Client Alert | Capital Markets / Financial Institutions Advisory

SEC Public Statement On Digital Asset Technologies – Innovative Investing and Trading Technologies Must Still Adhere to Well-Established and Well-Functioning Federal Securities Law Framework

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On November 16, 2018, the US Securities and Exchange Commission (the "SEC" or the "Commission") made a joint public statement (the "Statement") from its Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets reinforcing the message that technological innovation does not excuse non-compliance with federal securities laws.[1]

Offers and Sales of Digital Asset Securities

The Commission has recently brought several enforcement actions against parties involving the offerings of digital asset securities ("DAS"). Those actions principally focus on two foundational questions: (1) when is a digital asset a "security" for purposes of the federal securities laws, and (2) if a digital asset is a security, what Commission registration requirements apply? Of particular note are two recent settlement orders the Commission issued against AirFox and Paragon,[2] pursuant to which AirFox and Paragon agreed to pay penalties and register their previously issued tokens as securities under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Exchange Act registration is designed to provide investors with the type of information they would have received had an offering of DAS complied with the registration requirements of the Securities Act of 1933, as amended (the "Securities Act") prior to the offer and sale of the DAS. Pursuant to the registration, AirFox and Paragon will be required to file periodic reports with the Commission and, depending on their respective reporting status and applicable transition periods, develop appropriate reporting compliance functions within their business operations. AirFox and Paragon also agreed to compensate investors who purchased tokens in their offerings if any investor elects to make such a claim. The Commission stated that "[w]ith the benefit of the ongoing disclosure provided by registration under the Exchange Act, investors who purchased the tokens from the issuers in the [initial coin offerings] should be

1 Statement on Digital Asset Securities Issuance and Trading (Nov. 16, 2018), available at https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading.

2 Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities (Nov. 16, 2018), available at https://www.sec.gov/news/press-release/2018-264.

able to make a more informed decision as to whether to seek reimbursement or continue to hold their tokens."

The Statement and the recent settlement orders are significant in that they establish "a way to address ongoing violations by issuers that have conducted illegal unregistered offerings of digital asset securities."

Investment Vehicles Investing in Digital Asset Securities

Through the Statement, the Division of Investment Management reminds market participants that investment vehicles that hold DAS and those who advise others about investing in DAS, including managers of investment vehicles, must be mindful of registration, regulatory, and fiduciary obligations under the Investment Company Act of 1940 (the "Company" Act") and the Investment Advisors Act of 1940 (the "Advisors Act"). To illustrate the Commission's vigilance in enforcing these laws, the Statement cites the Commission's September 11, 2018, Crypto Asset Management Order,[3] which found the manager of a hedge fund formed for the purpose of investing in DAS to have improperly failed to register the fund as an investment company and to have violated the antifraud provisions of the Advisors Act by making misleading statements to investors in the fund.

The breadth of application of these laws may not be readily apparent to many market participants as new forms of business continue to test their limits. For example, new forms of pooling and extracting value from staking-based tokens might implicate these laws. In addition, investment and advisory syndicates should also consider the applicability of each of the Company Act and the Advisor Act when advising or investing in vehicles holding DAS as their underlying assets.

Trading of Digital Asset Securities

Exchange Registration Requirements

Despite the March 7, 2018 "Statement on Potentially Unlawful Online Platforms for Trading Digital Assets"[4] by the Divisions of Enforcement and Trading and Markets, the Commission's recent enforcement action against the founder of EtherDelta,[5] a platform facilitating trading DAS that was not registered with the Commission, seemed to catch the operators of digital asset trading platforms by surprise. The Commission found that EtherDelta's activities[6] clearly fell within the definition of an exchange and that EtherDelta's founder caused the platform's failure either to register as a national securities exchange or operate pursuant to an exemption from registration. The EtherDelta action calls into question the assumption made by many operators that structuring a trading platform through decentralized structures would cause the platform to fall outside the application of the federal securities laws.

The Statement marks the first time that the Commission has provided direct guidance on how the platforms facilitating trading in DAS should approach compliance with Exchange Act registration requirements. The Commission makes clear that any entity that provides a marketplace for bringing together buyers and sellers of securities, regardless of the applied technology, must determine whether its activities meet the definition of an exchange under the federal securities laws. The Statement, citing Exchange Act Rule 3b-16, emphasizes that "a functional approach" taking into account relevant facts and circumstances, and not necessarily a platform's self-characterization of its particular activities or the technology it uses to bring together the buyers and sellers, will be applied when assessing whether a platform constitutes an exchange. A platform that offers

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3 SEC Charges Digital Asset Hedge Fund Manager With Misrepresentations and Registration Failures (Sept. 11, 2018), available at https://www.sec.gov/news/press-release/2018-186.

4 Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (Mar. 7, 2018), available at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

5 SEC, Press Release, SEC Charges EtherDelta Founder With Operating an Unregistered Exchange (Nov. 8, 2018), available at https://www.sec.gov/news/press-release/2018-258 (order available at https://www.sec.gov/litigation/admin/2018/34-84553.pdf).

6 The Commission characterized EtherDelta's activities as a marketplace for bringing together buyers and sellers for DAS through the combined use of an order book, a website that displayed orders and a smart contract ran on the Ethereum blockchain. EtherDelta's smart contract was coded, among other things, to validate messages, confirm the terms and conditions of orders, execute paired orders, and direct the distributed ledger to be updated to reflect a trade.

trading in DAS and operates as an "exchange" must register with the Commission as a national securities exchange or be exempt from registration such as by operating as an alternative trading system in compliance with the Commission's Regulation ATS.

The Statement also notes that the term "order" for purposes of Exchange Act Rule 3b-16 is intended to be broadly construed and the "actual activities among buyers and sellers on the system – not the labels assigned to indications of trading interest – will be considered for purposes of the exchange analysis." While the exchange analysis will include an assessment of the totality of the activities and technology which brings together orders of multiple buyers and sellers for securities using "established non-discretionary methods", the Statement clarifies that a "system 'brings together orders of buyers 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."

Broker-Dealer Registration Requirements

The Statement also addresses the requirements of broker-dealer registration, to the extent that an entity facilitates issuance of DAS in the primary or secondary markets. This is a significant point to note for those consultants and promoters of tokens involved in market making and promotion activities when such tokens may have been considered non-securities during the rise of a robust token issuing market in 2016 and 2017. Section 15(a) of the Exchange Act provides that, absent an exception or exemption, it is unlawful for any broker or dealer to induce or attempt to induce the purchase or sale of any security unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.[7] The Statement underscores that, as with the "exchange" determination, a functional approach (taking into account the relevant facts and circumstances), will be applied to assess whether an entity meets the definition of a broker or dealer, regardless of how an entity may characterize either itself or the particular activities or technology used to provide its services.

The Commission recently brought an order against TokenLot[8] that illustrates the Commission's application of the broker-dealer registration requirements to entities trading or facilitating transactions in DAS. TokenLot's brokerage activities included marketing and facilitating the sale of DAS, accepting investors' orders and funds for payment, and enabling the disbursement of proceeds to issuers. TokenLot received compensation based on a percentage of the proceeds raised in the token offerings, subject to a guaranteed minimum commission. TokenLot also acted as a dealer by regularly purchasing and then reselling DAS for accounts in TokenLot's name that were controlled by its operators. TokenLot and its owners consented to the SEC's order and agreed to pay $471,000 in disgorgement, plus interest, and agreed to retain an independent third party to destroy TokenLot's remaining inventory of digital assets. Owners Kugel and Lewitt separately agreed to pay $45,000 in penalties each, and agreed to industry and penny stock bars and an investment company prohibition with the right to reapply after three years.

Practical Considerations

The SEC's message is clear – technological innovation, regardless of the benefit it provides to investors and the capital markets, does not fall outside of the bounds of the long-standing framework of the federal securities laws, whether or not the securities in question are issued in a certificated form or via a smart contract on a blockchain. If a digital asset is a security, market participants are advised to adhere to the well-established and well-functioning federal securities law framework. However, the Statement clarifies that "there is a path to compliance with the federal securities laws going forward" for issuers who may have conducted illegal unregistered DAS offerings, which will require registration of DAS under the Exchange Act, resulting in ongoing reporting obligations following effectiveness of such registration. Issuers should also consider how a Section 12(g) registration may impact the characterization of their DAS as equity securities for purposes of federal securities laws, and the related accounting treatment of such securities on the issuer's financial

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7 Section 3(a)(4) of the Exchange Act generally defines a "broker" to mean any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(5) of the Exchange Act generally defines a "dealer" to mean any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.

8 SEC Charges ICO Superstore and Owners With Operating As Unregistered Broker - Dealers (Sept. 11, 2018), available at https://www.sec.gov/news/press-release/2018-185.

statements.

Industry participants should keep in mind that the Commission interprets and applies the federal securities laws with a functional, rather than a form-over-substance, approach. Product and service labels, self-characterizations, and technical parsing of the securities laws designed to fall outside of the regulatory framework will not win the day when the results of a functionality test are directly or indirectly indicative of activities or services satisfying the definition of an exchange. Platforms that have relied on a decentralized model aiming to avoid regulatory burdens are well-advised to question the assumptions upon which their platforms have been structured.

Notably, the UK's Financial Conduct Authority ("FCA") is taking a similar approach to the Comission. In April 2018, the FCA set out[9] how different forms of digital assets would likely sit within its regulatory framework. Four weeks later, the FCA disclosed[10] its enquiries into the activities of 24 unauthorized firms involved in some form of digital assets business to determine whether they might be carrying on regulated activities requiring FCA authorization, noting its powers to take court action to stop activity and freeze assets, insolvency proceedings and, for the most serious cases, criminal prosecution. And by the end of 2018, the FCA will consult on guidance setting out its interpretation of the current regulatory framework for digital asset activities, while the UK government will consult in early 2019 on extending the regulatory framework to capture offerings of digital assets that may be structured in such a way that they avoid regulation.[11]

The role of a market participant in connection with a securities offering, including a DAS offering, resulting in such market participant's receiving compensation, which is directly or indirectly tied to the proceeds raised in the offering, should always be analyzed in the context of a broker-dealer registration requirements. Understanding the nature of a market participant's actions in connection with offering, buying and/or selling of securities, is critical to the determination as to whether such market particant should be registered as a broker-dealer. Industry participants should be aware that in the Statement the Commission's Divisions "recommend that those employing new technologies consult with legal counsel concerning the application of the federal securities law and contact Commission staff, as necessary, for assistance." As noted in our prior client alert, the Commission has established its Strategic Hub for Innovation and Financial Technology, called "FinHUB."[12] Industry participants are advised to think carefully about their approach to complying with the well-established federal securites laws as they continue to run their businesses or develop new products and services in light of the Statement, the Commission's various enforcement actions, and the presence of FinHUB.

Moreover, compliance with federal securities laws does not inoculate an entity from compliance with the applicable state securities laws or other banking, derivatives, sanctions, tax, consumer protection, and other relevant laws in each jurisdiction in which it operates (and not just where it is domiciled).

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9 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/digital-currencies/written/81677.html

10 https://www.fca.org.uk/publication/foi/foi5673-response.pdf

11 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf (at pp.43 and 48)

12 https://www.whitecase.com/publications/alert/sec-launches-finhub-new-resource-public-engagement-fintech-matters