

Crackdown: SEC's New Cyber Unit Targets Blockchain and ICO Abuses

IN SHORT

The Situation: The U.S. Securities and Exchange Commission has launched a special unit to bring enforcement actions against several forms of cyber misconduct.

The Result: The Cyber Unit has already brought enforcement actions against two promoters of initial coin offerings.

Looking Ahead: These actions signal that the U.S. federal government will be increasingly active in policing ICOs and securities law violations involving blockchain technology. Enforcement actions are expected to continue.

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A newly created "Cyber Unit" at the U.S. Securities and Exchange Commission ("SEC") has brought its first two enforcement actions against promoters of two initial coin offerings ("ICO"). This activity comes a little more than two months after the SEC's Division of Enforcement brought its [first-ever action in this emerging area](#), a case we reported on earlier this year.

In the first of the two recent actions, the Cyber Unit alleged that the promoters of the PlexCoin ICO offered an unregistered security in violation of the federal securities laws and also engaged in a fraudulent scheme to steal money from retail investors who had been promised extraordinary and illusory financial returns.

In the second—a case that did not involve allegations of fraud—the promoter of the Munchee ICO agreed to settle charges that it had offered an unregistered security in violation of the federal securities laws.

Initial Coin Offerings

Initial coin offerings are being used by companies for various purposes, including to raise funds for new projects by issuing new virtual currencies. In a typical ICO, buyers are given "tokens" or "coins" that are related to a specific company or project, in exchange for consideration in the form of either fiat currency or cryptocurrency.

While many ICOs may be legitimate opportunities for some buyers and experienced investors, ICOs (as with other consumer products and investments) carry with them a potential for fraud.

In addition, as SEC Chairman Jay Clayton stated, some ICOs are structured in such a way that they represent offerings of securities, which must be registered with the SEC (or offered under a recognized exemption) and must be accompanied by important disclosures.



These actions, and the creation of the Commission's Cyber Unit, reinforce the federal government's recent efforts to police investments being offered via distributed ledger technology and to crack down on allegedly fraudulent and unregistered initial coin offerings.



Securities and Exchange Commission Cyber Unit

This September, the SEC created a "Cyber Unit" to target a range of cyber misconduct, including hacking for nonpublic information, disrupting trading platforms, spreading false information through social media, and abuse of blockchain technology and ICOs.

Enforcement Action Related to the PlexCoin ICO

On December 1, 2017, the Cyber Unit filed its first enforcement action—against the promoters of an ICO for a proposed currency called "PlexCoin," which was advertised as "the next decentralized worldwide cryptocurrency." PlexCorps, the company behind the ICO, suggested that some investors might make more than a 1,000 percent return on their investment in under a month. In reality, according to the SEC, the company behind the ICO was not actually developing a new currency but rather simply accepting investments via PayPal and other platforms, and using that money for extravagant personal purposes.

As part of the alleged scam, more than 80 million "PlexCoin Tokens" were distributed on the Ethereum blockchain (a distributed ledger technology that can be used for organizing ICOs, among many other

things). These tokens weren't the actual currency that the alleged scammers promised but could, in theory, be redeemed for the currency in the future.

In addition to alleging fraud, the SEC also claimed that the ICO for the PlexCoin Tokens was an illegal offering of securities because no registration statement was filed or in effect during the offer and sale process, and there was no applicable exemption.

Enforcement Action Related to the Munchee ICO

On December 11, 2017, following a brief investigation by the Cyber Unit, the SEC accepted an offer of settlement from Munchee Inc., a California start-up business that created an iPhone application for users to review restaurants and post photos of meals, in regard to Munchee's offering of so-called MUN tokens. Under the settlement, Munchee agreed to cease and desist from violating Sections 5(a) and 5(c) of the Securities Act, which prohibit the offering and sale of securities in interstate commerce unless done pursuant to an effective registration statement or a recognized exemption.

The SEC concluded that the MUN tokens were investment contracts under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) and its progeny for various reasons. For example, the MUN tokens did not have immediate functionality because no one could use them to buy goods or services at the time of the offering. Rather, people discussing the tokens online commented on their future utility and Munchee itself said that it would use the ICO proceeds to further develop the Munchee iPhone application and the token ecosystem. Significantly, the SEC said that even if the MUN tokens had practical use at the time of the offering, it would not preclude them from being a security.

Looking Forward

These actions, and the creation of the Commission's Cyber Unit, reinforce the federal government's recent efforts to police investments being offered via distributed ledger technology and to crack down on allegedly fraudulent and unregistered ICOs.

THREE KEY TAKEAWAYS

1. The Securities and Exchange Commission has established a new Cyber Unit to target a range of cyber misconduct, including hacking for nonpublic information, spreading false information through social media, and abuse of investment opportunities conducted via blockchain technology such as ICOs.
2. The Cyber Unit's first enforcement action, meant to protect retail investors, was against an allegedly fraudulent and unregistered initial coin offering. The Cyber Unit followed that action by accepting an offer of settlement from another ICO promoter due to the promoter's failure to register the ICO. More enforcement activity by the SEC on ICOs is likely.
3. Tokens that do not have immediate functionality from the start very likely will be considered securities by the SEC and may be targeted by the SEC if they are not registered under the federal securities laws or exempt from registration. Even those that have practical use from the outset may still be deemed a security by the SEC.

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