Bloomberg Law®

bloombergbna.com

INSIGHT: The SEC's Paragon Coin and AirFox Settlements: a Path Forward?

BY JASON GOTTLIEB

On November 16, 2018, the SEC announced new settlements with two issuers of ''initial coin offerings'' (''ICOs''), Paragon Coin, Inc., and CarrierEQ, Inc. (d/b/a AirFox). That same day, the SEC's Divisions of Corporation Finance, Investment Management, and Trading and Markets jointly released a ''Statement On Digital Asset Securities Issuance and Trading.'' Taken together, the November 16 announcements may comprise a new roadmap for digital asset issuers to put themselves on the right side of the law: pay a penalty, offer refunds, and get registered.

Still, the SEC's latest moves leave open many questions for market participants. Although the SEC's actions may be seen as a first step toward weighing regulation and investor protection against the promotion of financial innovation, it remains to be seen whether the SEC will correctly strike that balance, and whether the ICO market will transition to a more compliant ''securities token'' market.

Robust ICO Markets, and the SEC's Warnings On July 25, 2017, the SEC issued a ''Report of Investigation Pursuant to Section 21(a) of the Exchange Act of 1934: The DAO'' (which has come to be known as the ''DAO Report''). The DAO Report asserted that that tokens issued by a company called The DAO were securities under the Securities Act of 1933 (the ''Securities Act'') and the Securities Exchange Act of 1934 (the ''Exchange Act'').

The ICO market was undeterred by the DAO Report. In 2018 to date, some 951 ICOs raised a total of over $21.9 billion, dwarfing the activity in 2017. In the face of this rising tide of potentially unlawful token offerings, the SEC issued a series of statements cautioning market participants about ICOs.

Securities Under the *Howey* Test In 1946, the Supreme Court made it clear that the Securities Act and the Exchange Act apply to any 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. W.J. Howey Co., 328 U.S. 293*, 301 (1946). ''Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.'' *Reves v. Ernst & Young, 494 U.S. 56*, 61 (1990).

In a November 2017 speech at the Institute of Securities Regulation, SEC Chairman Jay Clayton stated, ''I have yet to see an ICO that doesn't have a sufficient number of hallmarks of a security,'' and warned that the agency would crack down on coin issuers who fail to register.

Some ICO issuers have contended that their token was not a security, but was in fact a currency, or a ''utility token,'' or some other non-regulated object. So far, these attempts have been met with skepticism from the courts. To date, most courts to have considered whether a particular token is a security have concluded – at least as a preliminary matter – that it is. (In the one excep-

Jason Gottlieb is a partner in the business litigation department of Morrison Cohen, LLP, where his specialties include regulatory enforcement matters. He authors the MoCo Cryptocurrency Litigation Tracker, along with Morrison Cohen associates Daniel Isaacs and Chris Pendleton, who assisted in the preparation of this article.

tion, a denial of a preliminary injunction sought by the SEC, the limited factual record suggested that the tokens may not have been sold to any outside investors, but instead only given to a limited group of ''testers.'') No federal appellate court, much less the Supreme Court, has reached the issue. But the regulators' record in the courts has been strong, and barring a thunderclap from the Supreme Court (where the SEC and the *Howey* test may be afforded less deference), there seems little doubt that ICOs will be treated as securities offerings.

The SEC's Three Levels of ICOs The SEC is continuing to work toward striking a balance between applying securities regulations to new digital assets, without coming down so hard on digital asset companies that they squelch positive fintech developments, or force the industry to go offshore. Doing so in the wake of some 1,500 ICOs is quite a task: the SEC first needed to understand them, to see whether they were ''merely'' unregistered securities offerings, or something worse. After blanketing the crypto-street with subpoenas and information requests, the SEC appears to have come to a kind of taxonomy of ICOs.

The SEC seems to have divided the ICOs under investigation into three categories. First, the SEC targeted the outright frauds, where there was never any coin, token, or underlying business project. The SEC has teamed up with the Department of Justice to bring parallel civil and criminal proceedings against several of these types of ''offerings.''

Second, the SEC tackled frauds in the offering, where purchasers received a token that was tied to a bona fide business project, but the token was sold with fraudulent statements or omissions (such as guarantees of profitability, which are always a red flag).

Third, the SEC had long been watching ICOs that were bona fide token offerings for a bona fide business idea, and were offered without fraudulent promotion, but where the ICOs were sales of securities done without registration or exemption, in violation of Section 5 of the Securities Act.

While the SEC has brought a slew of cases in federal court on the first two categories (and reached administrative settlements in several others), the SEC's settlements with Paragon and AirFox are the first that fall into the third category. The settlement orders make no allegations of fraud, and indeed, the companies' respective white papers appear devoid of the blatant overpromises that typify a fraudulent offering. While we may never know what the SEC was alleging behind the scenes of these settlements (i.e., were there allegations of fraud?), the only issue addressed in the settlement orders is failure to register the ICO as a securities offering. On that point, the SEC's legal analysis and remedies are almost exactly identical.

The November 16 Settlements In the settlements with Paragon Coin and AirFox, the SEC issued cease-and-desist orders under the Securities Act, on the grounds that each company issued tokens that were not registered with the SEC, or within one of the available exemptions to registration.

The companies' businesses were quite different. AirFox, which reportedly raised approximately $15 million, ''sold technology to mobile telecommunications companies'' in which customers could watch ads to earn free air time. Paragon, which reportedly raised $12 million, is developing blockchain products for the cannabis industry.

However, as far as their use of tokens was concerned, both companies shared some key similarities. Both stated that their tokens would be ''utility tokens,'' forming part of an ''ecosystem'' in which the tokens could be publicly traded on a token exchange, or used for some value within the company's structure. But in each case, the SEC rejected the ''utility token'' categorization. The SEC stated that these tokens were securities, and, because they were offered without being registered and without having met an available registration exemption, they were offered in violation of Section 5 of the Securities Act.

Furthermore, in both cases, the issuer: (i) was charged a civil penalty of $250,000, (ii) was directed to register the tokens as securities under Section 12(g) of the Exchange Act, and (iii) is required to send investors a notice that they have the right to recover their investments, or to sue ''to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if [the purchaser] no longer owns the security.''

The two settlements, landmark though they are, leave many questions unanswered.

Question #1: Roadmap or Floor? While a $250,000 penalty may put some ICO issuers out of business, for an issuer that raised millions, a $250,000 penalty and the costs of registration and compliance may be a light penalty – if the token value remains robust enough and the investors decide not to flee the company. In that way, the SEC has provided the first roadmap for ICO issuers to ''get right'' with the SEC and come out from under the shadow that has been hanging over the industry.

The settlements, thus, may be a beacon to the more successful ICO issuers to engage with the SEC as soon as possible, to try to secure a similar deal.

It remains to be seen whether the Paragon and AirFox settlements are a roadmap, or a floor. If the SEC's price of admission remains a flat fee of $250,000 and registration, many companies may be expected to follow suit. However, if the SEC engages in escalating penalties as time goes on, it is more likely that, after an initial wave of companies coming in at more affordable settlement points, companies will instead dig in their heels, and either hope they stay under the radar, or fight the SEC in the courts.

Further, issuers who have seen the value of their tokens plummet may be afraid of an onslaught of investors seeking refunds. If that happens, a company without adequate liquidity could very easily fold under the pressure, making a similar settlement a corporate death penalty.

For that reason, the SEC would be wise not to escalate penalties. The SEC's goal should be to regulate the markets, and bring more of the cryptocurrency market into the regulated light. If the SEC escalates penalties, cryptocurrency companies will be less likely to bring themselves into compliance, and more likely to gear up for a protracted fight, or move offshore and ''wall off'' the United States and U.S. investors. Even if the law is on the SEC's side, the ICOs have the numbers.

Question #2: How Will Reimbursements Work? The SEC's requirement that Paragon and AirFox issue investors a refund, or a notice that they have the right to sue to ''recover the consideration paid'' upon tender of the security, or for damages if the investor no longer owns the security, packs a lot of open questions into a very small space.

A draft ''claims notice'' for AirFox indicates that investors in the AirFox ICO will be able to tender their AirTokens, and receive back the amount, in U.S. dollars, that the investor paid for the AirTokens (plus interest). Assuming the draft remains substantially similar when issued, if the investor sold the AirTokens at a loss, the investor can be reimbursed the amount of the loss. The SEC order requires AirFox to report all such submissions to the SEC.

This process is interesting, and sometimes nettlesome, in several ways.

First, the SEC appears to be circumventing a ''disgorgement'' requirement, which could have caused its own problems, as the SEC has previously treated disgorgement as a remedy that requires registration of the security, a problem that has delayed some other SEC settlement discussions. The SEC now appears ready to give up on its requirement that the tokens be registered first, before any return to investors can be accomplished.

Second, the SEC is leaving unanswered what happens if the consideration paid was not cash, but instead was a different cryptocurrency. Typically, reversing a securities transaction is straightforward: an investor tenders the security, and receives back the cash she paid for the security. Crypto disgorgement adds another layer of complexity, particularly when crypto assets are purchased with other crypto assets, most commonly Bitcoin, Ethereum, or Litecoin. In that case, the cryptocurrency used to purchase Paragon Coin or AirTokens may also have fluctuated in value, particularly given the huge run-up in cryptocurrencies generally at the end of 2017 that has since come back to earth.

For example, per the SEC settlement, AirFox's ICO started in August 2017. In early August 2017, one bitcoin was worth about $3,200. By October 5 (the end of the sale), one bitcoin was worth around $4,400. If an investor bought one bitcoin worth of AirTokens, should that investor now receive back the U.S. dollar equivalent at the time of purchase? If AirFox resold those bitcoins when bitcoin reached approximately $20,000 in mid-December 2017, AirFox may then have made a fortune off this deal, blunting the impact of any giveback.

On the other hand, should that investor receive the current value of one bitcoin (today just over $3,700)? That price has recently declined significantly – what if the price of bitcoin declines to $1,000 next month, by the time the reversal is executed? An investor who used bitcoin in 2017 may not be so happy to receive back the same amount of bitcoin in that case.

The mechanics of the refund process are not yet clear, and those mechanics will affect which companies decide to settle, and which decide to hide or fight.

Third, the order does not seem to reach the secondary market. It appears that only investors who bought in the ICO are eligible for a refund. It is unknown how many original ICO investors sold their tokens, or how many current tokenholders purchased on a secondary market. While such information is theoretically available – the beauty of a blockchain-based application is a permanent, publicly available record – it may be too difficult for now to address secondary market concerns.

Finally, many investors will not seek a refund at all. In any given crypto issuance, many investors knew full well what they were buying; or may believe there are no longer any recoverable assets; or purchased their coins with crypto assets that they do not wish to disclose to the SEC or United States courts in this time of regulatory uncertainty.

For that reason, the SEC's requirement that Paragon and AirFox tell investors they have a right to sue may also lack much impact. Undoubtedly, given the rash of investor-side lawsuits against ICO issuers, investors already knew they had that right, and plaintiffs' class action lawyers may choose to forego many suits for lack of gold at the end of the rainbow. Thus, the real monetary threat of these settlements – a flood of reimbursement requests – may or may not materialize.

Question #3: Will the Gatekeepers Be Next? Finally, one group of people should be very nervous about these settlements: the gatekeepers. Lawyers, accountants, underwriters, promoters (including celebrity endorsers), sellers, and the like, have all participated in the glut of ICOs. In testimony before the Senate, SEC Chair Jay Clayton warned that ''those who engage in semantic gymnastics or elaborate structuring exercises in an effort to avoid having a coin be a security are squarely within the crosshairs of our enforcement division.'' He said that some gatekeepers have ''not done their job,'' warning about potential regulatory enforcement to come.

Some ICOs in 2017 and 2018 were done without any legal advice whatsoever. But in many cases, lawyers advised that registration (or meeting an exemption) was unnecessary because the token was a ''utility token'' and not a security. Those lawyers may be in for a rude surprise. The SEC's view is that the DAO Report (and subsequent litigations) put the gatekeepers on notice of the SEC's views. Lawyers who were advising ICOs may also wish to seek SEC enforcement counsel in the near future, if they have not already done so, as SEC actions against certain lawyers, and certain law firms, may lie ahead in the coming months.

It is not only the lawyers who should be concerned. In the wake of the tidal wave of ICOs, an entire ecosystem of buying and selling issued tokens has arisen – and has largely been operating outside the securities laws.

The Paragon and AirFox settlements follow on the heels of other recent settlements, including with Crypto Asset Management and TokenLot (emphasizing the SEC's position that doing brokerage activity in cryptocurrency requires a broker's license) and with the founder of EtherDelta (emphasizing the SEC's position that a decentralized exchange for crypto assets still must register as an exchange, or meet the appropriate exemptions).

The next wave of enforcement action is thus likely to include not only settlements with lawyers and other gatekeepers, but actions against unlicensed broker-dealers and exchanges as well.

Cryptocurrency is a relatively new market development, but for the time being, the SEC is applying well-worn case law to regulate it. That approach may or may not be optimal from a market development point of view, but it is most decidedly the SEC's approach. Market participants who cling to the view that utility tokens

are a different breed of product, not subject to SEC regulation, are in for some unpleasant developments. Meanwhile, companies that take the SEC's new roadmap as a ''hint'' can put themselves on a more compliant path.

****

For up-to-date information on U.S. and international developments affecting ICOs and the blockchain sector, including regulatory and enforcement actions, class action lawsuits, and other private litigation, go to the Bloomberg Law ICO Developments Tracker.

Jason Gottlieb is a partner in the business litigation department of Morrison Cohen, LLP, where his specialties include regulatory enforcement matters. He authors the MoCo Cryptocurrency Litigation Tracker, *along with Morrison Cohen associates Daniel Isaacs and Chris Pendleton, who assisted in the preparation of this article.*