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Client Alert

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Recent SEC Settlements Reveal a Roadmap for Resolving Investigations of Unregistered Initial Coin Offerings

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Since at least July 2017, when the Securities and Exchange Commission (SEC) announced it expected initial coin offerings (ICOs) to either register under U.S. securities laws or qualify for an exemption, crypto-market participants have worried about what action the SEC might take regarding the thousands of ICOs that raised billions of dollars' worth of value, but that neither registered with the SEC nor qualified for an exemption. Two settlements announced on November 16, 2018 go a long way toward providing greater clarity.

Issuers CarrierEQ Inc. (AirFox) and Paragon Coin Inc. each agreed, without admitting or denying the SEC's findings, to a settlement that included (1) compensating token purchasers, (2) registering their tokens as securities, (3) filing periodic reports with the Commission, and (4) paying $250,000 in civil monetary penalties.[1] These are the first cases in which the SEC has imposed civil penalties solely for an ICO's failure to register absent other alleged wrongdoing.[2]

The compensation and registration requirements included in these settlements are likely to be key remedial aspects of any settlement resolving ongoing and future investigations of unregistered ICOs. And settlements like these may start coming at a faster clip, now that the Commission appears to have established a framework for sanctioning completed ICOs that were unregistered and did not qualify for an exemption, but that were not accompanied by more egregious conduct. The roadmap embodied in the *AirFox* and *Paragon* settlements also guides companies that want to comply proactively with federal securities laws in cleaning their own houses and emerging from regulatory uncertainty.

AIRFOX AND PARAGON ICOs

Both AirFox and Paragon conducted ICOs in 2017 after the Commission had already warned in the DAO Report (and oft-repeated thereafter) that tokens issued through ICOs can be securities.[3]

AirFox, a Boston-based cryptocurrency startup, raised approximately $15 million worth of digital assets to finance its development of a token-denominated "ecosystem" starting with a mobile application that would allow the exchange of tokens for data through advertisement interaction in emerging markets. According to the SEC's order announcing the settlement, AirFox advertised its forthcoming offering by posting a whitepaper on its website and providing additional information in blog posts, social media posts, online videos, and discussion boards. The SEC's order noted that the terms of AirFox's ICO "purported to require purchasers to agree that they were buying 'AirTokens' for their utility as a medium of exchange for mobile airtime, and not as an investment or a security."[4] According to the SEC, however, the tokens did not truly have that functionality at the time of the ICO, and investors instead purchased the AirTokens in anticipation that the tokens' value would rise based on AirFox's "future managerial and entrepreneurial efforts." This point is important, in part, because of the common assertion within the crypto community that a particular token's essence is more akin to a utility for commercial transactions, rather than a security for trading. With AirFox, the SEC was unconvinced.[5]

Paragon, an online entity, raised approximately $12 million, via its ICO of digital assets, to develop and implement its business plan to add blockchain technology to the cannabis industry and to work toward its legalization. Paragon announced the ICO—which it termed an "initial token crowdsale"—through a white paper on its website and marketed the ICO on various social media platforms. The SEC's order noted that Paragon described how the "PRG tokens" offered in the ICO would increase in value as a result of Paragon's efforts, including the actual creation of their "ecosystem." Paragon also reportedly stated that it would "ensure a secondary trading market for PRG tokens would be available shortly after the completion of the offering and prior to the creation of the 'ecosystem.'"[6]

Neither AirFox nor Paragon registered their respective ICOs pursuant to federal securities laws and, according to the SEC, neither qualified for an exemption.[7] The SEC's Order states that Paragon did not even attempt to qualify.

The SEC concluded that both offerings met the definition of a security as an "investment contract" under Section 2(a)(1) of the Securities Act,[8] and therefore both violated Sections 5(a) and 5(c) the Securities Act of 1933. By resolving these cases with the imposition of a novel set of "undertakings" agreed to in the settlements, a path forward is revealed.

LESS THAN FULSOME ATTEMPTS AT PURSUING AN EXEMPTION MAY BE INSUFFICIENT

As is often the case in SEC settlement orders, the SEC offered its view in the *AirFox* and *Paragon* orders regarding why the securities law registration requirements applied. While these two orders contain standard language stating that they are "not binding on any other person or entity in this or any other proceeding," their guidance should nonetheless be heeded as an indication of the Commission's thinking more broadly.

Reading the two orders together to better understand their significance, the Commission appears to convey a view that, absent registration, merely attempting to qualify for an exemption may be insufficient to escape the SEC's focus. The *Paragon* order observes that Paragon neither registered "nor did it *attempt to qualify* for an exemption." In contrast, the *AirFox* order notes that AirFox conducted its ICO without "*qualifying* for exemption."[9] The differing language suggests that AirFox attempted to qualify for an exemption, at least to some extent, but their efforts were insufficient to avoid SEC action. Note that the orders frame the securities laws as requiring that an issuer actually qualify for an exemption.

The exemptions for securities laws' registration requirements do not formally give points for trying to comply with them. With that said, efforts to do so may help show good intentions, and that could help convince SEC Enforcement staff that fraud-related charges are not warranted or that less severe penalties shall be imposed. Issuers may therefore want to

look back at any steps taken in good faith to qualify for an exemption. While the time to qualify for an exemption is when the tokens were first offered, and retroactive exemptions are not available, efforts taken, even now, to confirm and document the qualifications for an exemption may smooth any future discussions with the SEC Enforcement staff.

A ROADMAP FOR POTENTIAL FUTURE SETTLEMENTS

An extraordinary joint statement also issued on November 16 by the SEC's Divisions of Corporation Finance, Investment Management, and Trading and Markets on "Digital Asset Securities Issuance and Trading" serves to underscore the significance of recent crypto-related enforcement actions. Notably, the statement reiterates that "market participants must still adhere to [the SEC's] well-established and well-functioning federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain."[10]

The statement recognized the *AirFox* and *Paragon* 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." To the extent issuers might be concerned that refunding funds to token purchasers could be viewed by the SEC as conducting a separate offering, the settlements and joint statement should provide comfort. This "path to compliance" comprises a set of remedial "undertakings" set forth in both *AirFox* and *Paragon* that requires (1) posting the SEC's press release and the respective order on their web site, (2) distributing a notice to each ICO purchaser informing them of their right to be reimbursed for their original purchase (or to sue for recovery or damages if they no longer own the tokens), (3) offering (and paying) reimbursements for claims filed over a three-month period, (4) filing monthly reports to the SEC about the claims, and (5) filing a final report after seven months.

Additionally, as part of the settlements, AirFox and Paragon agreed to register their tokens as securities under Section 12(g) of the Securities Exchange Act of 1934. They are also required to submit certain securities filings with the SEC for at least one year, and until they become eligible for terminating the registration pursuant to Exchange Act Rule 12g-4, which applies when the number of investors who own a class of securities dwindles below certain thresholds.[11]

The joint statement explained that these undertakings are designed to ensure that token holders receive "the type of information they would have received had these issuers complied with the registration provisions" prior to their ICOs. The statement continues that the ongoing disclosure obligations aim to equip the ICO investors with information "to make a more informed decision as to whether to seek reimbursement or continue to hold their tokens."[12]

CONCLUSION

The *AirFox* and *Paragon* settlements follow a steady drumbeat in crypto-related enforcement actions during the past 16 months, starting with the SEC's release of the "DAO Report," which asserted that tokens issued in an ICO can be securities, and therefore subject to existing securities laws.[13] The SEC followed the DAO Report with waves of public guidance, including through Commissioner speeches and staff guidance, stating that the Commission considered most (if not all) crypto tokens to be securities. A series of enforcement actions also followed. Until these two new settlements were announced, however, none had levied civil penalties based solely on an ICO's failure to register.

Now that a new remedial framework has been used for the first time in the *AirFox* and *Paragon* matters, the SEC appears prepared to negotiate similar settlements with other issuers who conducted ICOs without formally complying with securities registration (or exemption) requirements, absent other misconduct. Each resolution will of course be fact-specific, and the settlements will reflect any differing circumstances, but a viable path forward has been revealed. Given the number of unregistered ICOs thus far unaddressed by the SEC (at least publicly), it is possible a wave of similar settlements could very well be on the horizon.

Even, if the SEC has not yet come knocking, any issuer that sold tokens through an ICO after the DAO Report was released without either registering the tokens or qualifying for an exemption would be well-advised to study the *AirFox* and *Paragon* settlements and consider proactively using the guidance they offer. With the SEC's substantive divisions joining with the Commission itself to shine a light on this path forward, all signs point to the SEC and its staff wanting to guide the digital asset community toward capital-raising activities that comply with existing securities laws.

[1] Press Release, Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities, SEC (Nov. 16, 2018), available at https://www.sec.gov/news/press-release/2018-264.
[2] In December 2017, the SEC instituted an administrative action against blockchain-based food review service Munchee, Inc., in its first non-fraud ICO registration case. The SEC did not, however, impose any civil penalties on Munchee. Instead, while the ICO was still underway, the SEC filed a cease-and-desist order to which Munchee consented. As a result, Munchee halted its ICO before it delivered any tokens, and promptly returned proceeds to investors. *In the Matter of Munchee, Inc.*, SEC Admin Proc. File No. 3-18304 (Dec. 11, 2017), available at https://www.sec.gov/litigation/admin/2017/33-10445.pdf.
[3] The SEC staked out this position in what has become known colloquially as the DAO Report. 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"), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.
[4] *In the Matter of CarrierEQ, Inc., D/B/A AirFox*, SEC Admin Proc. File No. 3-18898 (Nov. 16, 2018), available at https://www.sec.gov/litigation/admin/2018/33-10575.pdf.
[5] The SEC had already challenged the "utility token" line of arguments. For example, on December 11, 2017, SEC Chairman Jay Clayton issued a public warning to investors about ICOs and the risks of investing in cryptocurrencies. Clayton noted that "calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security." Chairman Clayton's Statement is available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.
[6] *In the Matter of Paragon Coin, Inc.*, SEC Admin Proc. File No. 3-18897 (Nov. 16, 2018), available at https://www.sec.gov/litigation/admin/2018/33-10574.pdf.
[7] Press Release, Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities, SEC (Nov. 16, 2018), available at https://www.sec.gov/news/press-release/2018-264.
[8] *See* 15 U.S.C. § 77b. An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *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).
[9] Compare *In the Matter of Paragon Coin, Inc.*, SEC Admin Proc. File No. 3-18897 (Nov. 16, 2018) to *In the Matter of CarrierEQ, Inc., D/B/A AirFox*, SEC Admin Proc. File No. 3-18898 (Nov. 16, 2018)(emphasis added).
[10] Public Statement, "Statement on Digital Asset Securities Issuance and Trading" (Nov. 16, 2018), available at https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

[11] *See In the Matter of Paragon Coin, Inc.*, SEC Admin Proc. File No. 3-18897 (Nov. 16, 2018); *see also In the Matter of CarrierEQ, Inc., D/B/A AirFox*, SEC Admin Proc. File No. 3-18898 (Nov. 16, 2018)(emphasis added).
[12] Public Statement, "Statement on Digital Asset Securities Issuance and Trading" (Nov. 16, 2018), available at https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.
[13] 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"), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.