PAUL HASTINGS

STAY CURRENT

December 2018

Follow @Paul_Hastings

Broader Implications of SEC Charges Against Celebrities for Unlawfully Touting ICOs

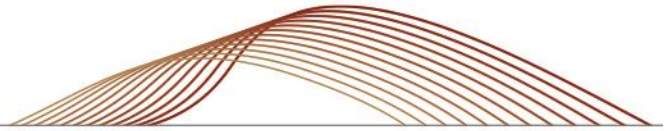
By Nicolas Morgan, David Hernand, Meagan Olsen & Vivian Tsai

On November 29, 2018, the Securities and Exchange Commission ("SEC") announced it settled charges against professional boxer Floyd Mayweather Jr. and music producer and actor Khaled Khaled, known as DJ Khaled, for promoting investments in Initial Coin Offerings ("ICOs") without properly disclosing their financial ties to the ICO issuers.[1] These cases mark the first time the SEC has charged individuals with "touting" violations involving ICOs and signal the SEC may bring enforcement actions against other celebrities or non-celebrities who have made similar ICO endorsements.

According to the SEC's allegations, in September 2017, Mayweather and Khaled, both of whom have significant social media followings, promoted the ICO of Centra Tech, Inc. ("Centra"). Centra raised money on the promise it would build a suite of financial products, including a debit card that supposedly could convert hard-to-spend cryptocurrencies into U.S. dollars at the point of sale.[2] Mayweather, who at the time had 21 million Instagram followers, 7.8 million Twitter followers, and 13.4 million Facebook followers, and sometimes referred to himself as "Floyd Crypto Mayweather," encouraged his followers: "Get yours before they sell out, I got mine . . . ."[3] Similarly, Khaled called Centra "a Game changer," urging his followers to "[g]et your CTR tokens now!"[4]

Against the backdrop of such celebrity endorsements, Centra raised $32 million from thousands of investors, despite serious allegations raised around the time of the offering, including that the company's named chief executive was a fictitious person.[5] Meanwhile, Mayweather received $100,000 from Centra as compensation for his promotion of Centra's ICO and another $200,000 from his promotion of two other ICOs, and Khaled received $50,000 from Centra as compensation. Shortly after Centra's ICO, the New York Times published an exposé on the company, detailing apparent lies told by Centra's management, including about its nonexistent partnerships with two major credit card companies.[6] In April 2018, the SEC filed civil charges against the three co-founders for securities fraud, specifically noting Centra's heavy reliance on celebrity endorsements in conducting its ICO.[7] In addition, the co-founders were criminally charged by the Department of Justice with securities fraud and arrested by federal authorities.[8]

For months, there was speculation regarding whether the SEC would bring enforcement actions against Mayweather and Khaled, the two unnamed celebrity endorsers in the SEC complaint.[9] Now, close to eight months later, the SEC makes clear that touting violations involving ICOs will be treated just like those involving traditional securities.



As a part of the settlement, Mayweather agreed to pay $300,000 in disgorgement and prejudgment interest and an additional $300,000 as penalty, while Khaled agreed to pay $50,000 in disgorgement with prejudgment interest and an additional $100,000 as penalty. Both Mayweather and Khaled also agreed not to promote any securities (digital or otherwise) for a period of two and three years, respectively.[10] Mayweather further agreed to cooperate with ongoing SEC investigations, presumably of the other two ICOs he also promoted.

Many celebrities, including actor Jamie Foxx[11] and rapper 50 Cent[12], have publicly supported ICOs on their social media,[13] contributing to the $6.2 billion in capital raised through ICOs in 2017 and $7.3 billion raised in 2018.[14] Television personality Paris Hilton, for example, tweeted on September 3, 2017: "Looking forward to participating in the new @LydianCoinLtdToken! #ThisIsNotAnAd . . . ."[15] Most of these celebrity promotions took place on social media platforms, such as Facebook, Instagram, and Twitter, after the SEC had issued its DAO Report of Investigation in July 2017. In that report, the SEC cautioned that ICOs can be securities offerings and that federal securities laws may accordingly apply to the promotion, offer, and sale of ICO tokens. The string of celebrity endorsements led the SEC to issue a statement on November 1, 2017, cautioning investors about celebrity-backed ICOs.[16]

The SEC has a long history of bringing actions against promoters of securities of various types and now applies that same enforcement of unlawful touting to the sphere of cryptographic tokens. An endorser, celebrity or otherwise, who promotes the sale of any security, generally runs the risk of four types of violations of the federal securities laws: (i) scalping, (ii) investment advisor registration violation, (iii) broker registration violation, and, most serious, (iv) pure securities fraud. We summarize each below.

I. Scalping

"Stock scalping" is a deceptive practice that typically consists of "purchasing shares of a security for [one's] own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following the recommendation."[17]

This deceptive practice could violate several provisions in federal securities law. Under Section 17(b) of the Securities Act, it is unlawful for a promoter to acquire shares of a stock for his or her own benefit before recommending or touting that very stock to others without disclosing in the tout the full details of his or her financial ties to the issuer.[18] A promoter who receives financial incentives in the form of cash, instead of stock shares, similarly violates Section 17(b) of the Securities Act, which makes it unlawful for any person to:

> "publish, give publicity to, or circulate any notice . . . or communication which . . . describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof."

II. Investment Adviser Registration

Depending on the specific facts applicable to persons involved in touting particular offerings of securities, the SEC may view a promoter as "an investment adviser" because he or she is a "person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in,

purchasing, or selling securities."[19] For instance, the SEC may view a newsletter publisher as an investment adviser if the newsletter charges subscription fees and disseminates investment advice.

If the SEC views a promoter as "an investment adviser," then the SEC may find that the promoter violates Section 203 of the Investment Advisers Act of 1940.[20] Section 203 of the Investment Advisers Act states that it is unlawful for any investment adviser, unless registered as an investment adviser, to make use of mails or interstate commerce in connection with his or her business as an investment adviser.[21]

III. Broker Registration

An endorser of a securities offering also runs the risk of engaging in unregistered broker activity. The SEC will view a person to be acting as a broker if he or she is "engaged in the business of effecting transactions in the securities for the account of others."[22] Section 15(a)(1) of the Securities Exchange Act of 1934 requires any broker to be registered with the SEC if he or she "effects transactions in or induce[s] or attempt[s] to induce the purchase or sale of securities."

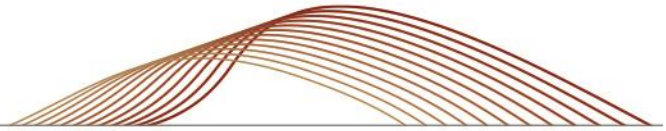
If an endorser fails to register as a securities broker when he or she (i) obtains custody of securities, (ii) attempts to sell those securities into the market, and then (iii) provides the net proceeds (minus a fee) back to the securities issuers, the SEC may charge the endorser with broker registration violation. In this scenario, similar to the scenario in a "scalping" case, a promoter receives payment for facilitating the sale of securities. Regardless of how the compensation arrangement is made, both scenarios could trigger a violation of federal securities law.

IV. Anti-Fraud

Lastly, the most significant risk for endorsers is being deemed to engage in pure securities fraud. Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 proscribe the use of any scheme to defraud in connection with the purchase or sale of a security. In a typical "pump and dump" case, the SEC alleges that a holder of securities—either the issuer of those securities or a third party—intentionally or recklessly disseminates false information about the issuer of such securities in an effort to increase their price.[23] Once the price of the securities has been inflated due to the false information, the promoter sells the securities he or she owns at the artificially high price to unsuspecting buyers.

Mayweather, as part of his promotion of Centra's ICO, recorded a video at a department store in Los Angeles, which purported to show him buying several items at the checkout counter by using a "Centra Card" and a "Centra Wallet" application on an iPhone.[24] This video, which was posted to YouTube, arguably was a false representation, since Centra's products were allegedly never capable of making these financial transactions for consumers.[25] Hypothetically, if Mayweather owned some of Centra's tokens, as he claimed he did, and knew the extent of Centra's misrepresentations about the company's capacities, then Mayweather could have been charged with securities fraud.

Anyone endorsing, offering for sale, or selling cryptographic tokens should be aware of the SEC's view that the federal securities laws apply to many cryptographic tokens just as they apply to other securities. We can expect to see the SEC bring additional enforcement matters against promoters of ICO tokens—whether celebrities or not—for violations of the anti-scalping, investment advisor and broker registration, and fraud provisions of federal securities laws.



Paul Hastings has leading payments regulatory, securities regulation, and SEC enforcement and securities litigation practices and regularly advises issuers and investors involved with emerging and established companies focused on blockchain technology, tokenized securities, and cryptocurrencies.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Century City

David M. Hernand
1.310.620.5750
davidhernand@paulhastings.com

Los Angeles

Nick Morgan
1.213.683.6181
nicolasmorgan@paulhastings.com

Meagan S. Olsen
1.213.683.6138
meaganolsen@paulhastings.com

New York

Yariv C. Katz
1.212.318.6393
yarivkatz@paulhastings.com

Michael L. Zuppone
1.212.318.6906
michaelzuppone@paulhastings.com

Palo Alto

Jeff Hartlin
1.650.320.1804
jeffhartlin@paulhastings.com

---

[1] https://www.sec.gov/news/press-release/2018-268.

[2] https://www.sec.gov/news/press-release/2018-53.

[3] https://twitter.com/floydmayweather/status/900459256784334851?lang=en ("You can call me Floyd Crypto Mayweather from now on . . . ."); https://www.sec.gov/litigation/admin/2018/33-10578.pdf ("Centra's (CTR) ICO starts in a few hours. Get yours before they sell out, I got mine . . . .").

[4] https://www.sec.gov/litigation/admin/2018/33-10579.pdf ("I just received my titanium centra debit card . . . This is a Game changer here. Get your CTR tokens now!").

[5] https://www.nytimes.com/2017/10/27/technology/how-floyd-mayweather-helped-two-young-guys-from-miami-get-rich.html.

[6] *Id.*

[7] https://www.sec.gov/litigation/complaints/2018/comp24117.pdf.

[8] https://www.justice.gov/usao-sdny/pr/two-co-founders-cryptocurrency-company-charged-manhattan-federal-court-scheme-defraud; https://www.justice.gov/usao-sdny/pr/third-co-founder-cryptocurrency-company-charged-manhattan-federal-court-scheme-defraud.

[9] *See*, *e.g.*, https://zycrypto.com/nick-morgan-celebrity-endorsers-of-scam-icos-will-soon-get-hammered-by-the-sec/.

[10] https://www.sec.gov/litigation/admin/2018/33-10578.pdf; https://www.sec.gov/litigation/admin/2018/33-10579.pdf.

[11] https://www.coindesk.com/actor-jamie-foxx-promotes-cryptocurrency-exchange-ico.

[12] https://www.bbc.com/news/business-42820246; *see also* https://www.npr.org/sections/thetwo-way/2018/02/27/589052493/rapper-50-cent-who-bragged-about-owning-bitcoin-now-denies-it.

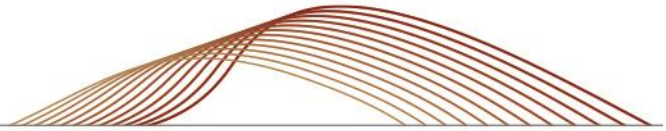
[13] Other celebrities who have openly promoted ICOs include actors Donald Glover and Steven Seagal, soccer players Lionel Messi and Luis Suarez, and rapper The Game. *See* https://cointelegraph.com/news/celebs-and-crypto-a-mixed-bag-of-crypto-collaboration.

[14] https://www.icodata.io/stats/2017; https://www.icodata.io/stats/2018.

[15] https://www.newyorker.com/business/currency/what-is-the-nature-of-a-digital-coin-paris-hilton-might-know-but-the-sec-doesnt.

[16] https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos.

[17] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 181 (1963); *see also SEC v. Blavin*, 557 F. Supp. 1304 (ED Mich. 1983) ("a practice called 'scalping,' that is, buying stock, touting it . . . and then selling it for profit").



[18] *See SEC v. Liberty Capital Group Inc.*, 75 F. Supp. 2d 1160 (W.D. Wash. 1999) (stating that a cause of action under Section 17(b) of the Securities Act of 1933 requires allegations that a defendant (i) describes a security (ii) for a consideration). In that case, the U.S. District Court for the Western District of Washington also held that "the plain meaning of § 17(b) excludes an element of intent, and none of the Supreme Court's reasons for reading that element into § 17(a)(1) in *Aaron* apply here." *Id.* at 1163.

[19] Section 202(a)(11) of the Investment Advisers Act of 1940.

[20] *See id*.

[21] Section 203(e)(6) of the Investment Advisers Act.

[22] Section 3(a)(4)(A) of the Securities Exchange Act of 1934.

[23] *See*, e.g., https://www.sec.gov/litigation/litreleases/2014/lr23072.htm.

[24] https://www.sec.gov/litigation/admin/2018/33-10578.pdf.

[25] https://www.sec.gov/litigation/complaints/2018/comp24117.pdf (noting that Centra's co-founders misrepresented facts and that Centra in fact did not have any "partnership" or other relationship with the credit card companies).