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SEC takes aim at digital tokens and smart contracts

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In his Blockchain Law column, Robert A. Schwinger discusses a wave of new enforcement actions brought by the SEC targeting blockchain-based digital token ventures under a variety of provisions in the securities laws. These proceedings show the breadth of the approaches the SEC is taking toward enforcement in this area, perhaps most notably in one case where it appears a "smart contract" blockchain application may have proved to be a bit too smart for its own good.

On the heels of the first-ever judicial holding this past summer that a cryptocurrency could qualify as a "security" under federal securities laws, the Securities and Exchange Commission has brought a wave of new enforcement actions targeting blockchain-based digital token ventures under a variety of provisions in the securities laws. These proceedings show the breadth of the approaches the SEC is taking toward enforcement in this area, perhaps most notably in one case where it appears a "smart contract" blockchain application may have proved to be a bit too smart for its own good.

Background

The SEC's *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Rel. No. 81207 (July 25, 2017) (the DAO Report) set forth the SEC's position that tokens (digital representations of assets or rights) issued on a blockchain platform, such as virtual currency sold in an Initial Coin Offering (ICO), may in appropriate circumstances be considered "securities" under the federal securities laws. The SEC based this position on the "*Howey* test," the U.S. Supreme Court's long-established test for determining whether certain transactions qualify as "investment contracts" and thus "securities" under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), and its progeny, which looks to whether there is (1) an investment of money, (2) in a common enterprise and (3) with profits to be derived solely from the efforts of others.

Several months after the DAO Report, in *In re Munchee*, Securities Act Rel. No. 10445 (Dec. 11, 2017), the SEC brought cease-and-desist proceedings against an offeror of tokens that were issued to raise capital for the offeror's business. The SEC took the position that because the tokens constituted "securities" under the *Howey* test, the offeror therefore had engaged in an unlawful sale of unregistered securities in violation of §§5(a) and 5(c) of the Securities Act.

While much discussed, the SEC's position was not judicially tested until the decision in *United States v. Zaslavskiy*, No. 17 CR 647, 2018 WL 4346339 (E.D.N.Y. Sept. 11, 2018), which held for the first time that an ICO could indeed be a security under the *Howey* test, and that therefore fraud in the ICO could be criminally prosecuted as a violation of §10(b) of the Exchange Act. The SEC's increased confidence in its view that ICOs could represent securities has resulted in a wave of new enforcement actions.

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Broker-Dealers, Investment Companies and Investment Advisers

The same day that the *Zaslavskiy* ruling was issued, the SEC announced cease-and-desist proceedings in two matters relating to cryptocurrency ventures, with consented-to findings and sanctions. In *In re TokenLot*, Securities Act Rel. No. 10543, Exchange Act Rel. No. 84075, Investment Company Act Rel. No. 33221 (Sept. 11, 2018), the respondents ran a so-called "ICO Superstore" where they advertised and sold digital tokens to retail investors using TokenLot's website platform, soliciting investors, taking customer orders for tokens, processing investor funds, taking marketing fees and handling more than 200 different digital tokens in connection with both ICOs conducted by other entities and TokenLot's own secondary market activities. Citing the DAO Report, the SEC charged that these digital tokens included securities and that the respondents were effecting unregistered securities transactions as unregistered broker-dealers, in violation of §15(a) of the Exchange Act and §§5(a) and (c) of the Securities Act.

Concurrently, the SEC took action in *In re Crypto Asset Mgmt., LP*, Securities Act Rel. No. 10544, Investment Advisers Act Rel. No. 5004, Investment Company Act Rel. No. 33222 (Sept. 11, 2018), where the respondents operated an unregistered pooled investment vehicle formed for the purpose of investing in, holding and trading digital assets. It was managed through the respondent's manager entity that was likewise unregistered but which earned incentive and management fees. Asserting that the digital assets being traded were "investment securities" under §3(a)(2) of the Investment Company Act, and that respondents' investment vehicle met the definition of an "investment company" under §3(a)(1)(C) of the Investment Company Act, the SEC in a consented-to order charged the respondents with selling unregistered securities in violation of §5(a) of the Securities Act, running an unregistered investment company in violation of §7(a) of the Investment Company Act, and making false or misleading statements to investors in violation of §206(4) of the Investment Advisers Act and Rule 206(4)-8 thereunder, as well as §17(a)(2) of the Securities Act.

'Ecosystems' and Celebrities

Another wave of SEC enforcement actions directed at digital token ventures arose in November 2018. In *In re CarrierEQ, Inc., d/b/a AirFox*, Securities Act Rel. No. 10575 (Nov. 16, 2018), the respondent ran an ICO to raise money for development of a browser and mobile data platform and an associated "ecosystem." Even though the terms of the ICO purported to require purchasers to agree that they were buying the tokens solely for their utility as a medium of exchange for mobile airtime on the system, and not as an investment or a security, the SEC asserted that these tokens were in fact "securities" under the *Howey* test and the DAO Report because purchasers reasonably expected they might obtain future profits from buying these tokens if the respondent was successful in its entrepreneurial and managerial efforts to develop its business. The SEC thus charged the respondents with selling unregistered securities in violations of §§5(a) and (c) of the Securities Act, and the respondents consented to the charges.

Similarly, *In re Paragon Coin*, Securities Act Rel. No. 10574 (Nov. 16, 2018), involved an online entity established to implement blockchain technology in the cannabis industry. While the respondent told potential purchasers that they would be able to use tokens to buy goods or services in the future after it created an "ecosystem" of various cannabis industry operations and services, no one was able to buy any good or service before or during the offering other than by pre-ordering merchandise, during which time the respondent was touting why the value of the tokens should be expected to rise over time. Because the ICO white paper made clear that increased token value would depend on the efforts and success of others who were developing the respondent's "ecosystem," the SEC charged that the token was an unregistered security under the *Howey* test and that the respondent was selling unregistered securities in violations of §§5(a) and (c) of the Securities Act. Here too, the respondent consented to the charges.

The SEC also targeted celebrity endorsers of cryptocurrency ventures. In *In re Floyd Mayweather Jr.*, Securities Act Rel. No. 10578 (Nov. 29, 2018), and *In re Khaled Khaled*, Securities Act Rel. 10579 (Nov. 29, 2018), boxing champion Floyd Mayweather Jr. and hip-hop music producer and rapper DJ Khaled accepted SEC sanctions for violating §17(b) of the Securities Act for promoting on Instagram, Twitter and Facebook social media accounts various ICOs for tokens that the SEC charged were securities, without disclosing that they had received compensation from the issuers for doing so.

Smart Contract as an Unregistered Securities Exchange

Perhaps the most intriguing of the recent SEC enforcement actions is *In re Zachary Coburn*, Exchange Act Rel. No. 84553 (Nov. 8, 2018), where the respondent's "EtherDelta" online

platform allowed buyers and sellers to trade certain digital assets in secondary market trading. The EtherDelta website had features similar to online securities trading platforms. EtherDelta's business operations were defined and executed by EtherDelta's "smart contract" (a computerized transaction protocol that executes terms of a contract) that ran on the Ethereum Blockchain. The EtherDelta smart contract consisted of coded functions that allowed for trading of its tokens at specified prices.

The SEC charged (and the respondent agreed) that the respondent's tokens were "securities," and as a result its smart contract platform constituted an "exchange" under §3(a)(1) of the Exchange Act and Rule 3b-16(a) thereunder. Rule 3b-16(a) uses a "functional test" that looks at whether the system "brings together the orders for securities of multiple buyers and sellers" and "uses established, non-discretionary methods" whereby "such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade." Because the EtherDelta smart contract's trading protocols had the sophistication to perform these functions, it was deemed to amount to an "exchange" within the meaning of the securities laws. The respondent was thus sanctioned for operating an unregistered exchange for the trading of securities in violation of §5 of the Exchange Act—an unhappy result that his trading platform was not "smart" enough to escape.

Conclusion

Because digital coins and tokens may be found in many instances to constitute "securities" under the *Howey* test, persons involved with such transactions need to be aware of the range of SEC enforcement actions they might face as a result, given the nature of their operations. As the SEC itself stated in its Nov. 16, 2018 "Statement on Digital Asset Securities Issuance and Trading" (issued the same day as its *CarrierEQ (AirFox)* and *Paragon Coin* settlements), it will apply "a functional approach" to assessing which securities statutes might be implicated, "regardless of how an entity may characterize either itself or the particular activities or technology used to provide the services." Moreover, the SEC noted, a violation does not mean that all is lost. It cited the particular remedies specified in the *CarrierEQ (AirFox)* and *Paragon Coin* settlements as demonstrating that "there is a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities."

It also bears noting that an SEC assertion that a cryptocurrency or digital token is a "security" under the *Howey* test is not immune to challenge. A stark example of this came from a judicial decision issued around the same time as these recent enforcement actions in *S.E.C. v. Blockvest*, No. 18CV2287-GPB(BLM), 2018 WL 6181408 (S.D. Cal. Nov. 27, 2018). There the court denied the SEC's request for a preliminary injunction in connection with an alleged unregistered ICO, concluding that because of stark "disputed issues of fact" as to what investors relied on "in terms of promotional materials, information, economic inducements or oral representations" in making their token purchases, and disputes about what investors' expectations were, the court was not able to conclude at a preliminary stage before discovery that the tokens were "securities" under the *Howey* test.

Nevertheless, the SEC has plainly intensified its enforcement efforts in this area. Persons involved in the selling and trading of digital tokens thus need to carefully scrutinize whether those tokens might constitute securities under the *Howey* test, lest the regulatory structure of the federal securities laws come into play over their activities.

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