UNITED STATES SECURITIES LAW COMPLIANCE AND LIABILITY IMPLICATIONS OF SEC CHAIRMAN'S STATEMENT ON ICOS

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The remarkable growth of initial coin offerings ("ICOs") in 2017 has attracted a feverish level of attention from those looking to launch, promote, and invest in ICOs. Not surprisingly, as a result, ICOs also garnered significant attention from regulators around the world, including those in the United States. [1] On December 11, 2017, the Chairman of the Securities and Exchange Commission ("SEC"), Jay Clayton, released a statement on ICOs and cryptocurrencies (the "Statement"). [2] While recognizing that ICOs "can be effective ways for entrepreneurs and others to raise funding, including for innovative projects," the Statement puts sharp focus on the securities aspects of these types of offerings.

The Statement addresses a number of key considerations for "Main Street" investors, ICO promoters, and the professionals that advise them or provide services to them, including one of the most important issues facing the industry: the effect of a secondary marketplace in determining whether tokens structured as "currencies" or "utility tokens" may constitute securities under the *Howey* test. [3]

The Statement, while technically not an expression of the views of the SEC, provides important guidance to the ICO market on how the SEC has and likely will continue to view ICOs. Specifically, the Statement serves as a guidepost for (i) the SEC's position with respect to whether tokens offered in ICOs are securities; (ii) the need for adequate disclosure; and (iii) the vital role of lawyers, accountants, consultants, and other professionals as "gatekeepers" of investor protection. Moreover, the Statement's importance is accentuated by the simultaneously filed SEC cease and desist order (the "Order") concluding that a purported "utility token" issued by Munchee Inc. ("Munchee") constituted an unregistered offering of securities. The Munchee Order is the subject of a separate alert by our firm(*see here*).

Taken together with the Statement, we believe that the two releases from the SEC will serve as important guidance for the ICO industry and for regulators around the world.

WHEN ARE TOKENS SECURITIES?

The Statement addresses one of the chief legal and regulatory issues surrounding ICOs—whether tokens issued pursuant to these offerings are securities that are subject to the federal securities laws, including securities registration and other investor protection requirements. In Chairman Clayton's view, the answer is that digital tokens often are, observing that "[b]y and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws." Chairman Clayton specifically addressed efforts by

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some promotors to avoid application of the securities laws by denominating a token a consumptive 'utility' token or structuring it to provide some facial utility. In Chairman Clayton's view, "simply calling something a 'currency' or a currency-based product does not mean that it is not a security."

Chairman Clayton used a book-of-the-month club analogy to provide an example of where the use of tokens may not be considered securities, observing that tokens that represent participation interests in such a venture "may not implicate the federal securities laws, and may well be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders." Using the same analogy, Chairman Clayton observed that many token offerings fail to fall into this construct and "are more analogous to interests in a yet-to-be-built publishing house with the authors, books, and distribution networks all to come."

GENERAL IMPLICATIONS FOR U.S. SECURITIES MARKET

The Statement indicates that promoters' emphasis on potential secondary market trading may be a material indicator of whether an ICO is a securities offering. Chairman Clayton observed that that this emphasis is "especially troubling," noting that the sale of tokens based on the potential for purchasers to profit by reselling tokens on a secondary market "are key hallmarks of a security and a securities offering."

Chairman Clayton noted that whether a cryptocurrency or digital token is a security depends upon its character and how it is used. He also noted that SEC will in all cases have an interest in how cryptocurrencies affect U.S. securities markets, just as the SEC has an interest in how fluctuations among fiat currencies impact these markets. This interest can extend to securities firms and others that permit or engage in transactions involving cryptocurrencies. Chairman Clayton also pointed out that market participants such as broker-dealers and others dealing in cryptocurrencies transactions need to "exercise particular caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations." [4]

MARKET PARTICIPANTS AS "GATEKEEPERS" OF INVESTOR PROTECTION

Chairman Clayton emphasized—in boldface type—the importance of market participants such as attorneys, accountants, broker-dealers, and consultants in assessing whether a particular ICO constitutes an offering of securities:

"**On this and other points where application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities**."

In an emerging industry where all participants are feeling their way through the regulatory landscape, the SEC expects professional advisers to play a key role in guiding market participants to the appropriate legal and regulatory conclusions and may even hold them liable for aiding and abetting violations of the federal securities laws in appropriate cases.

PROTECTION OF "MAIN STREET INVESTORS"

The overlay to the Statement is investor protection and the message is clear: "be open to these [ICO] opportunities, but ask good questions, demand clear answers and apply good common sense when doing so." Chairman Clayton points out (in bold) that the current ICO and cryptocurrency markets offer "**substantially less**

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investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation."

The Statement offers a series of questions that should be asked by investors, such as (i) with whom is the investor contracting; (ii) where are the investor's funds going, and what will they be used for; (iii) are there financial statements for the venture (whether or not audited); (iv) is there trading data for the tokens; (v) the role of digital wallets and blockchain in the ICO; (vi) whether the offering is structured to comply with federal securities laws; and (vii) whether and to what extent are there legal protections in the event of fraud, hacks, malware, or a downturn in business prospects.

KEY TAKEAWAYS OF THE STATEMENT

For Investors:

The Statement has come at a time when many ICO market participants have been wrestling with regulatory uncertainty amidst investor ebullience. For investors and intermediaries alike, the Statement counsels caution and offers a specific set of considerations and questions that investors should keep in mind when evaluating any ICO. [5]

For Promoters Planning an ICO:

The Statement serves as a strong message to give careful consideration to one's business plan and to the structure of the ICO and the attendant disclosures, including whether the tokens offered are securities subject to the requirements and protections of the federal securities laws. ICO promoters, working with their professional advisers, need to take heed of the considerations outlined in the Statement and evaluate their business models and answer such questions as whether (i) the token platform is fully functional, partially functional, or yet-to-be-built; (ii) there is any marketing emphasis on the possibility of returns and efforts to provide secondary trading markets; and (iii) the plan of distribution focuses on investors who are not the intended users of the utility token.

Given the current state of the ICO industry, it can be expected that the answers to these questions will lead many promoters to launch their ICOs as securities offerings in compliance with U.S. securities laws.

In particular, ICO sponsors, working with their advisers, will need to consider how to structure their digital token offerings in compliance with the exemptions or exclusions from registration under the Securities Actand also determine the level of disclosures about the token and the platform required in connection with an offering of securities under the anti-fraud provisions of the federal securities laws. This is especially important given the commencement of several securities fraud class action lawsuits and state securities law enforcement proceedings against ICO sponsors. [6]

For Promoters of Completed ICOs:

For completed ICOs that may in hindsight constitute an unregistered nonexempt offering of securities, sponsors (and other persons involved in the offer and sale of token in an ICO) should consider how to limit their potential liability under federal and state securities laws by taking appropriate remedial action. Given the current dynamics of the ICO marketplace, rescission may not be practicable given the volatility of the value of Bitcoin and Ether. In an offering conducted using Bitcoin or Ether as consideration, it is uncertain whether a rescission offer must include the appreciation of the Bitcoin or Ether or whether the dollar value of the consideration at the time of

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purchase would be sufficient. As discussed above, a sponsor will not necessarily be shielded from liability because it purported to structure the ICO outside the United States.

In addition, to the extent that an ICO is considered to be an unregistered securities offering, secondary trading platforms and other intermediaries facilitating trading tokens sold in the ICO could be in violation of the federal securities laws if they are not appropriately registered as exchanges, broker-dealers, or investment advisers.

For Advisers and Intermediaries:

Rescission issues described above may affect intermediaries to the extent they are involved in the offer and sale of token in an ICO. Additionally, the Statement urges market professionals involved in ICOs, such as lawyers, accountants, and consultants, to be mindful of their role as gatekeepers of investor protection. This is consistent with the SEC's longstanding focus on the roles of intermediaries in securities offerings, especially with respect to activities in the over-the-counter markets. As the ICO industry continues to face regulatory scrutiny, we expect the role of outside advisers to become increasingly important in this quickly evolving field.

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[1] For a fuller discussion of the position of various international regulators, *see* *Securities Regulators Warn That Certain "ICO's" May Be Subject to Securities Laws*, ABA BUSINESS LAW TODAY (November 1, 2017).

[2] SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[3] *See* SEC v. Edwards, 540 U.S. 389, 393 (2004); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); *see also* United Housing Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.").

[4] Cryptocurrencies and derivatives based on them may also be subject to regulation by the Commodity Futures Trading Commission as commodity interests independently of their status under federal securities law. The fact that an ICO issuer may be located outside the United States will not defeat the ability of the SEC or the Department of Justice to prosecute enforcement actions or criminal prosecutions in United States courts for violations of federal securities laws arising either from wrongful conduct in the United States or wrongful conduct that had a substantial effect in the United States or on U.S. citizens.

[5] As a signal that the concerns it highlights are not transitory, on January 4, 2018, all three commissioners of the SEC issued a joint statement endorsing a statement made on that date by the North American Securities Administrators Association ("NASAA") to highlight investor protection issues in ICOs and other cryptocurrency-related investment products. For the NASAA statement, *see* http://www.nasaa.org/44073/nasaa-reminds-investors-approach-cryptocurrencies-initial-coin-offerings-cryptocurrency-related-investment-products-caution/ For the SEC commissioners' statement, *see* https://www.sec.gov/news/public-statement/statement-clayton-stein-piwowar-010418.

[6] For example, on January 4, 2018, the Texas State Securities Board issued an emergency cease and desist order against BitConnect, an ICO sponsor based in England that promised investors a return on investment, and on December 28, 2017, a class action lawsuit alleging various securities law violations was filed in the Eastern

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District of Washington against Giga Watt, Inc., an ICO sponsor based in Washington state, in respect of a utility token offering.

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