

SEC BRINGS FIRST ENFORCEMENT ACTION AGAINST INITIAL COIN OFFERING

On September 29, 2017, the United States Securities and Exchange Commission ("SEC") brought its first enforcement action arising from an Initial Coin Offering ("ICO"). This action is the latest sign that the SEC will be carefully scrutinizing the ICO market and transactions involving ICOs.

WHAT IS AN ICO?

An ICO is a fundraising event, effected using distributed ledger technology, in which a "token" or "coin" is offered to a participant in return for either cash (fiat currency) or cryptocurrency, such as Ether or Bitcoin. A token entitles its holders to various rights, which typically include the right to use a service to be developed and offered by the issuer.ⁱ The proceeds of the token sale are used to fund a venture or a project undertaken by the ICO sponsors.

Similar to equity securities, however, tokens sold in ICOs may also confer profit rights, may appreciate in value, and can be traded. ICO tokens do not represent an ownership interest in a venture.

ICOs are typically announced through online channels such as cryptocurrency forums and websites. ICO sponsors typically provide access online to a white paper describing the project, including its status and key team members, and key terms of the ICO (for example, its economic terms, subscription details, and timeline).

In the subscription process, the participant typically is required to transfer cryptocurrency to one or more designated addresses (an online reference for cryptocurrencies similar to an account number) or online wallets of the ICO sponsor. Subscriptions may be completed in minutes. A participant may also be rewarded with tokens by taking certain actions, such as marketing on cryptocurrency forums. Once the ICO is completed, the ICO tokens are distributed to the participants' designated addresses or online wallets. The ICO sponsors may list the tokens on cryptocurrency exchanges to trade against other cryptocurrencies in an effort to create liquidity and value.

It is important to distinguish decentralized cryptocurrencies, such as Bitcoin, from the typical ICO model. Bitcoin is not administered by any promoter, sponsor, or company. The issuance of Bitcoin incentivizes the decentralized hashing of new transactions by minersⁱⁱ around the world, and the "proceeds" of Bitcoin's issuance are in the form of services provided—such as the computing power expended by miners to validate transactions on the blockchain—not money. The proceeds of Bitcoin's issuance do not go to finance a new business venture by an issuing entity because there is no such central entity within the Bitcoin ecosystem. Bitcoin and similar decentralized cryptocurrencies as a result do not resemble either investments in an enterprise or utility coins, but are instead passive stores of value, in the nature of a commodity, or mediums of value exchange, in the nature of a currency. The SEC has described Bitcoin as a commodity (as currencies would be described) and a digital asset, rather than as a security.ⁱⁱⁱ

SEC POSITION ON ICOS

ICOs, unlike IPOs, have generally been perceived by investors as unregulated transactions.^{iv} This perception is no longer accurate as the SEC and other regulatory agencies are increasing their investigative and enforcement activities in this space.^v

In July 2017, the SEC issued a Report of Investigation (the "DAO Report"),^{vi} related to the issuance of approximately 1.15 billion DAO tokens by a virtual organization known as "The DAO" in exchange for approximately 12 million Ether virtual currency (worth approximately \$150 million at closing). The DAO ICO was marketed to investors through a variety of channels: the co-founders launched a website where DAO tokens could be purchased, they published a

"White Paper" describing the concept behind The DAO and how it would operate, and they made frequent media appearances discussing The DAO.

According to The DAO's co-founders' explanation, The DAO was intended to "blaze a new path" in corporate governance by using blockchain to support "smart contracts" that would be enforced via software. In a YouTube video, co-founder Christoph Jentzsch described participating in the DAO ICO as being similar to "buying shares in a company and getting . . . dividends." As a result, participants in the DAO ICO would receive some voting and ownership rights, as well as the right to vote on how The DAO should treat any return on its investments. Moreover, The DAO also promised that DAO tokens would be able to be traded on the secondary market. During the two-month offering period, the offering was widely publicized, purchasers were not screened for accredited investor status, and the tokens were not subject to any transfer restrictions.

Following the launch of DAO tokens, the SEC initiated an investigation to determine whether The DAO and related parties had violated the federal securities laws in connection with the offer and sale of DAO tokens.^{vii} The SEC determined it would not pursue enforcement action based on the conduct and activities known to it at the time it completed its investigation. Instead, the SEC issued the DAO Report, setting out its views as to application of the federal securities laws to DAO tokens.

In the DAO Report, the SEC analyzed tokens issued by The DAO to determine whether they were in fact securities by using the "facts and circumstances" test established by the Supreme Court in *SEC v. W.J. Howey Co.*^{viii} Pursuant to this test, the SEC analyzed whether: (i) purchasers of the ICO invested money or valuable goods or services; (ii) purchasers of the ICO were investing in a common enterprise; (iii) purchasers of the ICO had a reasonable expectation of earning profits; and (iv) any profits earned from the ICO were to be derived from the efforts of others.^{ix}

Using this test, the SEC determined that the elements of the *Howey* test were met because: (i) the purchasers' payments in Ether were an investment of money; (ii) the Ether was invested in a common enterprise; (iii) investors had a reasonable expectation of profit; and (iv) investors relied on the efforts of others because of the key role played by the founders and "curators"^x of the DAO.^{xi} The SEC, however, did not state that all ICOs would be considered securities; instead, they stressed the importance of the facts and circumstances of a particular offering.

The DAO Report also addressed the secondary market for DAO tokens to determine whether these marketplaces functioned as an exchange subject to registration with the SEC. Pursuant to the Securities Exchange Act of 1934,^{xii} a securities exchange is "any organization . . . which . . . provides a market place. . . for bringing together purchasers and sellers of securities . . ." ^{xiii} and it is illegal to act as an exchange unless the exchange is registered as a national securities exchange or is exempted from such registration.^{xiv} Exchange Act Rule 3b-16 establishes that an organization is an exchange if it (i) brings together the orders of multiple buyers and sellers of securities; and (ii) uses established, non-discretionary methods to effect a trade.^{xv} Applying this test, the DAO report concluded that various platforms that traded DAO tokens met the definition of an "exchange" under the Exchange Act and did not appear to have valid exemptions from registration.^{xvi}

Coinciding with its release of the DAO Report, the Division of Enforcement also released a public statement in conjunction with the Division of Corporation Finance reminding market participants that the "hallmark of a security is an investment of money or value in a business or operation where the investor has a reasonable expectation of profits based on the efforts of others."^{xvii} Both divisions have subsequently followed up with additional actions that make clear that the SEC considers many ICOs to fall within its regulatory authority.^{xviii}

THE SEC'S FIRST ICO ENFORCEMENT ACTIONS

During the course of August, the SEC suspended trading in three public companies that had indicated they were likely to engage in an ICO. On August 9, 2017, the SEC temporarily suspended trading in the securities of CIAO Group, Inc. ("CIAU"), because of questions regarding the accuracy of assertions made by CIAU about, among other things, plans for an ICO.^{xix} Two weeks later, on August 23, the SEC temporarily suspended trading in the securities of First Bitcoin Capital Corp. ("BITCF"), because of concerns regarding the accuracy of publicly available information from the company about the value of its assets.^{xx} BITCF had already issued tokens,^{xxi} but the SEC did not address this issuance in its suspension order.^{xxii} The next day, the SEC temporarily suspended trading in the securities of American Security Resources Corp ("ARSC"), because of questions about publicly available information from the company about its plans to adopt blockchain technology and transition to cryptocurrency markets.^{xxiii} All of these suspensions were temporary, but they likely disrupted each company's plans for upcoming ICOs and plans to adopt blockchain

technology. A few days after the ARSC suspension, the SEC issued an Investor Alert specifically focused on companies making ICO-related claims, highlighting these suspensions and enumerating factors that they would consider when deciding in the future when suspensions were appropriate, including:

- "A lack of current, accurate, or adequate information about the company – for example, when a company has not filed periodic reports for an extended period;
- Questions about the accuracy of publicly available information, including in company press releases and reports, about the company's current operational status and financial condition; or
- Questions about trading in the stock, including trading by insiders, potential market manipulation, and the ability to clear and settle transactions in the stock."^{xxiv}

Next, on September 29, 2017, the SEC filed a civil complaint against Maksim Zaslavskiy and two of his companies that had engaged in ICOs.^{xxv} In the complaint against Zaslavskiy, the SEC alleged that he used two companies – REcoin Group Foundation and DRC World – to sell unregistered securities through ICOs for digital tokens, which ultimately did not exist. The complaint further alleged that the REcoin ICO included a number of false statements, including that REcoin had a "team of lawyers, professionals, brokers, and accountants" that would invest REcoin's ICO proceeds into real estate when in fact none of this "team" had been hired or even consulted. This scheme was then repeated with DRC, which purportedly invested in diamonds and obtained discounts with product retailers for individuals who purchase "memberships" in the company. Despite their representations to investors, the SEC alleged that Zaslavskiy

and DRC have neither purchased any diamonds nor engaged in any business operations, yet they allegedly continue to solicit investors and raise funds as though they have.

The Zaslavskiy enforcement action, which targeted what is in essence a fraud scheme, is notable for two reasons:

1. Speed. Zaslavskiy only started soliciting investments in REcoin in July 2017; the SEC began its investigation in August 2017.
2. Securities Presumption. It appears that the SEC will classify ICO tokens as securities unless the tokens are proven otherwise, in essence shifting the burden to operators of ICOs to show that the tokens being offered are not securities.

Conclusion

The SEC's recent actions related to ICOs suggests that the SEC is thoroughly scrutinizing these offerings. Speaking at an event on September 5, 2017, SEC Chair Jay Clayton identified ICOs as one of two new priorities for the SEC (the other being cybersecurity).^{xxvi} Additionally, the Cyber Unit announced by the SEC on September 25, 2017 lists as one of its enforcement priorities "violations involving distributed ledger technology [blockchain] and initial coin offerings."^{xxvii} Companies considering ICOs that allow U.S. purchasers to participate must be mindful of U.S. securities laws requirements. An ICO offering will be subject to all applicable securities requirements unless the issuer can establish that the ICO token is not a security. The SEC's recent enforcement activity seems to indicate their scepticism that ICO issuers will be able to do so.

CONTACTS

David Felsenthal
Partner

T +1 212 878 3452
E david.felsenthal@cliffordchance.com

Steven Gatti
Partner

T +1 202 912 5095
E steven.gatti@cliffordchance.com

Megan Gordon
Partner

T +1 202 912 5021
E megan.gordon@cliffordchance.com

Daniel Silver
Partner

T +1 212 878 4919
E daniel.silver@cliffordchance.com

Philip Angeloff
Counsel

T +1 202 912 5111
E philip.angeloff@cliffordchance.com

Benjamin Berringer
Associate

T +1 212 878 3372
E benjamin.berringer@cliffordchance.com

Allein Sabel
Associate

T +1 212 878 3371
E allein.sabel@cliffordchance.com

Jesse Overall
Associate

T +1 212 878 8289
E jesse.overall@cliffordchance.com

Brian Yin
Associate

T +1 212 878 4980
E brian.yin@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

© Clifford Chance 2017

Clifford Chance US LLP

Abu Dhabi • Amsterdam • Bangkok • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Dubai • Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

ⁱ ICO tokens may give the owner the right to access or participate in, or transact within, the issuer's ecosystem. ICO tokens may also be referred to as "utility coins" or "app tokens" in an attempt to distinguish them from tokens resembling investments in an ongoing enterprise. Utility coins have been described as analogous to the tokens that one inserts into video game machines at an arcade – prospective players buy tokens in order to play on the machines, not in order to invest in the business enterprise that owns the arcade. Ash Bennington, *Utility Coins or Crypto Assets? Token Terminology Is One Big Gray Area*, CoinDesk (Sept. 5, 2017), <https://www.coindesk.com/utility-coins-crypto-assets-token-terminology-one-big-gray-area>.

ⁱⁱ Bitcoin mining is the process of verifying Bitcoin transactions. Miners expend computing power in the hopes of earning Bitcoin. *Bitcoin Mining*, Investopedia (last visited Oct. 9, 2017), <http://www.investopedia.com/terms/b/bitcoin-mining.asp>.

ⁱⁱⁱ See, e.g., Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust, Release No. 34-80206, at 3, n.10 (Mar. 10, 2017) ("For the purpose of considering this proposal, this order describes bitcoin as a 'digital asset' and a 'commodity'").

^{iv} See, e.g., Izabella Kaminska and Paul Murphy, *Bitcoin's Surge Fuels Fears of Asset Bubble*, Financial Times (May 14, 2017), <https://www.ft.com/content/ce3ef54e-371b-11e7-bce4-9023f8c0fd2e> (defining ICOs as "unregulated issuances of crypto coins where investors can raise money in bitcoin or other crypto currencies").

^v See, e.g., Commodity Futures Trading Commission v. Gelfman Blueprint Inc. et al., No. 17-cv-7181, *complaint filed*, 2017 WL 4228737 (S.D.N.Y. Sept. 21, 2017).

^{vi} SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (July 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf> [hereinafter DAO Report].

^{vii} Press Release, SEC, *SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities* (July 25, 2017), <https://www.sec.gov/news/press-release/2017-131>.

^{viii} 328 U.S. 293, 301 (1946).

^{ix} DAO Report at 11–13.

^x Curators were given "considerable power" in the DAO and had the ability to control which proposals were submitted to the DAO and voted on by DAO tokenholders. DAO Report at 7.

^{xi} DAO Report at 11–13.

^{xii} Securities Exchange Act of 1934 § 3(a)(1), 15 U.S.C. § 78e.

^{xiii} *Id.* at § 78c(a)(1).

^{xiv} *Id.* at § 78e.

^{xv} 17 C.F.R. 240.3b-16.

-
- ^{xvi} DAO Report at 17.
- ^{xvii} SEC, *Investor Bulletin: Initial Coin Offerings* (July 25, 2017), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings>.
- ^{xviii} Notably, the Commodity Futures Trading Commission ("CFTC") has also begun to exercise jurisdiction over entities involved in ICOs. See *In re Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29, Order Instituting Proceedings Pursuant To Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (Sept. 17, 2015), at 3 ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities."); accord, *In the Matter of: BFXNA Inc. d/b/a BITFINEX*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, as Amended, Making Findings and Imposing Remedial Sanctions, CFTC Docket No. 16-19, at 5-6 (June 2, 2016) ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities, and are therefore subject as a commodity to applicable provisions of the Act and Regulations"). Look for an upcoming Clifford Chance news brief on this topic and the potential for overlapping jurisdiction between the SEC and CFTC over the ICO market.
- ^{xix} SEC, Release No. 81367 (August 9, 2017), <https://www.sec.gov/litigation/suspensions/2017/34-81367.pdf>.
- ^{xx} SEC, Release No. 81474 (August 23, 2017), <https://www.sec.gov/litigation/suspensions/2017/34-81474.pdf>.
- ^{xxi} OTC Disclosure & News Service, *First Bitcoin Capital Corp to Buyback Shares Utilizing the ICO* (July 3, 2017), <http://www.otcmrket.com/stock/BITCF/news?id=163718>.
- ^{xxii} See SEC, Release No. 81474 (August 23, 2017), <https://www.sec.gov/litigation/suspensions/2017/34-81474.pdf>.
- ^{xxiii} SEC, Release No. 81481 (August 24, 2017), <https://www.sec.gov/litigation/suspensions/2017/34-81481.pdf>.
- ^{xxiv} SEC, *Investor Alert: Public Companies Making ICO-Related Claims* (Aug. 28, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_ico-relatedclaims.
- ^{xxv} Press Release, SEC, *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds* (Sept. 29, 2017), <https://www.sec.gov/news/press-release/2017-185-0>.
- ^{xxvi} NYU Law News, *SEC Chairman Jay Clayton Identifies Agency's New Priorities: Cybercrime and ICOs* (Sept. 27, 2017).
- ^{xxvii} Press Release, SEC, *SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors* (Sept. 25, 2017), <https://www.sec.gov/news/press-release/2017-176>.