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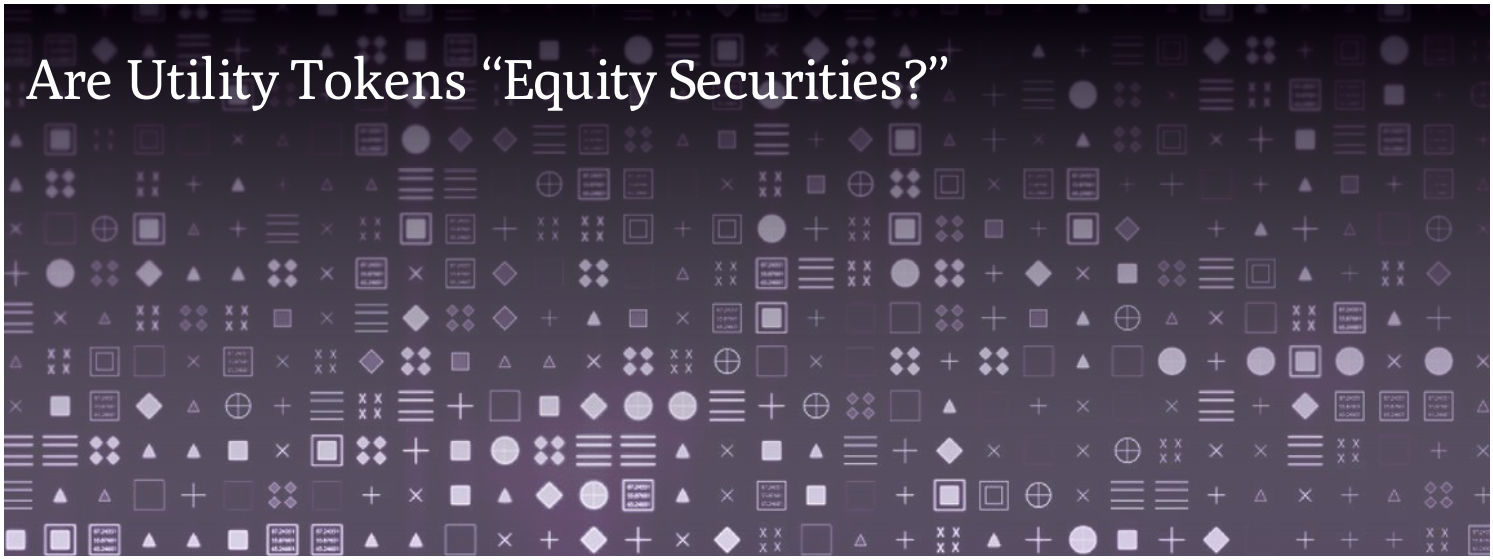

MARCH 13, 2019

On November 16, 2018, the Securities and Exchange Commission's (SEC) Divisions of Corporation Finance, Investment Management, and Trading and Markets issued a "Statement on Digital Asset Securities Issuance and Trading" (Statement) designed to summarize and explain (among other things) the position the SEC took in two enforcement actions—settled the same day as the Statement—with respect to the application of the federal securities laws to the offer and sales of digital asset securities.

In those two enforcement actions, the SEC brought charges against and imposed monetary penalties on two companies that engaged in unregistered, non-exempt initial coin offerings (ICOs). 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, and most importantly for purposes of this discussion, 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.[i] *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*); *see also*, SEC Press Release No. 2018-264 (November 16, 2019) (Paragon/Airfox Press Release).

In both *Airfox* and *Paragon*, 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 by those two cases to conclude that the ICOs in question constituted "investment contracts," and therefore "securities," within the meaning of Section 2(a)(1) of the Securities Act.[ii] 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.')."[iii]

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… 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."

None of this comes as a great surprise, given prior SEC actions relating to ICOs, which the SEC believes have given ample prior notice of its enforcement posture with respect to unregistered ICOs.[iv] However, *Airfox* and *Paragon* broke new ground by imposing a requirement that the token issuer in each case register its outstanding tokens as a class of "equity security" pursuant to Section 12(g) of the Exchange Act and to file related periodic reports with the SEC for at least one year and until such time as the issuer is eligible to terminate its registration pursuant to Rule 12g-4 under the Exchange Act.[v]

The Statement describes the imposition of the Section 12(g) reporting requirement as a "remedial" measure designed to provide "a way to address ongoing violations by issuers that have conducted illegal unregistered offerings of digital asset securities." The Statement explains that, in both *Airfox* and *Paragon*, the token issuer agreed to compensate investors who purchased tokens in the illegal offerings if an investor elects to make a claim of rescission. According to the Statement, the Exchange Act registration undertaking of each token issuer is "designed to ensure that investors receive the type of information they would have received had these issuers complied with the registration provisions of the Securities Act… prior to the offer and sale of tokens in their respective ICOs. With the benefit of the ongoing disclosure provided by registration under the Exchange Act, investors who purchased the tokens from the issuers in the ICOs should be able to make a more informed decision as to whether to seek reimbursement or continue to hold their tokens…" Thus, in the view of the three SEC divisions that issued the Statement, the *Airfox* and *Paragon* matters "demonstrate 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." [emphasis added]

What the Statement did not expressly address is whether an issuer that *lawfully* offers and sells tokens in an ICO (say, pursuant to Rule 506(b) or Rule 506(c) of Regulation D) will be required to register its tokens as a class of "equity security" under Section 12(g) of the Exchange Act within 120 days after the last day of its first fiscal year on which such issuer has total assets exceeding $10,000,000 and tokens held of record by either (i) 2,000 or more persons, or (ii) 500 or more persons who are not "accredited investors." But, by remarking that the *Airfox* and *Paragon* matters demonstrate that there is a path to compliance with the federal securities laws going forward, ***even*** where issuers have conducted an *unlawful* unregistered offering of digital asset securities, was the Statement subtly suggesting that, even where issuers have engaged in a *lawful* unregistered offering of tokens, they nonetheless must register those tokens as a class of "equity security" security if and when the asset and shareholder thresholds described above are exceeded?

If the Statement is simply observing that it is appropriate to require Exchange Act registration of, and ongoing public reporting with respect to, tokens *in the context of a settlement offer* where the issuer of such tokens has agreed to offer rescission rights to token holders and such public reporting is designed to afford token holders the information they need to determine whether to exercise such rights, then its position is unobjectionable.

But if the Statement is also arguing that tokens of the type at issue in *Airfox* and *Paragon* are in fact "equity securities" within the meaning of Section 3(a)(11) of the Exchange Act and Rule 3a11-1 thereunder, then it is breaking new ground—ground that should not be broken unless and until the SEC either (1) articulates, in a persuasive manner, precisely how such a token meets the definition of "equity security" contained in that rule or (2) proposes and adopts amendments to that rule (after complying with applicable notice and comment period requirements) that would bring tokens of that type squarely within the definition of "equity security."

Section 3(a)(11) of the Exchange Act provides that:

> "The term 'equity security' means any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."

Rule 3a11-1 under the Exchange Act provides that:

> "The term *equity security* is hereby defined to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so."

Unlike the definitions of "security" contained in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act—both of which expressly include the term "investment contract" —the definition of "equity security" contained in Section 3(a)(11) of the Exchange Act and Rule 3a11-1 thereunder makes no reference whatsoever to the term "investment contract." It would therefore be a jump to argue that, because a token is an "investment contract," and therefore a "security," for purposes of Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, it must also be an "equity security" for purposes of Section 3(a)(11) and Rule 3a11-1.

More importantly, none of the instruments listed in Section 3(a)(11) of Rule 3a11-1 appear to describe a token of the type at issue in *Airfox* and *Paragon*—that is, a token marked by the following characteristics: (i) it carries no claim on the assets of the token issuer; (ii) it does not entitle the token holder to any voting or similar rights or any rights to receive income or dividends; and (iii) the only gain that a token holder can expect on the token is a potential increase in the value of the token resulting from the efforts of the token promoter and/or market forces.

If challenged on this point, it is not clear that the SEC would be able to articulate a convincing argument that tokens of the type at issue in *Airfox* and *Paragon* are currently comprehended within the Section 3(a)(11) and Rule 3a11-1 definition of "equity security." It thus seems that, if the SEC wishes to include tokens of that type within that definition, outside the context of an enforcement settlement, it should follow normal rulemaking procedures to effect such inclusion.

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[i]Pursuant to Section 12(g)(1) of the Exchange Act, every issuer that is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce must—within 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding $10,000,000 and a class of "equity security" (other than an exempted security) held of record by either— (i) 2,000 persons, or (ii) 500 persons who are not "accredited investors"—

register such security by filing with the SEC a registration statement with respect to such security. (Similarly, Rule 12g-1 under the Exchange Act provides that an issuer is not required to register a class of "equity security" pursuant to Section 12(g)(1) of the Exchange Act if on the last day of its most recent fiscal year (a) the issuer had total assets not exceeding $10 million or (b) the class of "equity securities" was held of record by fewer than 2,000 persons and fewer than 500 of those persons were not "accredited investors," determined as of such day rather than at the time of the sale of the securities.) An issuer that is required to file such a registration is then required to file periodic public reports with the SEC pursuant to the provisions of Section 13 of the Exchange Act and the rules and regulations thereunder.

[ii]Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act define the term "security" in virtually identical terms. Each section defines the term "security" to an include an "investment contract." Neither section defines the term "investment contract," the parameters of which have been established by *Howey* and its progeny.

[iii]As a matter of fact, the *Howey* case stated 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." As a result, the "*Howey* test" has become a very elastic one—one whose elasticity can be a powerful tool in the hands of regulators and plaintiffs.)

[iv]*See*, *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) and *In the Matter of Munchee, Inc.*, Securities Act Release No. 10445 (December 11, 2017); also see the Paragon/Airfox Press Release.

[v]Subsequent to *Airfox*, *Paragon* and the Statement, the SEC imposed Section 12(g) reporting requirements on another company that, according to the SEC, engaged in an unregistered, non-exempt ICO. *See, In the Matter of Gladius Network LLC*, Securities Act Release No. 10608 (February 20, 2019) (*Gladius*). *Gladius* contemplates that, subject to certain conditions, the company may terminate Section 12(g) reporting requirements with respect to its tokens if it concludes that the tokens no longer constitute a "class of securities" under Rule 12g-4 because such tokens no longer constitute "securities" under Section 3(a)(10) of the Exchange Act.

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