Recent ICO Cease-and-Desist Orders Illuminate SEC's Crypto Framework: First Analysis

A Lexis Practice Advisor® Practice Note by
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Introduction

This article discusses the following cease-and-desist orders from the Securities and Exchange Commission (SEC) relating to initial coin offerings, or ICOs:

- An August 12, 2019 order against SimplyVital Health, Inc. (SimplyVital) based on findings that SimplyVital conducted sales and offers of certain digital assets without registration in violation of Section 5(a) and Section 5(c) of the Securities Act of 1933, as amended (the Securities Act) (15 U.S.C. §§ 77e (a) and (c)) –and–
- An August 20, 2019 order against ICO Rating based on findings that ICO Rating touted ICOs without disclosing that it received compensation from issuers in violation of Section 17(b) of the Securities Act (15 U.S.C. § 77q (b)).

ICOs are typically fundraising mechanisms whereby companies issue new digital assets (commonly referred to as coins or tokens) in return for traditional currency or established cryptocurrencies such as Bitcoin or Ethereum. For example, a startup airline may conduct an ICO through which it offers tokens representing miles to individuals in return for U.S. dollars it will use to purchase its initial fleet of aircraft.

Though digital assets such as cryptocurrencies are not new, the steep rise in their use, particularly around 2017, has required regulators across the globe to consider and begin to address their unique challenges. For its part, the SEC has focused on clarifying whether digital assets qualify as "securities" for the purpose of U.S. securities laws by providing facts-and-circumstances based tests. In the absence of bright line rules, then, enforcement actions such as these recent orders provide helpful and instructive illustrations of the application of those tests.

Background: The SEC's Crypto Framework

On April 3, 2019, the staff of the SEC (the Staff) consolidated the various pieces of guidance and enforcement actions it had previously issued in a framework (the Framework) that articulates the factors relevant to determining whether digital assets offered and sold in ICOs are "investment contracts" and therefore "securities" for purposes of U.S. federal securities regulation. The Staff grounded the Framework in the Howey test–promulgated by the U.S. Supreme Court in its 1946 decision in SEC v. W. J. Howey Co. (328 U.S. 293)–which evaluates whether a particular contract is a security based on whether it

represents (1) an "investment of money" (2) in a "common enterprise" (3) motivated by the "[expectation] of profits solely from the efforts of . . . a third party." The Framework lays out three primary inquiries to be considered when applying the Howey test to digital assets:

- Do efforts of a third party determine the success of the common enterprise?
- Are the investors in the digital assets motivated by an expectation of profit?
- Does the purchase of the digital asset represent an act of consumption or an act of investment?

Initial Guidance

The SimplyVital Cease-and-Desist Order

On September 21, 2017, SimplyVital announced that it planned to conduct a token sale in November of that year to raise money for the development of Health Nexus, a tool for healthcare providers to share patient data in a HIPAA-compliant manner. SimplyVital was offering a new token called Health Cash (or HLTH), which would ultimately be used as a currency to purchase various services from and within the Health Nexus tool. The company announced that it would conduct a "pre-sale" that would begin at the end of September 2017 whereby individuals could purchase HLTH tokens in advance of the main sale by entering into Simple Agreements for Future Tokens, or SAFTs, at, importantly, a significant discount to the main sale price. The main sale did not occur in November as announced, however. SimplyVital, in fact, continued to conduct pre-sales through early 2018, at which point it began offering tiered discounts to pre-sale investors such that those making larger investments received larger discounts.

Before executing the SAFTs, SimplyVital did not file a registration statement, instead noting in the offering memorandum that it was seeking to rely on either "the exemption provided by Section 4(A)(2) [sic] of the Securities Act and Regulation D promulgated thereunder" or the Regulation S safe harbor for offers and sales that occur outside the United States. The SEC, however, found that SimplyVital failed to take reasonable steps to verify that purchasers of securities sold in its pre-sale offerings were accredited investors. Moreover, the SEC found that the company was aware that several purchasers were so-called "ICO pools," which collected funds from various individuals to meet the company's investment minimum, consisting of individual purchasers whose identity was unknown to the company. On these facts, the SEC notified SimplyVital that its pre-sales and related offers, without an effective registration statement, violated Section 5(a) and Section 5(c) of the Securities Act, and the company consequently decided to abandon the token sale and return any funds it had received. In light of these remedial actions, the SEC decided not to impose any civil penalty on SimplyVital.

The SimplyVital order highlights that issuers' obligations when claiming registration exemptions are the same regardless of whether the assets being offered are digital assets or traditional securities. Those who conduct SAFT offerings must perform sufficient due diligence on purchasers to confirm accredited investor status, including by verifying the individual identities of the persons who contribute to the "ICO pools" investing in their platform. The SimplyVital order also provides further confirmation of the generally held view that the typical structure of a SAFT offering constitutes an offering of securities under the Framework: the pre-sale discounts guaranteed that the value of the tokens would rise significantly after the conclusion of the pre-sale, which created the risk that SimplyVital's investors would purchase the assets with an expectation of profit not merely "incidental" to their purchase.

The ICO Rating Cease-and-Desist Order

From approximately December 2017 through July 2018, ICO Rating, which described itself as an "ICO rating agency," issued research reports, ratings and publicity materials relating to ICOs. Issuers conducting ICOs would pay ICO Rating a fee for publication of a report or rating in respect of the ICO, but ICO Rating did not disclose its receipt of these fees in the publications. The SEC concluded that ICO Rating violated Section 17(b) of the Securities Act, which requires those who promote securities in return for fees from issuers or underwriters to disclose the receipt and amount of such fees. The SEC found that by touting ICOs that involved the offer and sale of securities without disclosing the existence or magnitude of the compensation it received for doing so, ICO Rating violated Section 17(b) of the Securities Act. In addition to ordering ICO Rating to cease and desist from further violations, the SEC also required the company to pay disgorgement, prejudgment interest and an additional civil penalty.

Though the Framework is addressed to "those engaging in the offer, sale, or distribution of a digital asset" (and indeed an overwhelming majority of enforcement actions are against issuers, broker-dealers or exchanges), the ICO

Rating enforcement serves as a reminder that the regulatory treatment of digital assets implicates the conduct of a wide variety of market participants. This group may also include, for example, individual programmers and information technology specialists who code the infrastructure required to support these digital assets especially if there is no entity that owns such infrastructure.

Looking Ahead

The SEC has indicated the possibility of rulemaking on the topic of digital assets so that market participants can proceed with offerings of digital assets without the need for an uncertain, judgment-based approach. Appearing alongside other SEC commissioners before the House Financial Services Committee on September 24, 2019, SEC Commissioner Hester Pierce noted that she is hopeful "[the SEC] can work to create some sort of safe harbor" to exempt certain types of digital assets from the definition of a security.

Unlike offerings of traditional equity and debt securities, ICOs present fundamental questions for market participants (and their advisors) relating to the definition of a "security" and the public policy principles behind the SEC's registration, offering and disclosure regime. Until such time as a robust body of regulatory guidance, case law and precedents on the subject develops, revisiting these questions and tracking new enforcement actions present the best strategy for successfully considering digital alternatives to traditional fundraising sources.

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