

Regulators keep a close eye on ICOs and Cryptocurrencies

DAVID WOODCOCK,
MARK RASMUSSEN
and SARAH ABOUKHAIR

Two of the more significant developments related to blockchain technology in 2017 were the rise in popularity of so-called initial coin offerings (“ICOs”) and the staggering increase in cryptocurrency valuations. In 2017, ICOs generated sales of more than \$3 billion, compared to a reported \$102 million in 2016 and \$14 million in 2015. And the value of a bitcoin increased from around \$1000 at the start of 2017 to over \$19,000 at one point late in the year.

Just as the market has kept a close watch on ICOs and cryptocurrencies, so too have federal and state regulatory watchdogs. In July, the Securities and Exchange Commission issued an investigative report regarding whether a coin issued by The DAO constituted an unregistered securities offering. Two months later, the SEC brought its first enforcement action related to an ICO, accusing the promoters of two coins backed by investments in real estate and diamonds of investor fraud. Since then, the SEC has continued to bring enforcement actions in this space, and the Texas Securities Commissioner has started to do the same.

RECENT SEC ENFORCEMENT ACTIONS

In December 2017, the SEC’s newly formed Cyber Unit, whose mission is in part focused on cryptocurrencies and blockchain technology, 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, PlexCorps was not actually developing a new currency but rather simply accepting investments and using that money for extravagant personal purchases. In addition to alleging fraud, the SEC also claimed that the ICO was an illegal offering of securities because no registration statement was filed or in effect, and there was no applicable exemption. The SEC charged that the PlexCoin promoters generally solicited buyers through statements posted on the internet and offered the tokens to the general public, in violation of securities laws.

Soon after that action was announced, the Cyber Unit struck again. This time, it settled claims against Munchee Inc., a California start-up business, in regard to Munchee’s offering of a coin called “MUN tokens.” According to the SEC’s al-

legations, which Munchee did not admit or deny in its settlement with the SEC, the MUN tokens were part of an overall ecosystem in which Munchee would pay users for food reviews with MUN tokens and sell advertisements to restaurants in exchange for MUN tokens. Eventually, Munchee said, the MUN tokens could even be used to buy food. The SEC concluded that the MUN tokens were investment contracts for various reasons, one of which being that the MUN tokens were marketed and promoted as a beneficial investment with potential returns. Also, 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, there was an emphasis on their future utility, and Munchee itself said that it would use the ICO proceeds to further develop the Munchee application and the token ecosystem. Significantly, the SEC noted that even if the MUN tokens had practical use at the time of the offering, it

would not preclude them from being a security.

RECENT TEXAS ENFORCEMENT ACTIONS

The Texas Securities Commissioner also began policing the cryptocurrency market late last year by issuing an emergency cease-and-desist order to a Dubai-based company and two residents of the United States related to their offer of interests in bitcoin mining contracts in Texas. In the order, the Commissioner found that the interests were securities under the Texas Securities Act; the respondents violated the Texas Securities Act by not registering the interests or offering them under a recognized exemption and by not registering as brokers or sales agents; and the respondents engaged in fraud and made materially misleading statements regarding the offers. Among other things, the respondents promised investors 1% daily returns independent of the value of bitcoin and represented that the product being offered was certified by the Federal

Trade Commission.

On the heels of that action, the Texas Securities Commissioner opened 2018 by issuing another emergency cease-and-desist order to halt multiple investment programs tied to a cryptographic token issued by BitConnect, a U.K. company. BitConnect’s investment offerings, the Commissioner claimed, are securities under the Texas Securities Act but were not registered as required under the law. Also, according to the order, BitConnect failed to disclose material facts about its programs and fraudulently touted its programs as a “safe way to earn a high rate of return on ... investments without having to undergo significant amount of risk.”

LOOKING FORWARD

The SEC and Texas Securities Commissioner are likely to continue cracking down on unregistered ICOs and other cryptocurrency offerings. This could cause short term pain for those trying to operate with little regulatory guidance. We are hopeful that securities regulators will provide more and clearer guidance in the coming year outside of the enforcement mechanism. Until then, we will see enforcement actions as the principal tool regulators use to apply decades-old securities laws to twenty-first century technologies.

The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

David Woodcock and Mark Rasmussen partners in Jones Day’s Dallas office. Sarah Aboukhair is an associate in Jones Day’s Dallas office. www.jonesday.com/dallas/