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SEC Moving Toward Sharper Clarity On Crypto Regs, ICOs

By Tom Zanki

Law360 (July 6, 2018, 8:10 PM EDT) -- Nearly one year since the U.S. Securities and Exchange Commission weighed in on cryptocurrencies and their related funding ventures known as initial coin offerings, attorneys say the regulatory landscape governing this nascent market is getting clearer.

The SEC, one of multiple regulators charged with overseeing digital currency transactions, has instituted a series of enforcement actions and public statements over the past year. The agency has sought to establish boundaries between lawful and unlawful fundraising conducted by an upstart industry that is using blockchain technology in an effort to change how startups raise capital.

While the regulatory rulebook is still being written and many legal questions pertaining to cryptocurrency don't invite one-size-fits-all answers, several attorneys who advise clients seeking to raise capital in digital currency endeavors said the SEC has sent consistent signals over the past 12 months. The result is a regulatory picture that, although still a work in progress, is much more fleshed out in mid-2018 than one year ago, attorneys say.

“If you look at where we are in early July 2018 from a regulatory perspective versus early July 2017, I feel the level of clarity has increased exponentially,” Goodwin Procter LLP counsel Nick Losurdo said.

Lawyers hope for additional clarity in the months ahead, be it from formal SEC guidance, more enforcement actions or relief from enforcement through no-action letters. At the same time, several court cases are pending, the outcomes of which could clarify the jurisdiction that regulators like the SEC and the U.S. Commodity Futures Trading Commission have over the market.

“We probably have another 12 months or so before we really get full clarity on things,” Orrick Herrington & Sutcliffe LLP partner Chris Austin said.

Initial coin offerings are a fundraising mechanism whereby startups create and sell their own digital currency in order to fund projects, using the same blockchain technology that powers bitcoin and other cryptocurrencies. Through ICOs, companies can sell digital tokens that promise purchasers access to a product or service, while other tokens are structured more like investments. ICO issuers have raised $13.7 billion on a global basis through May, according to PricewaterhouseCoopers, nearly double last year's $7 billion total.

In regulating ICOs, the SEC said it would rely on criteria set by a 1946 Supreme Court decision, SEC v. W.J. Howey Co., to determine whether an ICO is a securities sale. The so-called Howey test broadly concludes that an instrument is considered an “investment contract” — meaning a security — if an individual invests money in a common enterprise, expecting a profit based on the efforts of others.

The SEC threw down its first gauntlet July 25, when it concluded that an ICO conducted by a group known as The DAO amounted to an unregistered securities offering. The agency warned market participants that if they are conducting a securities sale, the law requires that they either register their securities offerings or obtain a valid exemption.

The SEC began regulating ICOs more aggressively following the DAO report, carrying out enforcement actions that alleged fraud in several cases and reportedly issuing dozens of subpoenas to parties engaged in ICOs as part of its broader crackdown on illegal offerings.

SEC Chairman Jay Clayton has said most ICOs he has seen resemble security sales, mainly that they are marketed on the prospect that the token will appreciate in value and can be resold for a profit on a secondary platform. The agency has also stressed to market participants that labeling a digital asset a “utility token” — meaning the token is being purchased to provide access to a product or service — does not mean it is not a security.

The SEC in December halted an ICO by the developer of a restaurant review app, charging it with failing to register a securities offering for its sale of utility tokens. The firm, Munchee Inc., in a white paper told potential investors that its tokens were likely to appreciate in resale value on secondary markets, which the SEC said fell within the ordinary concept of a security. Most SEC communications on these matters have come from its enforcement division.

More recently, SEC Division of Corporation Finance Director Bill Hinman spoke before a cryptocurrency gathering in San Francisco, shedding light on how market participants and their counsel can structure offerings in ways that comply with securities law. Hinman's June 14 speech, while not a formal statement by the agency, was interpreted by many lawyers as providing useful insight into the SEC staff's thinking.

Paul Hastings LLP partner Nick Morgan noted that before Hinman's speech, most SEC statements focused on defining what a security is and stating the agency’s jurisdiction, but said little about where that jurisdiction ends. Hinman’s speech was “very helpful” in that it began to describe the “outer limit” of the agency’s reach, he said.

“We are waiting for some drawing of lines,” said Morgan, who works in Paul Hastings’ litigation department and is a past senior trial counsel at the SEC.

Hinman indicated that a token may not be a security if it is sold only to consumers who are seeking access to a good or service, rather than sold for investment purposes. Hinman outlined more questions to consider before a case can be made that a token being offered is not a security and invited ICO promoters and their counsel to discuss these matters with SEC staff.

“Central to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers,” Hinman said at the June 14 conference.

Hinman also indicated that digital assets initially offered as securities could, in certain cases, be later

sold in a manner that does not constitute a security offering. Reaching this stage depends on whether the network that the token functions on is “sufficiently decentralized,” meaning there is no longer a person or group to carry out essential managerial or entrepreneurial efforts.

The premise behind blockchain technology, also called distributed ledger technology, is that it can automate transactions through a network of computers independent of a centralized party.

Hinman said he did not view current sales of digital currencies bitcoin and ether as securities transactions because there is no central third party whose efforts are key to the success of either enterprise. Hinman’s speech did not delve into initial fundraising that brought ether into being in 2014, nor did it address the status of other newer cryptocurrencies.

Lawyers advising clients that are conducting token sales said Hinman’s speech gave them added comfort that the SEC is willing to enter into conversations and address their questions. But many also expect the SEC will continue to regard most token sales as securities offerings.

“The hurdle is still pretty high,” said Morgan Lewis & Bockius LLP counsel Albert Lung, suggesting it will be difficult to persuade the SEC that most tokens are not securities.

Lung added that companies “that are trying to do ICOs, in the beginning … are not going to have a decentralized network like ether.” Lung is advising a client that seeking permission to conduct an ICO through the government’s “Reg A+” exemption, which allows companies to raise up to $50 million annually under lighter rules than a full-fledged initial public offering. No such ICOs have been approved, though several companies have said they filed with the SEC.

Security token issuers looking to pass muster with the SEC can also file for traditional private placements, which limit the sale to wealthier investors but otherwise allow unlimited fundraising and come with fewer disclosures than Reg A+. They can also seek an exemption to conduct an offshore offering, or pursue a fully registered offering in the U.S.

Assuming more companies seek to sell security tokens, questions remain as to whether secondary trading markets will develop.

The SEC has stated that venues that permit the trading of tokens that are deemed securities must either register as exchanges or obtain an exemption to operate as alternative-trading systems, which provide trading platforms under fewer regulations than a major stock exchange.

Several firms, including Overstock.com subsidiary tZero, have said they are developing legally compliant alternative trading systems for that purpose. The Wall Street Journal has reported that cryptocurrency platform Coinbase is talking with the SEC about registering as a licensed brokerage firm and electronic-trading venue, which would allow it to trade securities tokens.

Attorneys say they will watch whether the SEC pursues enforcement actions against nonlicensed venues that trade securities tokens. The SEC’s Enforcement and Trading and Markets divisions said in March it was concerned that “many online trading platforms appear to investors as SEC-registered marketplaces when they are not."

“Once the SEC figures out what it thinks is a security and is not, any exchanges who have been trading those are going to have grapple with the consequences,” said Benjamin Sauter, a defense litigator with

Kobre & Kim LLP.

More regulation in the secondary trading of tokens can be a long-term positive, some attorneys say. They note that having a clear set of rules that allow viable secondary platforms to take root is likely to give more security token issuers the confidence to proceed with their plans.

“When there is a secondary market that’s established, that’s compliant, it will be a big positive for the security tokens industry,” Fenwick & West LLP partner Dan Friedberg said.

--Editing by Kelly Duncan and Alanna Weissman.

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