WINSTON & STRAWN LLP

CLIENT ALERT

SEC Pursues Two More Coin Offerings

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REQUIRES TOKEN ISSUERS TO REGISTER TOKENS UNDER SECTION 12(G) OF THE SECURITIES EXCHANGE ACT

On November 16, 2018, the Securities and Exchange Commission (SEC) settled charges against – and imposed penalties on – two companies that engaged in unregistered, non-exempt initial coin offerings (ICOs). See *In the Matter of Paragon Coin, Inc.*, Securities Act Release No. 10574 (November 16, 2018) (*Paragon*) and *In the Matter of Carriereq, Inc., d/b/a Airfox*, Securities Act Release No. 10575 (November 16, 2018) (*Airfox*). This action follows warning shots fired by the SEC in its *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Securities Exchange Act Release No. 81207 (July 25, 2017) (Dao Report) and in *In the Matter of Munchee, Inc.*, Securities Act Release No. 10445 (December 11, 2017) (*Munchee*).

According to the SEC press release announcing the settlements, these two actions "are the first cases imposing civil penalties solely for ICO offering registration violations."[1] Further, as described below, in what appears to be another new development, each of the companies have agreed to become a public reporting company as part of its settlement with the SEC.

The SEC has been heading in this direction for some time now. In the DAO Report, its first official pronouncement regarding the registration obligations of companies conducting ICOs, the SEC did not bring an enforcement proceeding, but instead issued an "investigative report." That report analyzed the tokens issued by a "decentralized autonomous organization," concluding that such tokens were "securities" within the meaning of the federal securities laws and advised companies participating in the relatively new but burgeoning ICO market that "those who would use…distributed ledger or blockchain-enabled means for capital raising" should take "appropriate steps to ensure compliance with the U.S. federal securities laws."

In *Munchee*, which was brought roughly five months after the issuance of the Dao Report, the SEC once again applied a light touch against a company that engaged in an unregistered, non-exempt ICO. There, Munchee, Inc. agreed to halt its ICO (prior to the actual issuance of any of its tokens), to be bound by a "cease and desist" order prohibiting it from engaging in further violations of the registration provisions of the Securities Act of 1933 (Securities Act), and to refund investors' money. According to Munchee, the SEC, in determining to accept the company's offer of settlement, considered the "remedial acts promptly undertaken" by the company, as well as the "cooperation afforded the Commission staff" by the company, and determined not to impose a civil penalty against the company.

In *Paragon* and *Airfox*, the SEC has signaled that the days of the light touch are over. As was the case in *Munchee*, the SEC noted that each company had undertaken remedial acts and cooperated with the SEC staff. But, in contrast to *Munchee*, the SEC imposed a $250,000 fine on each company, noting that the remedial acts and cooperation of the companies had persuaded it "not to impose <u>greater</u> civil penalties." [Emphasis added.] Further, each company agreed to compensate harmed investors who purchased tokens (by paying them the difference between the price they paid for their tokens and the current value of their tokens). Finally, each company agreed to register its outstanding tokens as a class of "equity security" pursuant to Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act) and to file related periodic reports with the SEC for at least one year and until such time as such company is eligible to terminate its registration pursuant to Rule 12g-4 under the Exchange Act. As a result, each company will become a public reporting company, presumably until such time as the company is able to certify to the SEC under Rule 12g-4 either that (i) the tokens issued by such company are held by fewer than 300 persons; or (ii) the tokens issued by such company are held by fewer than 500 persons and the total assets of such company have not exceeded $10 million on the last day of each of such company's most recent three fiscal years.

True to the promise it made in the Dao Report and reiterated in *Munchee*, the SEC applied the so-called "*Howey* test" – named after the 1946 Supreme Court case entitled *SEC v. W. J. Howey Co.*, 328 U.S. 293 – to the "facts and circumstances" presented in *Airfox* and *Paragon* to conclude that the ICOs in question constituted "investment contracts," and therefore "securities," within the meaning of the federal securities laws. According to both *Airfox* and *Paragon*:

> "…a security includes 'an investment contract.' 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) (The 'touchstone' of an investment contract 'is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.')."[2]

After applying the "Howey test" to detailed descriptions of the facts and circumstances of the ICOs in question, the SEC concluded that each involved the offering of an "investment contract." So, in *Paragon*, the SEC stated that:

> "PRG tokens were securities pursuant to *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), and its progeny, including the cases discussed by the Commission in [the Dao Report]. A purchaser in the offering of PRG tokens would have had a reasonable expectation of obtaining a future profit based upon Paragon's efforts, including to develop Paragon's 'ecosystem' using the proceeds from the sale of PRG tokens, and to take steps to control and increase the value of PRG. Paragon violated Sections 5(a) and 5(c) of the Securities Act by offering and selling these securities without having a registration statement filed or in effect with the Commission or qualifying for exemption from registration with the Commission."

Similarly, in *Airfox*, the SEC stated that:

> "AirTokens were 'securities' pursuant to *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946) and its progeny, including the cases discussed by the Commission in [the Dao Report]. A purchaser in the offering of AirTokens would have had a reasonable expectation of obtaining a future profit based upon AirFox's efforts, including AirFox revising its app, creating an 'ecosystem,' and adding new functionality using the proceeds from the sale of AirTokens. AirFox violated Sections 5(a) and 5(c) of the Securities Act by offering and selling these securities without having a registration statement filed or in effect with the Commission or qualifying for exemption from registration with the Commission."

It is clear that the SEC now believes that companies contemplating ICOs are sufficiently on notice of the SEC's approach to ICOs. Stephanie Avakian, Co-Director of the SEC's Division of Enforcement, is quoted in the *Paragon/Airfox* Press Release as saying, "[w]e have made it clear that companies that issue securities through ICOs are required to comply with existing statutes and rules governing the registration of securities. These cases tell those who are considering taking similar actions that we continue to be on the lookout for violations of the federal securities laws with respect to digital assets."

The *Paragon/Airfox* orders also appear to be a message to other companies that have completed unregistered, non-exempt ICOs. Steven Peikien, the other Co-Director of the SEC's Division of Enforcement, is quoted in the *Paragon/Airfox* Press Release as saying that "[b]y providing investors who purchased securities in these ICOs with the opportunity to be reimbursed and having the issuers register their tokens with the SEC, these orders provide a model for companies that have issued tokens in ICOs and seek to comply with the federal securities laws."

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[1] See SEC Press Release No. 2018-264 (November 16, 2018) (Paragon/Airfox Press Release).

[2] As a matter of fact, *Howey* held that an "investment contract" means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits *solely* from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." 328 U.S. at 299-300. [Emphasis added.] Subsequent case law, however, has tended to ignore the word "solely," with courts differing on the scope or degree to which investors must rely on the efforts of others in order for there to be a finding that a particular "contract, transaction or scheme" constitutes an "investment contract" and therefore a "security." The resulting elasticity of the *Howey* test has proven to be a powerful tool in the hands of regulators and plaintiffs.

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