

# Client Alert

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## Bad Advice and Blockchain-R-US: Stern Warnings from the SEC and CFTC Chairmen on Unregistered ICOs, Cashing In on “Crypto-Mania”

### INTRODUCTION

SEC Chairman Jay Clayton has issued a broad warning to companies and individuals trying to “cash in” on the market frenzy surrounding Bitcoin and other cryptocurrencies. His prepared remarks at the Securities Regulation Institute in Washington D.C. on January 22 suggest that the SEC’s Enforcement Division is focused on abusive actors in the cryptocurrency marketplace.<sup>1</sup> These remarks and similar recent remarks were followed on January 24 by a joint Op-Ed in the Wall Street Journal with CFTC Chairman J. Christopher Giancarlo promoting the same themes.<sup>2</sup>

In his speech, Chairman Clayton expressed concern that securities lawyers were giving bad advice when they tell clients that unregistered ICOs are generally legal. Clayton also cautioned issuers that it would be inappropriate if a company marketed itself in connection with cryptocurrencies or distributed ledger technology with the sole purpose of promoting its own securities. He warned that companies with no legitimate experience or expertise with cryptocurrencies or ICOs (“initial coin offerings”) cannot merely “cash in” by issuing a press release.

### GATEKEEPERS

Chairman Clayton’s first warning was for “gatekeepers” – the professionals such as bankers, accountants, and lawyers that help companies offer securities to the market. The SEC has recently been focused on such professionals – especially securities lawyers – that have enabled dishonest stock promoters to take advantage of retail investors.<sup>3</sup> The SEC recently has brought a number of actions against securities lawyers related to their role in more traditional offerings and the theories of liability used in those cases could be applied to lawyers providing advice in the ICO context.<sup>4</sup> Here, Clayton voiced his concern that securities lawyers were advising clients that cryptocurrencies are not securities and that no registration is required before selling them to the public. Clayton noted that “ICO” sounds similar to “IPO.”

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Chairman Clayton expressed further concerns regarding attorneys providing equivocal advice to ICO clients about whether the securities laws applied to their offerings. He observed that when clients receive advice along the lines of “it depends,” many are willing to accept the related risks and go forward. In his view, ICO promoters and their securities lawyers should be prepared to hear from SEC staff in situations where they rush into an ICO without ensuring adequate investor protections and disclosures.

These warnings followed two ICO-related actions the SEC brought in December. On December 4, 2017, the Commission announced an emergency action to stop the sale of tokens called PlexCoins by an alleged “recidivist securities law violator” in Canada.<sup>5</sup> A week later, on December 11, 2017, the commission published a negotiated order preventing Munchee, Inc. from issuing and selling new tokens to raise funds for its restaurant review app.<sup>6</sup>

## ISSUERS

Issuers were not spared in Chairman Clayton’s remarks. Some companies have reportedly changed names to suggest blockchain expertise or issued press releases touting new blockchain research initiatives or products, only to announce a new securities offering immediately thereafter. Chairman Clayton suggested the name “Blockchain-R-US” and said he doubted anyone in the audience would think this practice was acceptable.

This may have been a reference to a beverage company that recently changed its name from Long Island Iced Tea Corp. to Long Blockchain Corp.<sup>7</sup> The company announced plans to begin mining bitcoin and to sell new shares at more than double the market’s prior closing price. Soon after the announcement, Long Blockchain Corp. reversed course, and cancelled its plans for new stock sales (it is unknown whether this decision may have been influenced by SEC staff contacting the company). Kodak recently made headlines and saw its stock price triple when it announced a blockchain initiative to help photographers manage and sell rights in their own digital images.<sup>8</sup> Kodak also announced its own unregistered ICO under Regulation D to be marketed to accredited investors in limited countries, not to the general public.

## STRONGER REGULATION

A few days after his speech, Chairman Clayton joined with CFTC Chairman Giancarlo in authoring a Wall Street Journal Op-Ed with similar points of emphasis and concern.<sup>9</sup> Distributed ledger technologies have been lauded as a major advancement, but Clayton and Giancarlo argued such claims should be tested within the established investor-protection regimes created by their respective Commissions. They commented that in their view, there is no reason to exempt these technologies from scrutiny.

The article’s comments on the recent surge in Bitcoin’s price indicate a greater confidence from both regulators that the public is treating Bitcoin as an investment and that stronger investor protections should be seriously considered. The authors noted that:

- The largest cryptocurrency exchanges are offshore, unregulated by SEC/CFTC
- Cryptocurrencies lack “governance standards, accountability, and oversight”
- The pretense of Bitcoin as a payment vehicle has dissolved, and
- Bitcoin and other cryptocurrencies are now viewed as “investor assets”

Clayton and Giancarlo concluded that investor expectations are clear – the public purchases Bitcoin and other cryptocurrencies seeking a profit. This is important because an expectation of profit is one key factor of the *Howey* test, used by the SEC to identify securities under its jurisdiction.<sup>10</sup> This Op-Ed makes clear that both these Chairmen (and their respective Commissions) believe they have the legal authority and mandate to pursue more

protections for consumers in the cryptocurrency market. As such, market participants should expect continued enforcement activity and scrutiny from both the SEC and CFTC.

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*This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."*

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<sup>1</sup> Speech of SEC Chairman Jay Clayton, Opening Remarks at the Securities Regulation Institute (Jan. 22, 2017), *available at* <https://www.sec.gov/news/speech/speech-clayton-012218>. The SEC's focus in this area is also demonstrated by the creation of the Cyber Unit in September 2017, whose new head echoed Chairman Clayton's remarks later at the same conference. Press Release, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), *available at* <https://www.sec.gov/news/press-release/2017-176>.

<sup>2</sup> Jay Clayton and J. Christopher Giancarlo, *Regulators are Looking at Cryptocurrency*, WALL ST. J. (Jan. 24, 2018) *available at* <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363>.

<sup>3</sup> Speech of SEC Commissioner Kara M. Stein, Keynote Address at Compliance Week 2014 (May 19, 2014), *available at* <https://www.sec.gov/news/speech/2104-spch051914kms>.

<sup>4</sup> Press Release, Lawyers Charged With Assisting a Microcap Fraud Scheme (Oct. 11, 2017), *available at* <https://www.sec.gov/news/press-release/2017-194>; Securities and Exchange Commission, Release No. 10215 (Sept. 16, 2016), <https://www.sec.gov/litigation/admin/2016/33-10215.pdf>.

<sup>5</sup> Complaint, Securities and Exchange Commission v. PlexCorps (a/k/a and d/b/a PlexCoin and Sidepay.Ca), Dominic Lacroix and Sabrina Paradis-Royer, No. cv 17-7007, 2017 WL 5988934 (E.D.N.Y. Dec. 1, 2017) *available at* <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-219.pdf>.

<sup>6</sup> Securities and Exchange Commission, Release No. 10445 (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

<sup>7</sup> Chuck Jones, *Kodak And Long Island Ice Tea Embracing Blockchain Is Just Like Dot Com In 1999. It Didn't End Well*, FORBES (Jan. 15, 2018) *available at* <https://www.forbes.com/sites/chuckjones/2018/01/15/kodak-and-long-island-ice-tea-embracing-blockchain-is-just-like-dot-com-in-1999-it-didnt-end-well/>.

<sup>8</sup> Cory Johnson and Olga Kharif, *Kodak CEO Plans to Seize Blockchain Moment and Win Over Skeptics*, BLOOMBERG (Jan. 12, 2018) *available at* <https://www.bloomberg.com/news/articles/2018-01-12/kodak-ceo-plans-to-seize-blockchain-moment-and-win-over-skeptics>.

<sup>9</sup> Echoing Clayton's speech, this included an extended warning to gatekeepers such as "lawyers, trading venues, and financial services firms."

<sup>10</sup> An investment contract, which is one type of security, is any investment of money from an expectation of profits arising from a common enterprise depending solely on the efforts of a promoter or third party. *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).