

SEC RENEWS FOCUS ON CRYPTOCURRENCIES AND INITIAL COIN OFFERINGS

On December 11th, 2017, the SEC filed a cease-and-desist order against Munchee Inc. to halt its Initial Coin Offering (ICO). This was the first SEC enforcement action brought on the basis that the ICO was an unregistered offer and sale of securities in violation of the registration requirements of the Securities Act, and not on a fraud-related claim. This order came just a week after the SEC secured an emergency asset freeze against PlexCorps for making materially false and misleading statements in addition to failing to comply with securities registration requirements in the context of an ICO. Following these two enforcement actions, SEC Chairman Jay Clayton released a Statement on Cryptocurrencies and Initial Coin Offerings reemphasizing the SEC's view - laid out earlier in the year with the release of the DAO report¹ - that simply ascribing the adjective "utility" to a token or even structuring it to provide some redemption-related use does not insulate the offer and sale of the token from being subject to the registration requirements of the Securities Act. Chairman Clayton's statement and these actions reveal that ICOs will continue to be an area of focus for the SEC.

Key takeaways

- ICOs and cryptocurrency will continue to be an area of focus for the SEC.
- Companies offering ICOs should carefully consider whether the proposed tokens would be considered securities under federal law, and thus subject to registration requirements.
- Investors should perform adequate due diligence to ensure they clearly understand the risks associated with ICOs and cryptocurrency investments.

MUNCHEE²

Munchee Inc. halted its ICO on December 11th, 2017, after agreeing to a cease-and-desist order in which the SEC found that Munchee was conducting an offer and sale of unregistered securities. Munchee had sought to raise \$15 million from its sale of "MUN" tokens to fund improvements to its restaurant meal review

¹ For an overview of cryptocurrencies and ICOs, see our earlier client briefing, *SEC Brings First Enforcement Action Against Initial Coin Offering* (Oct. 10, 2017), available on our website at https://www.cliffordchance.com/briefings/2017/10/sec_brings_firstenforcementactionagains.html.

² Press Release, Securities and Exchange Commission, *Company Halts ICO After SEC Raises Registration Concerns* (Dec. 11, 2017), <https://www.sec.gov/news/press-release/2017-227>.

iPhone application. Munchee consented to the SEC's order and agreed to halt its ICO and refund investor proceeds before any tokens were delivered.

The Munchee order directly addressed whether "utility tokens" can be securities:

[e]ven if MUN tokens had a practical use at the time of the offering, it would not preclude the token from being a security. Determining whether a transaction involves a security does not turn on labelling—such as characterizing an ICO as involving a "utility token"—but instead requires an assessment...of the relevant facts and circumstances.³

The SEC's earlier ICO-related actions were premised on claims that the offerors had misappropriated ICO proceeds or made materially false or misleading statements. The SEC did not make any such allegations against Munchee, and also did not impose any penalties, noting that Munchee had cooperated with the investigation and had quickly halted its ICO and returned investor proceeds.

According to the SEC's order, the Commission found the MUN tokens being offered to be securities, despite Munchee's characterization of them as "utility" tokens. Munchee issued a white paper in relation to its ICO that mentioned the DAO Report and stated that the company had conducted a "Howey analysis" to determine that the ICO did not "pose a significant risk of implicating federal securities laws." The SEC disagreed, however, noting the following:

- Munchee offered and sold MUN tokens in a general solicitation to potential investors in the U.S.;
- Munchee promoted the sale of tokens as an opportunity for investors to profit, creating a reasonable expectation by investors of such profit;
- Munchee represented that it would operate its business such that MUN tokens would rise in value;
- Munchee planned to allow MUN tokens to be traded on a secondary market; and
- Investors' profits would be derived from the entrepreneurial and managerial efforts of Munchee and its agents.

PLEXCOIN⁴

A week prior to the Munchee action, on December 4, 2017, the US District Court for the Eastern District of New York granted an emergency asset freeze against PlexCorps after the SEC filed a complaint⁵ alleging that PlexCorps' ICO had violated the anti-fraud and registration provisions of the securities laws.⁶

³ Securities and Exchange Commission, Release No. 10445 (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>

⁴ Press Release, Securities and Exchange Commission, *SEC Emergency Action Halts ICO Scam* (Dec. 4, 2017), <https://www.sec.gov/news/press-release/2017-219>.

⁵ Complaint, Securities and Exchange Commission v. PlexCorps (a/k/a and d/b/a PlexCoin and Sidepay.Ca), Dominic Lacroix and Sabrina Paradis-Royer, No. cv 17-7007, 2017 WL 5988934 (E.D.N.Y. Dec. 1, 2017) [hereinafter PlexCorps Complaint].

⁶ The SEC complaint alleged that PlexCorps violated Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and 17 C.F.R. § 240.10b-5. The complaint also alleged that because PlexCorps was offering the sale of a security without fulfilling any registration requirements, it had violated Sections 5(a) and 5(c) of the Securities Act of 1933, 15 U.S.C. §§ 77e(a), 77e(c). PlexCorps Complaint, at paras. 14–15.

This enforcement action is notable for two reasons. First, these charges were the first filed by the SEC's Cyber Unit, which was created in September to develop and centralize the Enforcement Division's expertise on misconduct involving distributed ledger (i.e. blockchain) technology and ICOs, among other things.⁷ Second, the SEC also noted in its complaint that, despite PlexCorps' attempt to "refashion" the tokens as a cryptocurrency akin to Bitcoin, "[i]n reality, PlexCoin Tokens are securities within the meaning of the U.S. federal securities laws."⁸ The SEC alleged that this attempt to "refashion" the tokens was done to "skirt the registration requirements of the federal securities laws." The complaint did not provide any further analysis of the cryptocurrency v. security issue, focusing primarily on alleged false and misleading statements made to investors, including misuse of investor funds and unreasonable projections of investment returns.

CHAIRMAN CLAYTON'S STATEMENT⁹

The same day as the Munchee order was announced, SEC Chairman Jay Clayton released a Statement on Cryptocurrencies and Initial Coin Offerings with warnings to both investors and market professionals.

First, Clayton cautioned investors that cryptocurrency and ICO markets are highly susceptible to fraud because there is substantially less investor protection in these markets. Clayton attributed this lack of protection to the fact that no ICOs have been registered with the SEC to date. Clayton emphasized that investors should ask questions (including the questions listed below) and seek clear answers before making any investments. Clayton also noted that jurisdiction over the products can be muddy, as the markets often span national borders, making it harder for market regulators to effectively pursue bad actors and recover funds.

Second, Clayton reemphasized the SEC's position that it will consider many if not most tokens offered as part of an ICO to be securities subject to federal securities laws. Highlighting the SEC's DAO report published in July, Clayton directly addressed "certain market professionals [who] have attempted to highlight utility characteristics of their proposed initial coin offerings in an effort to claim that their proposed tokens or coins are not securities," stating that these efforts "appear to elevate form over substance." Clayton went on to state that simply calling a token a "utility" token or even structuring it to provide some practical use does not prevent the token from being considered a security. Instead, the determination is based on whether the offering incorporates "features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others."

Similarly, with respect to cryptocurrencies Clayton stated that simply calling something a "currency" does not mean that it is not a security and cautioned that promoters need to either be able to demonstrate that a particular product was not a security or comply with applicable registration requirements.

⁷ Press Release, Securities and Exchange Commission, *SEC Emergency Action Halts ICO Scam* (Dec. 4, 2017), <https://www.sec.gov/news/press-release/2017-219>. For more on the Cyber Unit, see our earlier client briefing *SEC Announces Creation of Cyber Unit*, published on October 3, 2017 and available on our website at https://www.cliffordchance.com/briefings/2017/10/sec_announces_creationofcyberunit.html.

⁸ PlexCorps Complaint, at para. 9.

⁹ Public Statement of SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

CRYPTOCURRENCIES: SEC VS. CFTC JURISDICTION

Interestingly, while Chairman Clayton's statement was focused primarily on ICOs, it also signaled a broader debate between the SEC and CFTC over which agency has primary jurisdiction over the regulation of cryptocurrencies. In Clayton's statement, he acknowledged in a footnote that the CFTC had designated bitcoin a commodity and thus that "[f]raud and manipulation involving bitcoin traded in interstate commerce are appropriately within the purview of the CFTC." This note was later rebuffed by CFTC Chairman Christopher Giancarlo, who released a statement commanding the overall sentiment of the SEC's message but disagreeing with this characterization of the CFTC's authority and stating that "market participants should take note that the relatively nascent underlying cash markets and exchanges for bitcoin remain largely unregulated markets over which the CFTC has limited statutory authority," and that investors needed to be aware of the resulting high level of volatility and risk. Two days later, the CFTC stated "depending on their use, the tokens or units issued in an ICO may be commodities, commodity options, derivatives, or otherwise fall within the [CFTC]'s virtual currency definition However, any such tokens that are deemed securities (and trade in a manner that qualifies as a retail commodity transaction) would be excepted from the retail commodity transaction definition..."

As evidenced by these statements, there remains a degree of uncertainty over the regulation of cryptocurrencies and ICOs. Market participants should be mindful of both the SEC's and CFTC's enforcement priorities and regulatory mandates.

CONCLUSION

Entities considering ICOs as a vehicle for raising funds—as well as professionals advising these entities—must carefully consider whether the proposed tokens would be considered securities under federal law, and thus subject to registration requirements.

In addition, investors should perform adequate due diligence to ensure that they clearly understand the risks associated with ICOs and cryptocurrency investments.¹⁰ A good starting point is to consider the questions attached to Chairman Clayton's statement (reproduced below for reference). If any red flags arise, investors should consult legal advisers to consider what steps they can take to mitigate the risks.

Sample Questions for Investors Considering a Cryptocurrency or ICO Investment Opportunity¹¹

- Who exactly am I contracting with?
 - Who is issuing and sponsoring the product, what are their backgrounds, and have they provided a full and complete description of the product? Do they have a clear written business plan that I understand?

¹⁰ The SEC and CFTC are not the only entities warning investors about cryptocurrency-related investments. For example, on December 21, 2017, the Financial Industry Regulatory Authority (FINRA) released an investor alert warning of the risks associated with such investments. See Financial Industry Regulatory Authority, *Don't Fall for Cryptocurrency-Related Stock Scams* (Dec. 21, 2017), <https://www.finra.org/investors/alerts/don%E2%80%99t-fall-cryptocurrency-related-stock-scams>.

¹¹ Excerpted from Public Statement of SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

- Who is promoting or marketing the product, what are their backgrounds, and are they licensed to sell the product? Have they been paid to promote the product?
- Where is the enterprise located?
- Where is my money going and what will it be used for? Is my money going to be used to “cash out” others?
- What specific rights come with my investment?
- Are there financial statements? If so, are they audited, and by whom?
- Is there trading data? If so, is there some way to verify it?
- How, when, and at what cost can I sell my investment? For example, do I have a right to give the token or coin back to the company or to receive a refund? Can I resell the coin or token, and if so, are there any limitations on my ability to resell?
- If a digital wallet is involved, what happens if I lose the key? Will I still have access to my investment?
- If a blockchain is used, is the blockchain open and public? Has the code been published, and has there been an independent cybersecurity audit?
- Has the offering been structured to comply with the securities laws and, if not, what implications will that have for the stability of the enterprise and the value of my investment?
- What legal protections may or may not be available in the event of fraud, a hack, malware, or a downturn in business prospects? Who will be responsible for refunding my investment if something goes wrong?
- If I do have legal rights, can I effectively enforce them and will there be adequate funds to compensate me if my rights are violated?

CONTACTS

David Felsenthal
Partner

T +1 212 878 3452
E david.felsenthal
@cliffordchance.com

Daniel Silver
Partner

T +1 212 878 4919
E daniel.silver
@cliffordchance.com

Benjamin Berringer
Associate

T +1 212 878 3372
E benjamin.berringer
@cliffordchance.com

Allein Sabel
Associate

T +1 212 878 3371
E allein.sabel
@cliffordchance.com

Jesse Overall
Associate

T +1 212 878 8289
E jesse.overall
@cliffordchance.com

Brian Yin
Associate

T +1 212 878 4980
E brian.yin
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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