application fully functioning or in the early stages of development?

Importantly, Hinman left open the status of once-popular "SAFTs" (Simple Agreements for Future Tokens), which have recently come under SEC scrutiny, noting only that the legal analysis must follow the economic realities of the offering. He also suggested that the market "sizzle" of an ICO may be fading and that more risk-averse market participants opt for a more conventional alternative: raising debt or equity financing via a registered or exempt offering, and then disburse tokens to users once the network is functional.

While the ultimate direction of the SEC's regulatory authority remains to be seen, these remarks leave no doubt that the SEC aims to remain active in the digital currency markets, focusing on the ICO marketplace to push issuers within the bounds of existing legal precedent and in concert with their colleagues. After all, as Hinman was quick to add, even cryptocurrency transactions that are not subject to the securities laws are subject to a multitude of other regulations, including anti-money laundering laws, consent rules, know-

your-customer rules, the Internal Revenue Service code, state money transmission laws and the Commodities Exchange Act.

Categories

Policy & Regulation | Blockchain | Compliance