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If you have questions or would like additional information on the material covered in this Alert, please contact one of the authors:

Jennifer L. Achilles
Partner, New York
+1 212 521 5412
jachilles@reedsmith.com

Kari S. Larsen
Counsel, New York
+1 212 549 4258
klarsen@reedsmith.com

Michael Selig
Associate, Washington, D.C.
+1 202 414 9287
mselig@reedsmith.com

Wendy A. Grasso
Associate, New York
+1 212 549 0216
wgrasso@reedsmith.com

…or the Reed Smith lawyer with whom you regularly work.

Piecing together the SEC's framework for evaluating initial coin offerings

At a glance:

As capital continues to flood into initial coin offerings and cryptocurrency markets, the U.S. Securities and Exchange Commission has sought to apply the existing securities laws and regulations to novel digital assets. In the past few weeks, the SEC filed a complaint against PlexCorps for violating the securities laws in connection with its PlexCoin ICO, and issued a cease-and-desist order against Munchee Inc. to halt the Munchee ICO. SEC Chairman Clayton released a statement shortly after the issue of this order to explain that many digital assets qualify as securities and issuers must comply with applicable laws and regulations. In this client alert, we highlight the key takeaways for token issuers and market participants.

Nearly five months after issuing the 21(a) Report on the initial coin offering (**ICO**) of "The DAO," a decentralized autonomous organization,[1] and affirming its jurisdiction over cryptographic assets, the U.S. Securities and Exchange Commission (**SEC**) has now brought three enforcement actions involving ICOs, and its framework for evaluating these offerings is coming into focus. The first such action, against Maksim Zaslavskiy and involving cryptographic tokens purportedly backed by non-existent diamonds and real estate, is pending in federal court,[2] while, in the past few weeks, the SEC filed a complaint in federal court against PlexCorps[3] and issued an order instituting cease-and-desist proceeding against Munchee Inc.[4] for offering tokens that allegedly qualify as unregistered securities. The SEC's chairman, Jay Clayton, issued a warning to main street investors and market professionals about the risks of investing in cryptocurrencies and ICOs shortly after the issue of this order.[5]

This past year, the SEC has proceeded with caution against token issuers,

primarily offering warnings and guidance in these early days of ICOs, but is poised to bring more significant enforcement actions next year. The 21(a) Report, the Zaslavskiy and PlexCorps complaints, the Munchee Inc. order, and Chairman Clayton's statement offer insight into how the SEC might evaluate ICOs in 2018.

I. Chairman Clayton's statement

SEC Chairman Jay Clayton released a statement on cryptocurrencies and ICOs on December 11, 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. Similarly, even for functional utility tokens there is no "safe harbor" 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.[6]

Chairman Clayton explained that "[a] number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation." He urged investors to weigh these risks before making an investment, and to ask questions and demand clear answers, providing a list of sample questions that may be helpful to investors, including, among others, "Who exactly am I contracting with?" and "Where is my money going and what will it be used for?"

Clayton cautioned investors that no ICOs have been registered with the SEC and that the SEC has not approved for listing and trading any exchange-traded products that hold cryptocurrencies or other assets related to cryptocurrencies. "If any person today tells you otherwise, be especially wary," he warned.

Clayton also warned industry professionals that ICOs in many cases will need to comply with federal securities laws. He added that many platforms trading in cryptocurrencies may also be in violation of laws that require them to register as an exchange, or an alternative trading platform.

While acknowledging that ICOs can be an effective way for entrepreneurs and others to raise funding, including for innovative projects, he cautioned that any such activity that involves an offering of securities must be accompanied by the important disclosures, processes, and other investor protections that U.S. securities laws require.

"A change in the structure of a securities offering does not change the fundamental point that when a security is being offered, our securities laws must be followed," Clayton said. "Said another way, replacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance."

He also warned that market professionals attempting to highlight utility characteristics of their proposed ICOs in an effort to remove their proposed tokens or coins from the securities analysis may be elevating form over substance. "Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law," he said.

Clayton urged market professionals – including securities lawyers, accountants, and consultants – to "read closely" the 21(a) Report the SEC released earlier this year and to review the SEC's subsequent enforcement actions.

II. PlexCorps

On December 1, 2017, the SEC's newly created cyber unit filed its first civil enforcement action in federal court, against PlexCorps in connection with its ICO of the cryptocurrency "PlexCoin," also known as "PLX."[7] On December 4, the judge granted the SEC's request for an emergency freeze on PlexCorps' assets. A related statement by the SEC suggests that this is the first in a series of cases that will be brought by the SEC's cyber unit involving fraud in connection with distributed ledger technology and ICOs.[8]

The PlexCoin white paper written by PlexCorps characterizes PlexCoin as "the new Bitcoin," and boasts that it is comparable to Bitcoin but with faster confirmation speeds.[9] 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 percent 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. Market participants interested in issuing or investing in cryptographic tokens should carefully consider the factors that might lead the SEC to characterize a currency or utility token as a security.

a. The PlexCoin white paper

The 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.[10] The document provides an overview of the use case 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 "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 characterizes 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 (**ROI**) of various percentages depending on the "sale level" at which 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 percent

- Sale level 2: ROI after 29 days or less: 629 percent

- Sale level 3: ROI after 29 days or less: 332 percent

- Sale level 4: ROI after 29 days or less: 200 percent

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 percent of funds raised would be allocated to "market maintenance." In other words, PlexCorps planned 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. It 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 U.S. 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.

b. 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 a form of "money" rather than securities. For example, in the 21(a) Report on The DAO, the SEC explained that a transfer of Ether satisfies the "investment of money" prong of the Howey "investment contract" analysis. Similarly, the SEC argued in the Shavers case that Bitcoin is an alternative to dollars.[11]

The SEC's enforcement powers are generally limited to the purchase and sale of "securities" pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934. The definition of a security under section 2(a)(1) of the Securities Act and section 3(a)(10) of the Exchange Act encompasses instruments known as "investment contracts." This prophylactic catchall term captures arrangements where (1) a person invests money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of the promoter or a third party.[12] In *Howey*, the U.S. Supreme Court determined the test for when a financial instrument should be considered a "security." In that case, investors were primarily motivated to purchase orange grove land sold in conjunction with a service contract that provided for the harvesting and sale of oranges on the property as an investment. The Supreme Court held that it was not "economically feasible" to manage the land separately, making the service contract "essential."

The "investment contract" category of securities affords the SEC broad discretion in determining whether a given cryptographic token can be categorized as a security. Notwithstanding that discretion, the SEC has not previously considered cryptocurrencies to be securities – until now. The SEC alleged in the PlexCorps complaint that PlexCorps "attempted to refashion the PlexCoin Tokens as a 'cryptocurrency' and likened them to Bitcoin. In reality, PlexCoin Tokens are securities within the meaning of the U.S. federal securities laws."[13]

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." Although Bitcoin and Ether are not advertised as investment instruments by their respective foundations, Zcash is supported by the Zcash Foundation and Ether by the Ethereum Foundation, both of which exercise significant influence over the direction of each blockchain and the value of their respective native tokens. Notably, the extent of control is crucial. In contrast to other cryptocurrency white

papers, the PlexCoin white paper touted the experience of the PlexCorps core team and explained that 70 percent of the funds raised in the ICO would be used by PlexCorps to bolster the token's price. Accordingly, token issuers must be cognizant that the degree of control the issuer or foundation exercises over the value of the token is critical to the SEC's ability to categorize 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.[14] Horizontal commonality involves the pooling of assets from multiple investors where 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 characterizes 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.

III. Munchee

On December 11, 2017, the SEC halted the ICO of a California-based company, Munchee Inc. (**Munchee**), seeking to raise capital for its blockchain-based food review service by selling digital Munchee tokens, also known as "MUN," to investors. Munchee agreed to halt its offering and refunded the $15 million in funds it had collected from potential investors after receiving a cease-and-desist order from the SEC.[15]

Munchee consented to the SEC's cease-and-desist order without admitting or denying the findings. As with the PlexCorps action, the order resulted from an investigation by the SEC's cyber unit.

a. Munchee's manner of sale

According to the SEC, in the course of the offering, the company and other promoters emphasized that investors could expect that efforts by the company and others would lead to an increase in value of the tokens. The company also emphasized that it would take steps to create and support a secondary market for the tokens.

b. Functional tokens can be securities

The SEC stated in its order 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. "Even 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 characterizing an ICO as involving a 'utility token' – but instead requires an assessment of 'the economic realities underlying a transaction,'" the SEC wrote in the order.

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/or if the token has some use at issuance.

In the SEC press release announcing the Munchee order, 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."[16]

III. Conclusion

The contours of the SEC's framework for evaluating ICOs based on the current body of statements, complaints, the Munchee order, and the 21(a) Report is as follows:

- The SEC considers whether each product is an "investment contract" under a facts-and-circumstances Howey test analysis, as illustrated in the 21(a) Report on The DAO.
- There is no cryptocurrency "safe harbor" from the definition of security. The SEC will evaluate a product labeled as a "cryptocurrency" using the Howey test analysis to determine whether the product qualifies as a security. A significant factor is whether the issuer will exercise control over the product's value.
- There is no utility token "safe harbor" from the definition of security. Even functional tokens can qualify as securities under a Howey analysis.
- The SEC's action against Munchee indicates that the SEC will pursue issuers of tokens that the SEC deems to be unregistered securities, regardless of whether there is potential fraudulent activity.

The SEC has indicated that it will continue to review ICOs for compliance with the securities laws and bring enforcement actions against violators. 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 misstatements and omissions.

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[1] A Reed Smith client alert on the report is available here.

[2] A Reed Smith client alert on this case is available here.

[3] The complaint is available here.

[4] The order is available here.

[5] Chairman Clayton's statement is available here.

[6] *See SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

[7] The complaint is available here.

[8] The SEC's statement is available here.

[9] The PlexCoin white paper is available here.

[10] The Bitcoin white paper is available here.

[11] The 21(a) Report is available here. The Shavers complaint is available here.

[12] See *SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

[13] PlexCorps complaint at ¶ 9.

[14] See *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001).

[15] The Munchee order is available here.

[16] The SEC's press release is available here.