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SEC Subpoenas Signal Heightened Cryptocurrency Focus

Insight — 03/19/2018

Escalating its regulatory scrutiny of initial coin offerings ("ICOs"), the U.S. Securities and Exchange Commission (the "SEC") has recently issued subpoenas to a reported 80 or more firms involved in the burgeoning industry of crypto-token sales. Although the SEC has previously signaled its intent to enforce federal securities laws in the ICO context with a series of public statements on the topic, notably a Report of Investigation in July 2017 (the "DAO Report") – and, indeed, has already brought a number of cases involving ICOs – this step is significant and potentially far-reaching in that it expands the spotlight from ICO sponsors and token issuers to other industry facilitators, including "technology companies" and "advisers." While this investigatory flurry may be driven in large part by the SEC's interest in information gathering to better understand the market dynamics of ICO investment, policy analysts indicate that it is "highly likely" that these subpoenas will result in findings that some tokens have been issued and sold in violation of federal securities laws, raising the specter of an uptick in enforcement activity potentially impacting a wide range of industry participants.

According to *CoinDesk*, a leading news service for the blockchain and crypto asset community, monthly investment in ICOs experienced an exponential increase in the past year, culminating in over $3 billion in investment during the first two months of 2018 alone. Although the SEC has responded to this rapid pace of growth by launching a dedicated cyber unit within its Enforcement Division, such responsive measures are complicated by the fact that ICO structures are constantly evolving in ways that may or may not implicate federal securities laws in the first place. In other words, absent a regulatory scheme tailored to ICOs, the SEC continues to grapple with the predicate question of whether, and under what circumstances, crypto-tokens constitute securities subject to the agency's jurisdiction.

The *Howey* Test

Because crypto-tokens do not neatly fit within the conventional categories of securities enumerated under Section 2(a)(1) of the Securities Act of 1933 (the "Act") – for example, corporate stocks and bonds – the SEC indicated in its 2017 DAO Report that it will apply the *Howey* test to determine whether specific token offerings nonetheless constitute a form of "catch-all" security known as an investment contract. Under the *Howey* test, originally formulated by the Supreme Court in 1946, an agreement qualifies as an investment contract if it involves: (i) an investment of money, (ii) in a common enterprise, (iii) with an expectation of profit, and (iv) such profit is to be derived from the essential managerial efforts of

others.

However, the 2017 DAO Report stopped short of providing concrete guidance or safe harbors for structuring a token offering outside the *Howey* test framework. In fact, SEC Chairman Jay Clayton subsequently noted in a February 2018 Senate hearing that, in his view, every ICO token reviewed by the SEC to that point would be considered a security under federal law.

“Utility Token” Argument

Nonetheless, a significant number of companies and their advisors continue to take the legal position that their ICOs involve non-security “utility tokens” and are therefore outside the SEC's jurisdiction. In principle, an ICO is a fundraising vehicle enabling startups to issue and sell virtual tokens to the public on open, distributed ledgers – commonly known as “blockchains” – in exchange for cash purportedly to be used in developing a business (generally network-based computing services). If a given ICO involves tokens that are designed to ultimately provide functional access to the issuer's products or services, some have argued that such tokens are more akin to a pre-purchase or coupon for future redemption than they are to an investment in securities, which derive value from their speculative profit-generating potential and tradability on secondary markets.

However, especially where an ICO token is “pre-functional” (i.e., issued before a company has developed its product), the SEC's recent wave of subpoenas sends a clear signal that such arguments have gained little traction with the agency. The focus of the SEC's investigation is reported to include executives and board members from companies purporting to issue “utility tokens,” as well as promoters who have marketed such offerings without registering as broker dealers, large investors who have driven up the market for tokens before dumping them in secondary sales, platforms that have listed ICOs and received compensation through undisclosed commissions and other advisors who have failed to register as such or who have counseled their clients on how to avoid SEC regulation.

Regulation D Exempt ICOs & SAFTs

Taking heed of the SEC's stance, an increasing number of startups are attempting to structure ICOs to comply with the Act and related SEC regulations. Aside from The Praetorian Group, which became the first company to register a token sale by filing a Form S-1 with the SEC on March 6, 2018, these companies have largely relied on the registration exemption afforded by Rule 506(c) of Regulation D under the Act. Pursuant to Rule 506(c), which was created by the JOBS Act of 2012, an issuer may raise an unlimited amount of money from unregistered securities sales provided that all investors are “accredited investors.” However, any securities sold in reliance on Rule 506(c) are restricted, resulting in a one-year lock-up on token resales to the public.

Additionally, as a hybrid of Rule 506(c) exemption and the popular, if inauspicious, “utility token” rationale, a white paper published in October 2017 introduced the concept of a “Simple Agreement for Future Tokens”

(or “SAFT”). Notably put into practice with a $205 million token sale by Protocol Labs in 2017, SAFTs are traditional paper documents – conceded to be investment contract securities – providing for a cash investment from accredited investors in exchange for the promise that tokens will be delivered to such investors at a discount once they are functional. Proponents of SAFT-based ICOs tout the benefit of reducing risk through SEC compliance under Rule 506(c) for the SAFT itself, while preserving the argument that the underlying crypto-tokens, when issued at a functional stage after product launch, will then truly be non-security “utility tokens” free of ongoing SEC regulation. However, many critics have cast doubt on this argument on the basis that tokens purchased pursuant to a right derived from a SAFT (itself a security) are themselves derivative securities subject to the same limitations imposed generally on restricted securities. The SEC has not endorsed the pro-SAFT argument and is said to be assessing its merits within the scope of the agency's current investigation.

Conclusion

Like the public at large, the SEC faces an ongoing challenge to keep pace with the technological and market dynamics of crypto-token offerings. Operating without clear guideposts for this relatively nascent form of investment, the agency's toolkit – namely the *Howey* test – is drawing on decades-old principles of U.S. securities law to address unprecedented methods of capital formation. What is not unprecedented, however, is the SEC's concern with investor protection in a “gold rush” – similar to the IPO frenzy and resulting bubble of the early 1990s. The wave of subpoenas issued by the SEC in recent weeks represents a clear wake-up call to many individuals and entities involved in the ICO process that they are not operating above the fray of federal securities laws. However, only as the SEC's investigation unfolds will market participants and securities lawyers gain a clearer understanding of how the SEC will balance its regulatory concerns against the persuasive arguments in favor of free market innovation.

If you have questions about ICOs and cryptocurrency, or the SEC's ongoing investigation into such matters, please contact Lucy Stark, Amy Bowler or any other member of Holland & Hart's Securities & Capital Markets team.

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might affect the analysis or commentary. Similarly, the analysis may differ depending on the jurisdiction or circumstances. If you have specific questions as to the application of the law to your activities, you should seek the advice of your legal counsel.