SULLIVAN & CROMWELL LLP

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SEC Statement on Securities Law Considerations for Digital Asset Securities

Reiterates That ICO Tokens and Other Digital Asset Securities May Raise Issues Under Not Only the Securities Act But Also the Exchange Act, Investment Company Act and Investment Advisers Act; Notes Remedies of Rescission Rights and Forced Public Company Reporting

SUMMARY

On November 16, 2018, the Divisions of Corporation Finance, Investment Management and Trading and Markets of the Securities and Exchange Commission published a statement reviewing many of the SEC's recent enforcement actions, statements and other guidance regarding the issuance of and trading and investment in digital asset securities. The Divisions emphasized that while technological innovations that benefit investors are encouraged, market participants must still adhere to federal securities laws, regardless of whether the securities at issue are issued in certificated form or using new technologies. Among other topics, the Statement outlined a "path to compliance" for tokens that were issued in unlawfully unregistered initial coin offerings ("ICOs"), including notifying investors of potential rescission rights and promptly complying with public-company reporting requirements. The Statement also reiterates that digital asset securities, and businesses involving them, may raise concerns under U.S. investment company and investment adviser laws, and considers the circumstances under which platforms or firms offering the ability to trade digital asset securities in the secondary market may implicate securities exchange or broker-dealer registration requirements. The Divisions specifically encouraged "those employing new technologies [to] consult with legal counsel concerning the application of the federal securities laws and contact [SEC] staff, as necessary, for assistance."

PATH TO COMPLIANCE FOR INITIAL COIN OFFERINGS

Discussing the offering and sale of digital assets that are securities ("digital asset securities"), the Statement[1] highlighted the focus that the Divisions of Corporation Finance, Investment Management and Trading and Markets (the "Divisions") have placed on providing consistent guidance to market participants regarding the threshold question of when a digital asset is a "security" for purposes of the federal securities laws.[2] For example, in recent enforcement actions, as well as in remarks by Chairman Jay Clayton in December 2017,[3] the Securities and Exchange Commission (the "SEC") has emphasized that digital assets offered and sold as investment contracts (regardless of the terminology or technology used in the transaction) may be securities if "the value received for the digital asset is invested with an expectation of profit derived from the efforts of others" or "the digital asset is sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others."[4]

In the Statement, the Divisions reviewed the SEC's recent enforcement actions against AirFox and Paragon in connection with their unregistered offerings of digital tokens[5] and noted that the remedies imposed by the SEC included:

- financial penalties;
- registration of the digital tokens as securities under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act");
- following completion of the registration process, providing notification to investors of their potential claims against the issuer under the Exchange Act and the means for pursuing those claims, and paying the claims within three months after the end of the claims period;
- compliance for at least one year with the periodic reporting requirements of the Exchange Act; and
- submission of reports to the SEC regarding claims received from investors, including the identity of the claimant and the disposition of the claims.

In particular, AirFox and Paragon agreed to compensate investors who purchased tokens in the illegal offerings by paying to them the amount they paid for the securities, with interest, after deducting any income, where the investor elects to make a claim. AirFox and Paragon make clear that digital securities which are being sold, promoted, marketed or are accessible to U.S. investors, particularly though the use of websites or other online media, remain an enforcement priority for the SEC. The Statement focused on the provision of disclosures designed to allow investors to inform themselves before determining to invest, and indicated that these remedies demonstrate a potential "path to compliance" with the federal securities laws for other issuers of digital tokens in unregistered offerings. Issuers of digital assets should note, however, that this path to compliance is a potentially onerous one. Specifically, William Hinman, Director of the Division of Corporation Finance, noted in recent remarks at a conference that the few dozen draft filings at the SEC in the digital asset space are moving slowly through the review process because of the complex issues they present. The challenges of registration include, among other things, generating audited financial statements for a decentralized entity, identifying suitable secondary market

trading facilities and SEC compliant post-trade infrastructure, and the implications of the specific securities law categorization of the digital asset (*i.e.*, as equity, debt, warrants, or otherwise). Separately, while many ICOs might be seeking to take the view that they were offered and conducted solely outside of the United States (and thus outside of the SEC's jurisdiction), the SEC has focused on the use of promotion efforts within the U.S. as well as the relative technological difficulty in keeping persons located in the U.S. from accessing a non-U.S. offering (using, for example, VPN services).

INVESTMENTS IN DIGITAL ASSET SECURITIES

With respect to investment vehicles investing in digital asset securities, the Statement emphasized that investment vehicles that hold digital asset securities and those who are in the business of advising others about investing in digital asset securities, including managers of investment vehicles, must be mindful of registration, regulatory and fiduciary obligations under the Investment Company Act of 1940 (the "Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act"). Illustrating the focus areas of the Divisions, the Statement pointed market participants to the SEC's recent enforcement order against Crypto Asset Management,[6] in which the SEC highlighted a series of securities law violations:

- the manager had engaged in the unlawful, unregistered, non-exempt, public offering of securities (*i.e.*, interests in the fund);
- by investing more than 40 percent of the fund's assets in digital asset securities and engaging in a public offering of interests in the fund, the manager caused the fund to operate unlawfully as an unregistered investment company; and
- because the fund's manager was an investment adviser, it was liable under the antifraud provisions of the Advisers Act for making misleading statements to investors in the fund.

The key takeaway from the Statement in this area is that the Division of Investment Management clearly expects full compliance with Investment Company Act and Advisers Act requirements, where applicable, by those entities that are forming, operating and advising investment vehicles that may invest in digital asset securities. Illustrating other areas where this concern might be relevant to these vehicles and their advisers, but without providing further clarification or guidance on the underlying issues, the Statement included a reference to the January 18, 2018 letter from the SEC Director of the Division of Investment Management to the Investment Company Institute and the Securities Industry and Financial Markets Association.[7] The letter, titled "Engaging on Fund Innovation and Cryptocurrency-related Holdings," identified several SEC requirements for investment funds that present unique challenges in the context of digital asset securities, including valuation, liquidity, custody, arbitrage (for exchange-traded funds), and potential manipulation and other risks. Each of these issues continue to present unresolved compliance challenges for investment funds, and the Divisions appear prepared and eager to engage with market participants in order to work through proposed solutions for fulfilling these requirements.

SECONDARY MARKET TRADING OF DIGITAL ASSET SECURITIES

Addressing the secondary market for trading in digital asset securities, the Divisions made clear in the Statement that their focus remains on determining whether and to what extent various activities of entities or platforms which provide services to issuers, investors or intermediaries engaged in transactions involving digital asset securities would require registration as a national securities exchange or would require registration as a broker-dealer under the federal securities laws.

1. Exchange Registration

Consistent with prior SEC guidance, the Divisions re-emphasized that any entity that meets the definition of "exchange" (as defined by the federal securities laws under Section 3(a)(1) of the Exchange Act and the functional test set forth in Exchange Act Rule 3b-16) must register with the SEC as a national securities exchange or be exempt from registration, such as by operating as an alternative trading system ("ATS") in compliance with SEC Regulation ATS. Accordingly, a platform that offers trading in digital asset securities and operates as an "exchange" must register with the SEC as a national securities exchange or be exempt from registration. Therefore, any entity that provides a marketplace for bringing together buyers and sellers of securities, regardless of the technology on which it is based, must determine whether its activities meet that definition of an exchange.

From this perspective, the Divisions addressed decentralized exchanges by reference to the SEC's enforcement order against the founder of EtherDelta for operating an unregistered securities exchange,[8] making the following key observations:

- notwithstanding how an entity may characterize itself or the particular activities or technology used to bring together orders of buyers and sellers, the SEC will use a functional approach (taking into account the relevant facts and circumstances) when assessing whether a system constitutes an exchange;
- a system "brings together orders of buyer and sellers" if, for example, it displays, or otherwise represents, trading interest entered on a system to users or if the system receives users' orders centrally for future processing and execution; and
- a system uses established non-discretionary methods if it provides a trading facility or sets rules.

The Statement describes examples of various algorithmic and electronic methodologies that a platform may use to match orders and that could be viewed as an exchange.

2. Broker-Dealer Registration

The Statement also warned that "an entity that facilitates the issuance of digital asset securities in ICOs and secondary trading in digital asset securities"[9] may be acting as an unregistered "broker" or "dealer" under Section 15(a) of the Exchange Act (in addition to possibly being an unregistered national securities exchange). Brokers and dealers are required to register with the SEC and join a self-regulatory organization ("SRO") that governs the conduct of member broker-dealers, in particular their conduct

toward retail investors.[10] Under Sections 3(a)(4) and 3(a)(5) of the Exchange Act, a "broker" is "any person engaged in the business of effecting transactions in securities for the account of others" and a "dealer" is "any person engaged in the business of buying and selling securities for such person's own account."[11] Consistent with the way in which the SEC analyzes whether an entity is an exchange for purposes of Section 3(a)(1) of the Exchange Act, the Divisions made clear that (i) they will look to the totality of the circumstances in assessing whether an entity meets the definition of a broker or dealer, and (ii) as with the definition of "exchange," an entity is a broker-dealer if it acts in the manner of a broker-dealer, "regardless of how an entity may characterize either itself or the particular activities or technology used to provide the services."[12]

In this context, the Statement reviewed the key activities that caused it to conclude that the respondent in the recent SEC enforcement order against TokenLot, LLC ("TokenLot"), a self-described "ICO superstore,"[13] was operating as an unregistered broker-dealer:

- it allowed users to purchase or pre-purchase allotments of digital asset securities (through both ICOs or on a secondary market) on its own platform, using a proprietary matching algorithm;
- it provided issuers with a listing facility; and
- it provided buyers and sellers with services consistent with those typically provided by a broker-dealer, including market making, marketing, facilitation, distribution, transmission and exchange services, in each case, in exchange for payment.

In some cases, the compensation that TokenLot received was explicitly transaction-based and determined as a percentage of the proceeds raised in the ICOs, subject to a guaranteed minimum commission, similar to how underwriters receive and facilitate payment in connection with public offerings of securities generally and, in other cases, TokenLot acted as a dealer by regularly purchasing and then reselling digital tokens for accounts in TokenLot's name that were controlled by its own operators.

Given the continuing focus and increased pace of enforcement in this space and the expansive definitions of broker and dealer under the federal securities laws, market participants should take note of the principles discussed in the Statement and the potential consequences of acting as an unregistered exchange or broker-dealer, which include being barred from the securities industry, penalties, disgorgement of profits, and rescission.

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ENDNOTES

[1] *See* Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets (Nov. 16, 2018), *available at* https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

[2] *See, e.g.*, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Rel. No. 81207, (July 25, 2017), (the "DAO Report"), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf; William Hinman, Director, SEC Division of Corporate Finance, Remarks at the Yahoo Finance All Markets Summit: Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), *available at* https://www.sec.gov/news/speech/speech-hinman-061418; "Company Halts 'Initial Coin Offering' After SEC Issues Cease-and-Desist Order; SEC Chairman Issues Statement on Blockchain-Based Offerings" (Dec. 13, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Company_Halts_Initial_Coin_Offering_After_SEC_Issues_Cease_and_Desist_Order.pdf; "Digital Assets as Securities: SEC Corporation Finance Director Lays Out the Staff's Analysis in Assessing Whether Digital Assets Constitute Securities" (June 18, 2018), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_SEC_Director_Remarked_on_the_Application_of_Securities_Laws_to_Digital_Assets.pdf.

[3] *See* Jay Clayton, Chairman, SEC, Statement on Cryptocurrencies and Initial Coin Offerings (December 11, 2017), *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[4] *Id*.

[5] *See, e.g.*, CarrierEQ Inc. (dba AirFox), Rel. No. 33-10575 (Nov. 16, 2018), *available at* https://www.sec.gov/litigation/admin/2018/33-10575.pdf ("AirFox"); Paragon Coin, Inc., Rel. No. 33-10574 (Nov. 16, 2018) ("Paragon"), *available at* https://www.sec.gov/litigation/admin/2018/33-10574.pdf.

[6] *See* Crypto Asset Management, LP and Timothy Enneking, Rel. No. 33-10544 (Sept. 11, 2018) (settled order) (the "Crypto Asset Management Order"), *available at* https://www.sec.gov/litigation/admin/2018/33-10544.pdf.

[7] *See* Staff Letter to the Investment Company Institute and Securities Industry and the Financial Markets Association AMG: Engaging on Fund Innovation and Crypto-related Holdings (Jan. 18, 2018), *available at* https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.

[8] Zachary Coburn, Rel. No. 34-84553 (Nov. 8, 2018) (settled order) (the "Coburn Order"), *available at* https://www.sec.gov/litigation/admin/2018/34-84553.pdf.

[9] *See* Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets (Nov. 16, 2018), *available at* https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

[10] *Id*.

[11] Sections 3(a)(4) and 3(a)(5) of the Exchange Act.

[12] Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets (Nov. 16, 2018), *available at* https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

[13] TokenLot, LLC, Lenny Kugel, and Eli L. Lewitt, Rel. No. 33-10543 (Sept. 11, 2018) (settled order) (the "TokenLot Order"), *available at* https://www.sec.gov/litigation/admin/2018/33-10543.pdf.

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