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# *SEC Offers Possible Path to Compliance for ICO Issuers*

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On November 16, 2018, the Securities and Exchange Commission ("SEC") announced settlements with two companies that had raised funds through initial coin offerings ("ICOs"), which allegedly were neither registered nor exempt from registration under federal securities laws. These cases mark the first time that the SEC has imposed civil penalties solely for violations of Section 5 in connection with ICOs and introduce a novel method for redressing unregistered, non-exempt offerings under federal securities laws.

The defendants in the two cases were CarrierEQ Inc. ("Airfox"), which raised $15 million to build an "ecosystem" in emerging markets that would allow users to earn digital tokens for mobile data, and Paragon Coin Inc., which raised $12 million to implement blockchain technology in the cannabis industry. Both ICOs occurred after the SEC issued its DAO Report of Investigation in July 2017, in which the SEC cautioned that ICOs can be securities offerings.

In each of the Airfox and Paragon settlements, the issuers and the SEC agreed that the company would issue a press release "informing all persons and entities that purchased []tokens from Respondent . . . of their potential claims under Section 12(a) of the Securities Act, including the right to sue 'to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if [the purchaser] no longer owns the security' . . . ."[1] Airfox and Paragon agreed to pay the amount due under Section 12(a) of the Securities Act to token purchasers who submitted a claim before a prescribed deadline on a form provided by the issuer. They also agreed to register the tokens as a class of securities under Section 12(g) of the Securities Exchange Act of 1934 and to maintain such registration and timely file all required periodic reports for at least one year. Each of Airfox and Paragon also agreed to pay a civil penalty of $250,000.

In the press release announcing the settlements, a Co-Director of the SEC's Enforcement Division stated that the settlements "provide *a model* for companies that have issued tokens in ICOs and seek to comply with the federal securities laws."[2] These actions outline a new path forward for companies that issued digital tokens in the good faith belief that their ICOs did not need to be registered or exempt but that have since come to the conclusion that such prior belief was mistaken.

ICOs became an increasingly popular means of raising capital in 2017, with 875 ICOs bringing in an aggregate of $6.2 billion.[3] During 2018 to date, nearly 1,200 ICOs have raised an aggregate of

$7.3 billion,[4] though the market has cooled considerably since the beginning of the year, likely due to increased scrutiny from regulators.

Beginning in late 2017, members of the SEC's top brass publicly stated their views that most tokens sold in ICOs constitute securities and warned issuers and other market participants to comply with federal securities laws in connection with offers and sales of such tokens.[5] In December 2017, the SEC brought its first non-fraud-related ICO enforcement action, halting an ongoing ICO by Munchee Inc. that was neither registered nor exempt from registration, and causing the issuer to refund proceeds before any tokens were delivered to investors.[6] Earlier this month, the SEC charged an online cryptocurrency trading platform with operating an unregistered securities exchange.[7] Together, these statements and actions settle a question that was once the subject of genuine debate and point to the conclusion that, indeed, most ICOs involve offerings of securities and accordingly, must either be registered or exempt from registration under the Securities Act of 1933.

Historically, to cure an unregistered offering, companies would make a rescission offer, which is a process detailed in many states' securities law statutes. Generally, offerees who reject a rescission offer lose the right of action to a refund under state securities laws. However, besides being time-consuming and costly, making a rescission offer can be a risky remedial measure because it may not eliminate an issuer's liability under federal securities laws. After making a rescission offer, companies could still be liable to investors under federal securities laws or face penalty by the SEC.

Through no-action letters, the SEC has issued guidance indicating that a rescission offer does not eliminate an issuer's liability to a purchaser who rejects the offer.[8] However, two circuit courts have taken a different view, holding that purchasers who reject rescission offers consequently waive their rights to recovery under federal securities law.[9] In light of the divergent views of the SEC and the federal courts to date, ICO issuers considering a rescission offer are faced with a difficult choice—make a rescission offer despite the risks that remain or do nothing and hope investors and securities law regulators fail to assert claims before claims became barred by statutes of limitations.

Adding to this conundrum is that the SEC historically has viewed a rescission offer as both an offer to buy the security issued in violation of applicable securities law and an offer to sell the same security.[10] As a result, companies may need to register a rescission offer with the SEC or qualify for an exemption. Otherwise, a company may be engaging in a second securities law violation while, ironically, attempting to cure the first.

The Airfox and Paragon settlements suggest SEC acceptance of a new roadmap for ICO issuers that are eager to remove the taint from past illegal offers and sales of securities. With this approach, ICO issuers can implement a "claims process" to give investors an opportunity to receive a refund without having to register the offer of such refund, which should enable a faster and more efficient process for removing the taint on a prior unlawful offering. The claims process approach also may provide more certainty regarding future liability under federal securities laws. Lastly, it may be possible for the claims process to satisfy the requirements for effecting rescission offers under applicable state securities laws, which would effectively cut off liability under state law.

Many ICO issuers may wish to consider whether to implement the claims process identified in the Airfox and Paragon settlements to address possible past defects in their offerings. Each issuer should evaluate with legal counsel the facts and circumstances applicable to its ICO, its appetite for registering its securities and becoming subject to periodic reporting requirements (similar to other public companies), and what steps would be necessary in jurisdictions applicable to such issuer.

The viability of this approach for many ICO issuers may hinge on the issuer's resources and how "the amount due under Section 12(a) of the Securities Act" is calculated. The SEC orders do not specify whether repayment is to be made in the same currency as used by an investor for its original investment or the U.S. Dollar equivalent (and if the latter, whether it is calculated as of the time of investment or the payment of a claim). Both Airfox and Paragon accepted payment for tokens in cryptocurrencies like Bitcoin and Ether. Given the general volatility of the cryptocurrency market and the fact that the prices of many cryptocurrencies have declined significantly in the past year, the SEC's position on this issue can decidedly affect whether ICO issuers would be able to take advantage of this new method for addressing unregistered, non-exempt offerings.

The new claims process approach identified by the SEC is not perfect, but represents an effort to create a lighter regulatory construct to remedy prior violations.

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[1] https://www.sec.gov/litigation/admin/2018/33-10574.pdf; https://www.sec.gov/litigation/admin/2018/33-10575.pdf.

[2] https://www.sec.gov/news/press-release/2018-264 (emphasis added).

[3] https://www.icodata.io/stats/2017.

[4] https://www.icodata.io/stats/2018.

[5] https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11; https://www.sec.gov/news/speech/speech-hinman-061418.

[6] https://www.sec.gov/news/press-release/2017-227.

[7] https://www.sec.gov/news/press-release/2018-258.

[8] *See Clover Mini-Marts Inc., SEC No-Action Letter*, 1985 WL 52008 (Feb. 2, 1985); *Steiger Tractor, SEC No-Action Letter*, 1975 WL 11392 (Aug. 21, 1975) (reiterating "its previously-expressed view that liabilities under the Federal securities laws, including the civil liabilities arising under Section 12 of the Act, are not terminated merely because potentially liable persons make a registered rescission offer with a prospectus meeting the requirements of Section 10 of the Act").

[9] *Topalian v. Ehrman*, 954 F.2d 1125 (5th Cir. 1993); *Meyers v. C & M Petroleum Producers Inc.*, 476 F.2d 427 (5th Cir. 1973).

[10] *See* SEC Release No. 33-6653 (1986); *but see Meyers v. C&M Petroleum Producers, Inc.*, 476 F.2d 427 (5th Cir. 1973), cert. denied, 414 U.S. 829 (1973) ("Since . . . the [unregistered rescission offer] . . . was an offer to provide the remedy prescribed by statute, we find no merit in the…argument…that the repurchase offer itself violated the registration requirements of the Act.").