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The Next Shoe Drops: SEC Makes Clear Crypto Exchanges Must Register

The Securities and Exchange Commission (SEC) took an important step yesterday in its steady march of enforcement actions involving digital assets. On November 8, 2018, the SEC announced that Zachary Coburn, the founder of crypto token exchange EtherDelta, agreed to settle charges that he “should have known his actions would contribute to EtherDelta’s violations.” The problem from the SEC’s perspective was that EtherDelta met the criteria of an “exchange” under the federal securities laws, but it was neither registered nor exempt from registration.

Coburn continues a series of SEC enforcement actions during the past year that have gradually highlighted the variety of federal securities laws that come into play around crypto tokens deemed to be securities. At this point, the SEC has brought enforcement actions in cases involving unregistered crypto token issuers,¹ unregistered broker-dealers,² unregistered investment companies,³ and now unregistered exchanges, among others. The DAO Report,⁴ it now appears, and as anticipated by many, was just the beginning.

PRIOR ACTIONS AGAINST CRYPTO EXCHANGES

While the case announced yesterday is likely to be viewed as establishing the SEC’s position on unregistered exchanges, it is actually not the first SEC enforcement action against an unregistered cryptocurrency exchange.

In December 2014, the SEC brought a case against BTC Trading, Corp. and its founder, which allegedly operated two unregistered, online stock exchanges, LTC-Global Virtual Stock Exchange and BTC Virtual Stock Exchange. The founder also allegedly offered unregistered shares for sale on the exchanges. According to the settled SEC order in that case, the founder worked cooperatively with SEC staff as soon as he was contacted and was able to wind down both exchanges in an orderly fashion. He paid penalties, disgorgement, and prejudgment interest totaling approximately \$68,000, and agreed to several industry-related bars.⁵



In February 2018, the SEC also filed a federal lawsuit in the Southern District of New York against Bitfunder and its founder, claiming violations of registration rules as well as the securities laws anti-fraud provisions. According to the complaint, BitFunder allegedly operated as an unregistered online securities exchange and defrauded exchange users by misappropriating their bitcoins and failing to disclose a cyberattack. The SEC's charges included the sale of unregistered securities (called Ukyo.Loan) that purported to be investments in the exchange itself.⁶

Those two earlier cases may not have clearly defined the SEC's position on crypto token exchange registration, however, due to their particular facts. The BTC Trading case preceded the DAO Report, in which the SEC declared that it viewed DAO tokens as securities. And the BitFunder case involved several other dimensions, including the fact that the founder was ultimately arrested and charged criminally with perjury and obstruction of justice during the SEC's investigation.⁷ In contrast, the EtherDelta case seems to more clearly provide guidance on what the SEC expects from exchanges that list tokens the SEC views as securities.

Coburn is the first case involving a digital asset exchange since the SEC's Divisions of Enforcement and Trading and Markets issued joint guidance in March 2018 that addressed, at a high level, how securities laws apply to token platforms. That guidance stated, "If a platform offers trading of digital assets that are securities and operates as an 'exchange,' as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration."⁸

SIGNS OF A METHODOICAL APPROACH

Within the crypto community, there has been concern, on the one hand, that the SEC might soon bring dozens – or even hundreds – of enforcement actions against the many companies that received subpoenas or document requests during the past year. Although the wave may come, *Coburn* seems to illustrate the more measured approach that SEC Enforcement Co-Director Stephanie Avakian described as part of some crypto-related comments in a September 20, 2018 speech: "We have tried to strike the balance by being proactive and working collaboratively with experts both within the agency and outside of it. ... We are very focused on considering – at the outset – whether and why pursuing a particular matter is a good use of our resources."⁹

This case is reflective of that commentary and provides a good illustration of when, and how, the SEC will use its resources. After what the SEC describes as prompt remedial actions, cooperation, and helping the SEC Enforcement Staff investigate an emerging technology, *Coburn* settled (without admitting or denying the SEC's findings) by paying \$388,000 in disgorgement, pre-judgment interest, and penalty, and agreeing to cease and desist from committing or causing any future violations of the statute prohibiting transactions on unregistered exchanges.¹⁰ The SEC found that *Coburn* caused the violation and charged him personally, even though in late 2017 he had sold EtherDelta to foreign buyers and stopped collecting fees from platform users.

A STEP BEYOND "GARDEN VARIETY FRAUD"

Another observation within the crypto community in recent months is that many of the enforcement actions the SEC has taken during the past year have been against clear frauds. This is a point that Co-Director Avakian also acknowledged in her September 20, 2018 speech, stating, "We have tried to be thoughtful about how to handle ICO registration cases that do not involve fraud. We want to recognize legitimate efforts to use new methods to raise capital, but we also want to make sure investors receive the information, and protection, they are entitled to under our laws."¹¹

Notably, the SEC did not allege that *Coburn* committed fraud, or even that he knew he was violating the law. For anyone who speculated that the SEC would pursue only fraud cases in the token world, this case demonstrates otherwise.



FOCUS ON INDIVIDUALS APPLIES TO CRYPTO CASES

In recent years, and even in last month's Fiscal 2018 Enforcement Highlights, the SEC has emphasized its efforts to hold individuals accountable and not just to bring enforcement actions against companies. The *Coburn* case shows that this effort applies to cases involving digital assets. That is perhaps particularly important in this market, given the aim of many crypto firms to "decentralize" various aspects of fundraising and financial services. In this situation, the SEC found that Coburn shouldered responsibility for causing the registration violations, noting that he "wrote and deployed the EtherDelta smart contract to the Ethereum Blockchain, and exercised complete and sole control over EtherDelta's operations."

Section 21C of the Exchange Act of 1934 allows the SEC to bring administrative charges against individuals who knew or should have known that their actions (or failures to act) would contribute to the underlying violation. The SEC noted in its settled order that Coburn previously spent nearly five years as a registered representative with an SEC registered broker-dealer. We suspect the staff viewed that as one reason that Coburn "should have known" his work on EtherDelta would cause a securities law violation.

THE SEC IS FOCUSED ON INITIAL COIN OFFERINGS AND TOKENS

The SEC's sophisticated and detailed description of the EtherDelta smart contract, which runs on the Ethereum Blockchain, probably reflects some of the cooperation for which Coburn was credited in the settlement. The 31-year old Coburn almost certainly learned a lot from this experience across from the SEC. But the SEC staff obviously has become fluent in this material, which is a credit to the Cyber Unit that is barely a year old.¹²

Even so, anyone hoping to find out which of EtherDelta's approximately 500 official token listings were deemed by the SEC to be securities will be disappointed. The SEC merely found that the tokens "included securities as defined by Section 3(a)(10) of the Exchange Act." The SEC explained that "The purchasers of such digital tokens invested money with a reasonable expectation of profits, including through the increased value of their investments in secondary trading, based on the managerial efforts of others," citing sources including the United States Supreme Court's 1946 decision in *SEC v. W. J. Howey Co.*¹³ But there is no list specifying which tokens fit this definition, and no list of any tokens that may not have fit the definition. Maybe that will be the next shoe to drop.

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- ¹ Complaint, *SEC v. REcoin Group Foundation, LLC*, No. 17-5725 (S.D.N.Y. Sept. 29, 2017), <https://www.sec.gov/litigation/litreleases/2018/lr24081.htm>. *In the Matter of Munchee Inc.*, SEC Admin Proc. File No. 3-18304 (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.
- ² *In the Matter of Tokenlot, LLC, et. al*, SEC Admin. Proc. File No. 3-18739 (Sept. 11, 2018), <https://www.sec.gov/litigation/admin/2018/33-10543.pdf>.
- ³ *In the Matter of Crypto Asset Management, LP*, SEC Admin. Proc. File No. 3-18740 (Sept. 11, 2018), <https://www.sec.gov/litigation/admin/2018/33-10544.pdf>.
- ⁴ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 with respect to the DAO token, SEC Rel. No. 81207 (Jul. 25, 2017) (“DAO Report”), <https://www.sec.gov/litigation/investreport/34-81207.pdf>.
- ⁵ *In the Matter of BTC Trading, Corp.*, SEC Admin Proc. File No. 3-16307 (Dec. 8, 2014), <https://www.sec.gov/news/press-release/2014-273>.
- ⁶ Complaint, *SEC v. Montroll*, No. 1:18-cv-01582 (S.D.N.Y., Feb. 21, 2018), <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-23.pdf>.
- ⁷ Complaint, *U.S. v. Montroll*, No. 18-mag-1372 (S.D.N.Y. Feb. 20, 2018), <https://www.justice.gov/usao-sdny/press-release/file/1037116/download>.
- ⁸ Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, Divisions of Enforcement and Trading and Markets (Mar. 7, 2018), <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.
- ⁹ Co-Director Stephanie Avakian, Division of Enforcement, Measuring the Impact of the SEC’s Enforcement Program (Sept. 20, 2018), <https://www.sec.gov/news/speech/speech-avakian-092018>.
- ¹⁰ Securities Exchange Act of 1934, Section 5.
- ¹¹ Co-Director Stephanie Avakian, Division of Enforcement, Measuring the Impact of the SEC’s Enforcement Program (Sept. 20, 2018), <https://www.sec.gov/news/speech/speech-avakian-092018>.
- ¹² Press Release, Securities and Exchange Commission, 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>.
- ¹³ 328 U.S. 293 (1946).