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Company Halts “Initial Coin Offering” After SEC Issues Cease-and-Desist Order; SEC Chairman Issues Statement on Blockchain-Based Offerings

Without Alleging Fraud, SEC Order Finds That Company’s Token Sale Was an Unregistered Public Securities Offering; SEC Chairman Jay Clayton Cautions on Initial Coin Offerings and Cryptocurrencies, While Noting Possibility of Valid Private Placements and Non-Security Tokens

SUMMARY

On December 11, 2017, the SEC issued an order against Munchee Inc. finding that the California-based company’s marketing of digital “utility tokens” to raise capital for its blockchain-based food review service constituted unlawfully unregistered offers and sales of securities. The SEC found that: (1) Munchee was planning to take steps to increase the value of the tokens; and (2) purchasers of the tokens had a reasonable expectation of obtaining future profits from the efforts of Munchee and its agents. Accordingly, the SEC found that the tokens were securities, and the offering and sale of the tokens was subject to the Securities Act of 1933.

On the same day, SEC Chairman Jay Clayton released a public statement addressing cryptocurrencies and initial coin offerings. The statement cautioned both market professionals and investors and reiterated the SEC’s focus on the application of U.S. federal securities laws to blockchain-based offerings and products, including secondary trading. The statement also noted the possibilities of legally compliant private placements of tokens, tokens that are not securities and other avenues by which

blockchain-based investment and trading might be conducted lawfully, suggesting a goal of regulating rather than eliminating these growing digital markets.

BACKGROUND

The SEC's action against Munchee Inc. ("Munchee")¹ highlights the focus of the U.S. Securities and Exchange Commission (the "SEC") on "initial coin offerings" ("ICOs")² and on the question of whether "tokens" offered and sold in ICOs are securities under the U.S. federal securities laws.

The SEC's "DAO Report" of July 2017 announced the SEC's view that many tokens are securities.³ In November, Chairman Clayton was quoted by several media outlets as having said that he had "yet to see an ICO that does not have a sufficient number of hallmarks of a security."⁴ The clear implication was that many of these ICOs had been conducted unlawfully, as many ICOs have been offered publicly, yet none has been registered under the U.S. Securities Act of 1933 (the "Securities Act"), as a public offering and sale of securities in the United States generally must be.

The SEC has brought several prior enforcement actions relating to ICOs. However, each of these previous enforcement actions alleged plainly fraudulent schemes, including one that promised a 13-fold return in a month's time.⁵ The Munchee Order, by contrast, is notable in part for the fact that the SEC makes no allegation that the offering involved fraud.

Munchee's tokens (called "MUN" tokens) were "utility tokens," said to represent a right to use or access Munchee's services, rather than an equity, debt or other interest in Munchee itself or any Munchee assets

¹ *Munchee Inc.*, SEC Securities Act Release No. 10445, File No. 3-18304 (Dec. 11, 2017) (the "Munchee Order").

² An ICO is a capital-raising event in which an entity issues digital tokens to purchasers in exchange for a contribution of value in the form of either fiat currency or other digital currencies or tokens. The terms of the tokens are typically described in various promotional materials that may include, among other things, informational posts on the entity's website and an informational "white paper" document.

³ *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, SEC Release No. 81207 (July 25, 2017) (the "DAO Report," concluding that the DAO tokens, a digital asset, were securities).

⁴ Dave Michaels and Paul Vigna, *SEC Chief Fires Warning Shot Against Coin Offerings*, Wall Street J., Nov. 9, 2017, <https://www.wsj.com/articles/sec-chief-fires-warning-shot-against-coin-offerings-1510247148>.

⁵ See the SEC complaint filed on Sept. 29, 2017, against Recoin Group Foundation, LLC, DRC World Inc. a/k/a/ Diamond Reserve Club and Maksim Zaslavskiy, alleging that a businessman and two companies defrauded investors in a pair of ICOs purportedly backed by investments in real estate and diamonds; and the SEC complaint filed on Dec. 1, 2017, against Plexcorps (a/k/a and d/b/a Plexcoin and Sidepay.Ca), Dominic Lacroix and Sabrina Paradis-Royer, halting an ICO-based fraud that had raised up to \$15 million from thousands of investors since August by falsely promising a 13-fold return in less than a month's time.

or income stream. The MUN tokens would allow holders to purchase goods or services that Munchee intended to offer or facilitate:

Munchee was seeking \$15 million in capital to improve an existing iPhone app centered on restaurant meal reviews and create an “ecosystem” in which Munchee and others would buy and sell goods and services using the tokens. The company communicated through its website, a white paper, and other means that it would use the proceeds to create the ecosystem, including eventually paying users in tokens for writing food reviews and selling both advertising to restaurants and ‘in-app’ purchases to app users in exchange for tokens.⁶

Munchee’s white paper (the “MUN White Paper”) stated Munchee’s view that “as currently designed, the sale of MUN utility tokens does not pose a significant risk of implicating federal securities laws,” although the SEC found that Munchee offered no support for that claim.⁷

SEC FINDINGS IN THE MUNCHEE ORDER

Under the U.S. Supreme Court’s holding in *Howey*, a security under U.S. federal securities laws includes an “investment contract,” defined as “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.”⁸

The Munchee Order made several factual findings relevant to the SEC’s conclusion that the MUN tokens met this definition of an investment contract:⁹

- Munchee offered MUN tokens to raise capital to build a profitable enterprise.
- While Munchee told potential purchasers they would be able to use MUN tokens to buy goods or services in the future after Munchee created an “ecosystem,” no one was able to buy any good or service with MUN tokens throughout the relevant period.¹⁰
- On the Munchee website and in the MUN White Paper, Munchee described several ways in which token holders could use the MUN tokens within the Munchee ecosystem and indicated that “[a]s a result, MUN tokens would increase in value[.]”¹¹
- In the MUN White Paper, on the Munchee website, in public appearances and elsewhere, Munchee and its agents primed purchasers to expect a profit from its token offering. These included statements and endorsements of others’ statements that the MUN tokens would increase in value

⁶ SEC Press Release 2017-227, Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017), available at <https://www.sec.gov/news/press-release/2017-227>.

⁷ See Munchee Order at 3-4.

⁸ *Id.* at 8.

⁹ See *id.* at 4-6.

¹⁰ The Munchee Order added that, even if MUN tokens had had a practical use at the time of the offering, that fact would not have precluded the token from being a security. *Id.* at 9.

¹¹ *Id.* at 4.

and that purchasers would receive a return by participating in the offering. Munchee specifically targeted the cryptocurrency-investing community, not its app users or the restaurant industry, by promoting the tokens in forums where prospective digital asset investors gather and paying others in MUN tokens to publish promotional materials in those forums.

- Munchee intended that the MUN tokens would trade in a secondary market. The MUN White Paper stated that Munchee intended to buy or sell MUN tokens using its retained holdings in order to ensure a liquid secondary market in MUN tokens.
- Purchasers had a reasonable expectation that, in buying MUN tokens, they would obtain a future profit derived from the entrepreneurial and managerial efforts of Munchee to develop its business.

REGISTRATION AND OFFERING VIOLATIONS

Having concluded that the MUN token was a security, the SEC found that Munchee violated Sections 5(a) and 5(c) of the Securities Act by offering and selling the MUN tokens to the general public, including potential U.S. investors, without registering the securities or complying with an exemption from the registration requirement.¹² Because Munchee agreed to return all money to purchasers and cooperated with the SEC, the SEC did not impose any civil penalty or other sanction (beyond the cease-and-desist provisions of the Munchee Order) on Munchee or any of the individuals involved.

STATEMENT BY CHAIRMAN CLAYTON

On the same day that the Munchee Order was issued, Chairman Clayton released a statement entitled “Statement on Cryptocurrencies and Initial Coin Offerings.”¹³ The Statement is not formal SEC guidance or a statement of the Commission, but is instead an informal statement by the Chairman addressed to both “Main Street” investors and securities market professionals (e.g., broker-dealers, investment advisers, exchanges and lawyers).¹⁴ In the Statement, Chairman Clayton cautioned against investing in cryptocurrencies or ICOs without making adequate inquiry into the specifics of an offering. He further called on market professionals to focus on “the protection of our Main Street investors” when exercising their expertise and judgment in their involvement with ICOs or cryptocurrencies:

[A]ny such activity that involves an offering of securities must be accompanied by the important disclosures, processes and other investor protections that our securities laws require [R]eplacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance. . . .

¹² *Id.* at 10. Munchee actually sold MUN tokens to about 40 investors.

¹³ Public Statement, SEC Chairman Jay Clayton Statement on Cryptocurrencies and Initial Coin Offerings, SEC (Dec. 11, 2017), available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11> (the “Statement”).

¹⁴ *Id.*

Merely calling a token a “utility” token or structuring it to provide some utility does not prevent the token from being a security.¹⁵

Chairman Clayton noted: “By and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities.”¹⁶ He concluded, “I have asked the SEC’s Division of Enforcement to continue to police this area vigorously.”¹⁷ Yet the Statement also acknowledged that “[i]t is possible to conduct an ICO without triggering the SEC’s registration requirements,” giving the example of a private placement exempt from registration under Regulation D under the Securities Act.¹⁸ The Statement also affirmed the prospect of a token that is *not* a security:

For example, *a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws*, and may well be an efficient way for the club’s operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens.¹⁹

OBSERVATIONS

- The Munchie Order, which focuses on the issuer’s failure to provide investors with the required protections of the securities laws, follows logically from earlier crackdowns on fraudulent ICOs. After recent statements of SEC Commissioners and Staff, many observers were expecting just such an enforcement action. At the same time, one might argue that the offering of the MUN tokens was not a particularly close call given the promoters’ emphasis on investment profit and trading markets associated with the tokens. Thus, practitioners and market participants should continue to engage in detailed “facts and circumstances” analysis in connection with any ICO or similar activity.
- Similarly, the “book-of-the-month club” remark—beyond being notable for suggesting that not all tokens are necessarily securities—seems likely to inspire many promoters of ICOs to reason by analogy that they are more like the “book-of-the-month club” than the “publishing house.” Exactly how to apply this analogy to the facts of a particular ICO will likely be subject to vigorous debate, especially given that many structures fall naturally somewhere between the two extremes.
- A compliant private placement is likely a far more plausible alternative than a registered public offering for most ICOs, and the Statement’s validation of this approach is helpful. At the same time, private placements traditionally involve restrictions on publicity, investor qualifications and resales that may require adaptation to the ICO context and may in some cases decrease the appeal of an ICO as a means of raising capital expediently.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* at n.4.

¹⁹ *Id.* (emphasis added).

- The Statement's references to broker-dealers, investment advisers and exchanges should be construed as a reminder that the Securities Act is not the only U.S. federal securities law that requires consideration in the ICO context. If a token is a security, then dealing in it, structuring a transaction in it, advising on purchasing it, or operating an exchange on which it may be traded may all fall under the SEC's jurisdiction under other statutes.
- The Statement avers that while "[i]t has been asserted that cryptocurrencies are not securities . . . [w]hether that assertion proves correct with respect to any digital asset that is labeled as a cryptocurrency will depend on the characteristics and use of that particular asset."²⁰ On the other hand, the Statement also says: "The CFTC has designated bitcoin as a commodity. Fraud and manipulation involving bitcoin traded in interstate commerce are appropriately within the purview of the CFTC, as is the regulation of commodity futures tied directly to bitcoin."²¹ These passages can be read together to offer at least tacit support to the view that bitcoin, in particular, is not a security.
- Overall, Chairman Clayton has made clear that investor protection remains the lens through which the SEC will scrutinize the markets for cryptocurrencies, tokens and other digital assets.

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²⁰ *Id.*

²¹ *Id.* at n.2.

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