

Client Update

Developments in the Enforcement of Token Sales

Securities and Exchange Commission (“SEC”) Chairman Jay Clayton recently discussed the uncertainties surrounding token offerings and other forms of distributed ledger-based financing.¹ Mr. Clayton cautioned that the lack of information regarding online platforms that list and trade virtual coins or tokens may lead to price manipulation and other fraudulent trading practices on these platforms. The Chairman stated, “The [SEC] recently warned that instruments such as ‘tokens’ offered and sold in ICOs may be securities, and those who offer and sell securities in the United States must comply with the federal securities laws.” The Chairman’s statements regarding token sales reiterate the SEC’s position articulated in the DAO investigative report issued in July and mirror the SEC’s recent steps towards more rigorous enforcement of distributed ledger based offenses.² In what *The Wall Street Journal* described as an unscripted remark during the speech, Mr. Clayton added “I have yet to see an ICO that doesn’t have a sufficient number of hallmarks of a security.”

Adding further weight to the SEC’s take on token launches, the SEC established the Cyber Unit within its enforcement division, focused entirely on cyber-related issues affecting the securities markets. One of the unit’s stated goals is to prioritize the enforcement of emergent issues relating to distributed ledger technologies.³ During a press conference describing the new Cyber Unit’s activities and responsibilities, Co-Director of Enforcement Stephanie Avakian stated that blockchain technology “warrants a consistent, thoughtful approach and the best way to do that is to centralize the expertise and focus in a single unit.” She also commented that “blockchain technology presents many interesting issues and can of course present legitimate opportunities

¹ Jay Clayton, Remarks at the PLI 49th Annual Institute on Securities Regulation (November 8, 2017), available at <https://www.sec.gov/news/speech/speech-clayton-2017-11-08>.

² Press Release 2017-185, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017), available at <https://www.sec.gov/news/press-release/2017-131>.

³ Stephany Avakian, The SEC Enforcement Division’s Initiatives Regarding Retail Investor Protection and Cybersecurity (October 26, 2017), available at <https://www.sec.gov/news/speech/speech-avakian-2017-10-26>.

for raising capital. But, like many legitimate ways of raising capital, the popular appeal of virtual currency and blockchain technology can be an attractive vehicle for fraudulent conduct.”⁴

The SEC has shown its willingness to bring charges against token issuers where fraudulent activity is believed to exist. A recent complaint filed by the SEC raised charges of fraud and securities laws violations against two defendants related to their token offering activities.⁵ The complaint alleged that the tokens issued by the defendants were securities and that the defendants willfully mislead investors into thinking they were investing in tokens backed by diamonds and real estate where no such asset backing in fact existed.⁶ The complaint, along with the SEC’s recent notice regarding celebrity endorsements of token sales, demonstrates the SEC’s willingness to target blockchain projects if they present a risk to participants.⁷

While our belief that not all tokens are securities remains unchanged, it is important for the blockchain community and participants, particularly sponsors of projects contemplating a token offering, to clarify how tokens will be listed, valued, and traded on their platforms and to work with counsel to ensure compliance with the federal securities laws and regulations. It is also imperative to include Know Your Customer (“KYC”) and Anti Money Laundering (“AML”) protections for investors in blockchain projects. We strongly encourage and remind blockchain participants to do their due diligence by confirming the viability and legitimacy of blockchain platforms prior to investing.

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⁴ *Id.*

⁵ Complaint, *Securities and Exchange Commission v. Recoin Group Foundation, LLC, DRC World Inc. a/k/a Diamond Reserve Club, and Maksim Zaslavskiy*.

⁶ Press Release 2017-185, *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds*, Sept. 29, 2017, available at <https://www.sec.gov/news/press-release/2017-185-0>.

⁷ Press Release, *Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others*, November 1, 2017, available at <https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos>.

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