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SEC ANNOUNCES FIRST ENFORCEMENT ACTION AGAINST DIGITAL TOKEN PLATFORM AS UNREGISTERED SECURITIES EXCHANGE

To Our Clients and Friends:

On November 8, 2018, the U.S. Securities and Exchange Commission (SEC) announced that it had taken its first enforcement action against a digital "token" trading platform on the basis that the platform operated as an unregistered national securities exchange. This action follows on a number of recent enforcement actions relating to unregistered broker-dealers and unregistered initial coin offerings (ICOs) and demonstrates that the SEC continues to be vigilant in the area of digital tokens.

In its Order accepting an offer of settlement,[1] the SEC found that EtherDelta founder, Zachary Coburn, caused the EtherDelta platform to operate as an unregistered national securities exchange in violation of Section 5 of the Securities Exchange Act of 1934 (Exchange Act). EtherDelta is an online platform that allows buyers and sellers to trade digital assets issued and distributed on the Ethereum Blockchain that use the standard coding protocol (ERC20) used by the majority of issuers in ICOs. Coburn launched the website in July 2016; it made limited token pairs available for trading (particular tokens for Ether only) and displayed current top 500 firm bids and offers by symbol, price, and size. Users could therefore enter orders to buy or sell specified quantities of a particular token at a specified Ether price and with a specified time-in-force.

The SEC noted that in July 2017, it had issued its Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 on The DAO (DAO Report). The DAO Report had advised that if a platform offered the trading of digital assets that are securities and operates as an "exchange" under the federal securities laws, then it must register as an exchange or be able to claim an exemption from registration. It further noted that 3.3 million buy and sell orders in ERC20 tokens were processed on EtherDelta between the issuance of the DAO Report and December 15, 2017.[2] The EtherDelta platform was available to anyone, including U.S. persons, and had no limits on its hours of operation. Certain of the tokens traded were securities within the meaning of the federal securities laws.

The SEC further asserted that Coburn was responsible for performing due diligence on the tokens traded before those tokens were added to EtherDelta's list of official token listings – a list that included approximately 500 tokens.

Under Exchange Act Rule 3b-16(a), a platform will be considered to be an exchange if the platform "(1) brings together the orders for *securities* of multiple buyers and sellers; and (2) uses established non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the

trade."^[3] If a platform is an exchange, it must register with the SEC or have an exemption, such as for an alternative trading system (ATS).

The SEC stated that EtherDelta satisfied the Rule 3b-16(a) criteria in that it "receiv[ed] and stor[ed] orders in tokens in [its] order book and display[ed] the top 500 orders (including token symbol, size, and price) as bids and offers" on its website. The platform was the means "for these orders to interact and execute through the combined use of the EtherDelta website, order book, and pre-programmed trading protocols" defined in the platform's smart contract – which were "established, non-discretionary methods" within the meaning of Rule 3b-16(a). In addition, certain of the tokens were securities under the *Howey* test: purchasers invested money with a reasonable expectation of profits, including through the increased value of their investments in secondary trading, based on the managerial efforts of others.

Because EtherDelta did not register as a national securities exchange or operate pursuant to an exemption, it violated Section 5 of the Exchange Act. Coburn, as the founder of EtherDelta, should have known that his actions would contribute to EtherDelta's violations, and thus he caused EtherDelta's violations within the meaning of Section 21C(a) of the Exchange Act.

In settling the action, Coburn agreed to pay disgorgement of \$300,000 plus prejudgment interest. In addition, the SEC imposed a \$75,000 civil money penalty. The order notes that Coburn cooperated in the investigation and agreed to testify in any related enforcement action, suggesting that the civil money penalty would have been higher absent this co-operation.

Conclusion

The EtherDelta action demonstrates that the SEC continues to keep a watchful eye on ICO and token offerings, and that it believes that it put participants in these markets on notice when it issued the DAO Report in July 2017. In addition, just as the order does not indicate precisely how many of the EtherDelta tokens were securities under the *Howey* test, it also does not contain any mention of the extent or quality of Coburn's diligence under *Howey* – his civil money penalty appears to have been low due to his cooperation with the SEC alone. The action is the first unregistered securities exchange action taken by the SEC, but it may well not be the last. Given the continued vigilance of the SEC, it is to be expected that more and more firms will seek to buy or establish ATSS for token trading, because this exemption from registration as a national securities exchange is clearly available for tokens that are securities under *Howey*.

[1] In the Matter of Zachary Coburn, Respondent (November 8, 2018), available at <https://www.sec.gov/news/press-release/2018-258>.

[2] Coburn entered into an agreement to sell EtherDelta to non-U.S. buyers in November 2017.

[3] 17 C.F.R. § 240.3b-16(a) (emphasis added).



The following Gibson Dunn lawyers assisted in preparing this client update: Arthur Long, Alan Bannister, Nicolas Dumont, Michael Mencher, and Jordan Garside.

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