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Client Alert Commentary

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SEC Takes Enforcement Action against Utility Token ICO

The SEC's latest enforcement action and its Chairman's statement clarify the application of securities laws to ICOs and cryptocurrency markets.

Introduction

On December 11, 2017, the US Securities and Exchange Commission (SEC) issued an order (Order) instituting cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 with respect to Munchee Inc. (Munchee). Munchee, a California-based company, was in the process of offering digital tokens (designated as "MUN" tokens) to investors through an initial coin offering (ICO).[1] In the Order, the SEC determined that the ICO was an offering of securities without registration or an available exemption, notwithstanding that the digital tokens offered and sold in the ICO were intended to have a utility function.

On the same day the Order was entered, the Chairman of the SEC (Chairman) issued a public statement (Statement) on cryptocurrencies and ICOs.[2] The Statement — directed to "Main Street" investors and market professionals — provided the Chairman's general views on the cryptocurrency and ICO markets.

The Order

Munchee created a visual food review and social networking smart phone application (app) for users located in the US. It developed a plan to conduct an ICO of MUN tokens in October and November 2017 in order to raise approximately US$15 million in capital to fund its operations, including the development of blockchain-based apps. Munchee announced its ICO to the general public on or about October 1, 2017. Munchee posted — on its website, a cryptocurrency blog, Facebook, Twitter, and other social media — its White Paper[3], which described the MUN tokens and the offering. The White Paper described the creation of an "ecosystem," in which users of the app, restaurants, and Munchee's advertising business would be connected and would transact using MUN tokens. App users would be paid in MUN tokens for writing food reviews and could use MUN tokens to pay for "in-app" purchases and food at participating restaurants. Restaurants participating in the ecosystem could receive MUN tokens by selling food to app users and could use MUN tokens to purchase advertising from Munchee and to pay rewards to app users who reviewed their meals. However, at the time of the offering, the ecosystem was not functional and none of these goods or services were available for purchase with MUN tokens.

Munchee stated in its White Paper that it would run its business in ways that would increase participation in the ecosystem, which would lead to increased value of MUN tokens — users would create additional quality content to attract more restaurants onto the platform, and, with more restaurants participating in the platform, MUN tokens could be more widely used, increasing the value of the MUN token. Munchee

also stated in its White Paper that it would list MUN tokens for trading on at least one US-based exchange within 30 days of the offering. Moreover, Munchee also agreed that it would use its reserves in order to provide liquidity to the MUN token market.

Munchee's ICO marketing efforts targeted a broad audience. According to the SEC these efforts included web postings such as "199% GAINS or MUN token at ICO price! Sign up for PRE-SALE NOW!" as well as links to promotional videos touting the possible returns investors could make on the tokens. The SEC noted that Munchee "did not use the Munchee App or otherwise specifically target current users of the Munchee App to promote how purchasing MUN tokens might let them qualify for higher tiers and bigger payments on future reviews."

On November 1, 2017, the second day of the ICO, SEC staff contacted Munchee, which determined within hours it would shut down the ICO. Munchee had not delivered any MUN tokens to purchasers and promptly returned the proceeds that it had received.

In applying the *Howey* test to the MUN token ICO, the SEC determined that MUN tokens were securities and cited the following factors:

- Munchee intended to use the proceeds from the ICO to revise the app and build an ecosystem based on the MUN tokens, which MUN token purchasers reasonably expected would increase the value of the MUN tokens. Furthermore, Munchee promised to facilitate a secondary market for the MUN tokens in advance of creation of the ecosystem in which they could be used. And finally, investors' profit expectations were "primed" by Munchee's marketing, which compared the MUN tokens to previous ICOs that had generated profits for early ICO investors. Specifically, Munchee "marketed to people interested in those assets – and those profits – rather than to people who, for example, might have wanted MUN tokens to buy advertising or increase their 'tier' as a reviewer on the Munchee App."

- Such profits would be realized through the appreciation in value of MUN tokens, which would require the "significant entrepreneurial and managerial efforts of others" in the form of building the ecosystem, designing the revised app and supporting the secondary market for the MUN token. Due to Munchee's conduct and marketing approach during the course of the ICO, investors' belief that they could rely on the significant efforts of Munchee to drive increased MUN token value was reasonable.

Because MUN tokens were securities, and Munchee offered and sold these securities to the general public without filing a registration statement or through a valid exemption, Munchee violated Sections 5(a) and (c) of the Securities Act.

Considering the prompt remedial actions to discontinue the offering and return all funds to investors, the SEC determined not to impose a civil penalty.

SEC Chairman's Statement on Cryptocurrencies and ICOs

In the Statement, the Chairman asserted that whether offers and sales of cryptocurrencies are within the SEC's jurisdiction will depend on the characteristics and use of the particular asset. The Chairman stated that the SEC has the same interests and responsibilities with respect to cryptocurrencies as it has with respect to other fiat currencies that may impact the US securities markets. With respect to ICOs, the Chairman drew an analogy to membership in a book-of-the month club that is raising money to purchase books — while such membership interest may not represent a security, many token offerings appear to

have gone beyond this construct and are more akin to interests in a "yet-to-be built publishing house with the authors, books and distribution networks all to come." He noted that it is "especially troubling" when ICO promoters emphasize the secondary market trading potential of the tokens because purchasers are being sold on the potential for tokens to increase in value and their ability to lock in those increases by reselling the tokens on a secondary market.

In conclusion, the Chairman stated that he has asked the Division of Enforcement to "police this area vigorously" and urged market participants and their advisers to consider thoughtfully the securities laws.

What Do the Order and Statement Mean to ICO Market Participants?

The Order helps further clarify the application of US securities laws to the offer and sale of cryptocurrencies, including tokens that have a current or prospective utility function. Consistent with prior guidance,[4] the Order reiterates that whether a transaction involves a security does not turn on labeling — such as characterizing an ICO as involving a "utility token" — but instead requires an assessment of "the economic realities underlying a transaction." All of the relevant facts and circumstances must be considered in making that determination.

The Order demonstrates that such relevant facts and circumstances are not limited to the rights and interests the tokens are purported to provide the holders, which may be of a utility or consumptive nature. In this case, the SEC also considered the manner of the offering, including how the tokens were marketed, to whom they were marketed and sold, how the offering proceeds were to be used, whether the promoter touted a potential increase in token value, the utility of the token (whether current or proposed), and the promoter's promise of secondary market trading.

Although the Chairman's Statement is not an SEC action, the Statement sends a clear message to the marketplace that the economic substance of many token sales manifests key elements of an investment contract. In fact, the utility of a particular token does not guarantee that it will not be viewed as an investment contract, particularly if the promoter of such token is seeking to raise capital to build the token platform. Rather, it matters not only that the token have a true consumptive value, but also how the sale is marketed and to whom the token is marketed, among other factors.

Issuers and promoters of ICOs that involve utility tokens should carefully consider whether their ICOs contain the indicia of securities offerings mentioned in the Order and the Statement.

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Endnotes

[1] The Order is available at https://www.sec.gov/litigation/admin/2017/33-10445.pdf.

[2] The Statement is available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[3] The White Paper is available at https://s3.amazonaws.com/munchee-docs/Munchee+White+Paper.pdf.

[4] See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (DAO Report), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.