

SEC Brings First Enforcement Action Related to Initial Coin Offerings

IN SHORT

The Situation: Promoters of two recent initial coin offerings face charges of investor fraud brought by the SEC, after allegedly misrepresenting the assets purportedly backing the offerings, exaggerating the amount of funds already raised, and falsifying information relating to an advisory team involved in the process.

The Result: This is the SEC's first enforcement action relating to initial coin offerings and confirms that its commitment to protecting investors from fraud remains the same, regardless of the technologies involved and the means of raising capital.

Looking Ahead: Initial coin offerings should continue to be viewed as a valid process for raising capital, but promoters, investors, and other stakeholders should also be aware that the marketplace is being carefully monitored in an effort to protect investors.

The popularity of initial coin offerings ("ICOs") has grown significantly in 2017. This year alone, roughly the equivalent of US\$2 billion in capital has been raised through ICOs. In an apparent attempt to stand out in a crowded field, the promoters of a recent pair of ICOs—REcoin and Diamond Reserve Club ("DRC")—got creative with their marketing materials, alluding to Led Zeppelin's iconic 1976 album *The Song Remains the Same* to highlight the purported benefits and opportunities that accompanied the coins.

While the musical allusion was dubious in the context of the REcoin and DRC ICOs, one could easily apply it to the enforcement activities of the U.S. Securities and Exchange Commission: Although technologies and capital-raising schemes may change, the SEC's mandate to protect investors from fraud remains the same.



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Consistent with this mission, the SEC late last month charged the promoters of the REcoin and DRC ICOs with defrauding investors, marking the first time the SEC has brought an enforcement action related to ICOs. In a suit filed in the U.S. District Court for the Eastern District of New York, the SEC alleged that the defendants illegally offered unregistered securities and made fraudulent misstatements that were designed to deceive investors in connection with the ICOs.

According to the civil complaint, the defendants fraudulently raised US\$300,000 from hundreds of investors by falsely touting that the REcoin offering was backed by investments in real estate and the DRC offering was backed by diamonds. In reality, the defendants never purchased any real estate or diamonds, the complaint said. What's more, the coins themselves did not even exist; individuals who invested in the coins received nothing in return.

Also, according to the complaint, the defendants described their offerings as "Initial Membership Offerings," to distinguish them from ICOs in an effort to avoid having the coins designated as securities. But the SEC alleged that the distinction was a "sham." Because the ICOs were ongoing when the complaint was filed, the SEC sought emergency relief and obtained an order freezing the defendants' assets.

This enforcement action follows a raft of guidance from the SEC over the past several months. As [we previously reported](#), in July, the SEC issued an investigative report ("DAO Report") to warn market participants that "virtual coins or tokens may be securities and subject to the federal securities laws." In August, the SEC issued an investor alert regarding potential scams involving companies using ICOs in pump-and-dump schemes. Likewise, the SEC suspended trading in the common stock of several issuers due to concerns regarding statements about their plans for ICOs. In early September, an SEC co-director of enforcement reportedly warned about fraudulent coin offerings at a panel discussion in New York.

The recent enforcement action concerning REcoin and DRC reinforces this guidance and also reminds market participants of several key lessons:

- According to the DAO Report, whether a coin is a security depends on the facts and circumstances of

the offering, including the economic realities of the transaction, not on labels that are applied. The mere fact that the REcoin and DRC offerings were marketed as memberships in a club, as opposed to an ICO, did not change their fundamental nature or exempt them from securities laws.

- ICOs that are marketed as investment opportunities or tout the potential for returns on an investor's capital very likely are securities that should be registered with the SEC, unless an exemption applies. Information about registered offerings can be found on the SEC's website.
- Promoters of ICOs should take care with how they describe their offerings and the rights that accompany the coins they are issuing. White papers and other offering documents should clearly explain the business model and risks associated with the project.
- Promoters of ICOs should consult with experienced securities counsel regarding how to structure their ICOs so they are compliant with federal and state securities laws. Promoters also may need to consult with lawyers from international jurisdictions if they intend to target investors globally.

Going forward, expect the SEC to scrutinize other ICOs for potential securities law violations and to bring more enforcement actions. In the near term, the SEC likely will focus on the most egregious examples of fraudulent conduct, such as what allegedly occurred in the REcoin and DRC offerings. As it does so, market participants will gain more clarity about the SEC's enforcement priorities in this space.

Despite the SEC's increased attention to ICOs, companies seeking to use them to raise capital should not lose hope. Proper ICOs can be a legitimate means of raising funds from investors in the United States and could give birth to promising companies. Even so, market participants should bear in mind that the SEC is carefully monitoring the ICO marketplace so that it can continue to fulfill its role of protecting investors from bad actors.

THREE KEY TAKEAWAYS

1. This first enforcement action confirms the SEC's approach will be to look at the substance of any offering rather than the way it is described when assessing classification and/or regulatory compliance.
2. Coin promoters should seek experienced securities counsel to ensure their offerings are compliant with federal and state laws.
2. Promoters and investors should expect the SEC to scrutinize future offerings for potential securities law violations, possibly leading to additional enforcement actions.

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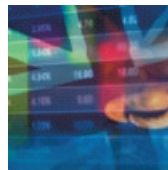
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