Skadden

The Current State of Cryptocurrency Enforcement and Securities Litigation

Alexander C. Drylewski
Partner / New York
212.735.2129
alexander.drylewski@skadden.com

Peter B. Morrison
Partner / Los Angeles
213.687.5304
peter.morrison@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

On April 24, 2019, Skadden hosted a webinar titled "The Current State of Cryptocurrency Enforcement and Securities Litigation." The presented topics largely focused on the SEC's evolving regulatory approach to cryptocurrency enforcement actions and related guidance. The panelists were Skadden litigation partners **Peter Morrison** and **Alexander Drylewski**.

SEC's Initial Approach

DAO Report

On July 25, 2017, the SEC issued a report analyzing for the first time whether digital assets constituted securities. In its report, the SEC determined that DAO tokens, issued by the DAO Organization, were securities because they qualified as investment contracts under the test set forth by the U.S. Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The SEC concluded that all three prongs of *Howey* were met (investment of money; common enterprise; and reasonable expectation of profits derived from the efforts of others).

Following the DAO Report, the SEC continued enforcement efforts under the same analysis.

SEC Provides Further Guidance

When Howey Met Gary (Plastic)

On June 14, 2018, the director of the SEC's Division of Corporate Finance, William Hinman, gave a speech titled, "When *Howey* Met *Gary (Plastic)*." Hinman suggested in the speech that digital assets could evolve to a point where they no longer constituted securities even though they would have once met the *Howey* test. Hinman stated that a blockchain network may become sufficiently "decentralized" such that its native digital token could no longer constitute an investment contract. In particular, he stated that he did not believe that Bitcoin and Ethereum were securities based on his understanding of the current facts and circumstances of those platforms.

Path to Compliance

On November 16, 2018, the SEC announced a pair of settlement agreements: Paragon Coin, Inc. and Carriereq, Inc. (d/b/a AirFox). Both companies had engaged in initial coin offerings (ICOs) after the release of the DAO Report. As part of their settlement agreements, Paragon and AirFox each agreed to registration under Section 12(g) of the

Exchange Act; distribution of a notice and claim form under Section 12(a) of the Securities Act; filings of all reports required by Section 13(a) of the Exchange Act for at least one year; and a civil penalty. The SEC characterized these settlement agreements as a path to compliance for other unregistered ICOs.

Similarly, on February 20, 2019, the SEC settled charges against Gladius Network LLC relating to its unregistered ICO from 2017. Gladius self-reported to the SEC and was not required to pay a fine, suggesting leniency for those that self-report and cooperate with the SEC.

Recent Developments

Framework

On April 3, 2019, the SEC's Strategic Hub for Innovation and Financial Technology (FinHub) released non-binding guidance titled, "Framework for 'Investment Contract' Analysis of Digital Assets" (Framework). The Framework asserts that the first two prongs of *Howey* are typically satisfied for most digital assets. The Framework also noted that airdrops — where a digital asset is distributed to holders of another digital asset or simply offered at no cost — can nonetheless satisfy the investment of money prong.

The bulk of the Framework's focus relates to the reasonable expectation of profits derived from the efforts of others prong under *Howey*, and the Framework lists a number of factors both pre- and post-ICO that guide the *Howey* determination in the view of the SEC staff. Many of these factors turn on the role "Active Participants" play at the platforms under analysis, defined broadly to include promoters, sponsors, or other third parties or affiliated groups of third parties.

Under the reliance on the efforts of others portion of the prong, many of the factors focused on the extent to which the Active Participants controlled the success of the digital asset versus the platform operating as a "decentralized community of users." Under the reasonable expectation of profits portion of the prong, the factors largely focused on whether the digital asset's value was intended to be and actually shown to be stable or provided holders the ability to realize a benefit from capital appreciation. Additionally, the Framework listed "other relevant considerations" that included such factors as whether the digital asset's value appreciation was "incidental" to obtaining the right to use the digital asset and whether it can act as a substitute for fiat currency.

FinHub explained that the Framework "is not a rule, regulation, or statement of the [SEC], and the [SEC] has neither approved nor disapproved its content." Additionally, the Framework "does not replace or supersede existing case law." Furthermore, the Framework leaves a number of questions unanswered, including how the factors will be weighed by the SEC in deciding whether to bring enforcement actions in the future.

TurnKey Jet, Inc. No-Action Letter

On the same day that the SEC released the Framework, FinHub issued its first "no-action" letter with respect to a proposed digital asset, TKJ Tokens, which were to be offered by TurnKey Jet, Inc. (TKJ). In its initial letter to the SEC, TKJ explained that its TKJ Tokens would only be used on its platform, were nontransferrable and had no assurance that they could be redeemed for cash. Additionally, the TKJ Tokens had a fixed price, thus limiting the ability for their value to appreciate. In response, the SEC recommended no enforcement action because the token sales would not be used to finance the development of the platform, the platform would be "fully developed and operational" at the time of the TKJ Token sales, the TKJ Tokens would be immediately available for use in purchasing air charter services and the TKJ Tokens had a fixed price.

It is not clear from the Framework or the no-action letter how the SEC will proceed with respect to other digital asset cases where the factors may provide a closer call.

Token Taxonomy Act

Shortly after the release of the Framework and TKJ no-action letter, Representatives Warren Davidson (R-Ohio) and Darren Soto (D-Florida) reintroduced the Token Taxonomy Act of 2019 (the Act) in the U.S. House of Representatives. The Act, which is a revised version of the act initially introduced late last year, would exclude cryptocurrencies from being classified as securities under the Securities Act of 1933 and Securities Exchange Act of 1934 and clarifies the jurisdiction of the CFTC and FTC in regulating digital assets. Additionally, the Act would preempt state regulation of the same matters. As of April 9, 2019, the Act has been referred to the Committee on Financial Services and the Committee on Ways and Means for consideration.