Goodmans LLP Update

Securities Law and Technology

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ICO Wars: The SEC Strikes Back

The emergence of initial coin offerings (ICOs) as a new form of fundraising and the dramatic gains in the price of many cryptocurrencies is, without doubt, one of the biggest capital markets stories of 2017. Notwithstanding a relatively widespread view that we may now be within a cryptocurrency bubble, ICO markets barrelled ahead in the third quarter, during which time135 ICOs raising US$2.3 billion were completed. This represents more than 100% growth in ICO activity since the second quarter of 2017 and dwarfs 2016, when ICOs raised a total of US$100 million for the entire year.

In addition to valuation concerns, the ongoing crypto-mania is, not surprisingly, drawing significant attention from securities regulators who are growing increasingly concerned about the risks and lack of investor protection inherent in most ICOs. In particular, we have seen increased activity from the United States Securities and Exchange Commission (SEC) in recent weeks – with the SEC Chairman publicly stating his views as to when tokens qualify as securities under U.S. law and encouraging regulatory action against ICOs that have either defrauded investors or did not comply with applicable securities laws.

Statement on Cryptocurrencies and Initial Coin Offerings

On December 11, 2017, SEC Chairman Jay Clayton released a public statement on cryptocurrencies and ICOs that contained strong warnings for investors considering investing in ICOs and further guidance for market professionals on whether an ICO will be considered to be an offering of securities under U.S. securities laws.

The statement reinforced the guidance contained in the SEC's earlier report on the DAO's ICO (as discussed in our August 30 Update, *Initial Coin Offerings in Canada: The CSA Weighs In*) by emphasizing that the securities law analysis applicable to any particular token sale will be focused on the specific terms and context of the offering. While Chairman Clayton noted certain types of tokens (for example, a token that represents a participation interest in a book-of-the-month club) may not implicate securities laws, he also indicated many token offerings emphasize the potential for realizing profit by way of secondary market trading, which he described as "key hallmarks of a security and a securities offering".

The statement also takes direct aim at the argument that utility tokens (tokens that can be used to access functionality on a network or service) are not securities on the basis that holders of these tokens do not have an expectation of profits based on the efforts of others. Chairman Clayton characterized this as elevating "form over substance" and very sensibly pointed out that calling a token a utility token or giving it some functionality is not determinative. This suggests, among other things, that issuers who conduct token sales by way of a SAFT should carefully consider the features of their particular token and the circumstances in which it is sold before concluding the token, when issued under the terms of the SAFT, will not be subject to regulation as a security.[1]

SEC Enforcement Actions

Chairman Clayton concluded his statement by noting that he has asked the SEC's Division of Enforcement to police ICOs "vigorously" and "recommend enforcement actions against those that conduct initial coin offerings in violation of the federal securities laws". Primary responsibility for this mandate falls to the SEC's "Cyber Unit", created in September 2017 to focus on cyber-related misconduct, including violations involving distributed ledger technology and ICOs.

The Cyber Unit demonstrated its commitment to Chairman Clayton's direction by bringing two enforcement actions against ICOs in relatively short order.

[1] For a more detailed discussion of SAFTs, see our December 6, 2017 Update, *Read this Before Your ICO: Exploring the SAFT Framework for Compliant Token Sales in Canada.*

In the first action, the SEC obtained an emergency order freezing the assets of Quebec based PlexCorps and its founder Dominic Lacroix in connection with a $15 million ICO of tokens known as "PlexCoins". According to the SEC, the ICO was a "full-fledged cyber scam" in which Lacroix and PlexCorps sold PlexCoins on the basis that purchasers in the ICO would realize a 1,345% profit in just 29 days. The SEC charges followed cease trade orders that were issued against PlexCorps and Lacroix in Quebec by the Autorité des marchés financiers, which were intended to prevent PlexCorps from proceeding with its ICO (and which PlexCorps and Lacroix violated).

In the second action, announced on the same day Chairman Clayton released his ICO statement, California based Munchee halted a $15 million ICO of its MUN token and agreed to return the funds it had already received after the SEC contacted the company and advised the ICO constituted an illegal distribution of securities. Munchee took the view (stated in its white paper) that "the sale of MUN utility tokens does not post a significant risk of implicating federal securities laws". The SEC disagreed and issued an order outlining its analysis as to why the MUN tokens were securities, which focused significantly on the fact that Munchee's marketing around the offering had emphasized the steps it was taking to increase demand for the token and support secondary market trading.

Investor Class-Action Lawsuits

As illustrated by the SEC's recent actions, promoters of ICOs now face a significant risk of regulatory agency intervention if the offering does not comply with applicable securities laws. At the same time, entities conducting ICOs – and the individuals leading or promoting them – may also be exposed to civil claims, including class-action lawsuits, if investors lose money in a token offering.

For example, the founders and directors of Tezos are currently facing a number of class-action lawsuits in the United States related to Tezos' high profile US$232 million ICO that was completed in July 2017 to fund development of a new smart contract blockchain platform. Following the ICO, disputes between the founders of the project and the president of the Swiss foundation, established to conduct the ICO, reportedly led to significant delays in the project causing the futures price of the Tezos token to fall significantly. This led to the initiation of a number of class-action lawsuits alleging the ICO was an illegal and fraudulent sale of securities.

A similar class-action lawsuit was recently filed against Centra Tech and its founders accusing them of violating U.S. securities laws by conducting an unregistered US$30 million ICO of Centra Tokens to fund the development of a cryptocurrency-focused debit card. Following the ICO, which was famously promoted by boxing champion Floyd Mayweather, Jr., two of the founders left the project and questions arose regarding the accuracy of a number of statements the company had made to promote its ICO. The lawsuit seeks a return of the ICO funds to the investors.

Conclusion

The explosive growth of ICOs represents an exciting new fundraising option for early stage companies and has created a new asset class which gives investors direct exposure to emerging blockchain based technologies and products which many believe will create enormous value. However, the current "fast money" available through ICOs encourages unscrupulous promoters to flog fraudulent schemes aimed at taking advantage of investors. A number of these schemes are already starting to come to light and many more will undoubtedly surface in the coming months.

The SEC's recent pronouncements and enforcement actions, along with the rise of investor class-action lawsuits, represent a continuation of the trend towards greater regulatory scrutiny of ICOs and increased efforts to hold promoters who raise capital in this new way accountable for their actions and promises. Issuers who rely on distinctions between "utility" and "investment" / "securities" tokens to justify completing an ICO without complying with securities laws (or who continue to ignore securities laws altogether) risk being targeted by securities regulator or in class-actions (or both).

For further information relating to this bulletin, please contact any member of our Securities Law Group or Technology Group.