

November 29, 2019

## **SEC IMPOSES CIVIL PENALTIES FOR ICO REGISTRATION VIOLATIONS; SUGGESTS A PATH FOR FUTURE COMPLIANCE**

To Our Clients and Friends:

On November 16, 2018, the Securities and Exchange Commission (SEC) announced settled charges in its first cases imposing civil penalties solely for registration violations related to initial coin offerings (ICOs).[1] The SEC brought charges against CarrierEQ Inc. (AirFox) and Paragon Coin Inc. (Paragon) for their respective ICOs conducted in 2017 on the basis that (i) the digital tokens sold in those ICOs were securities under Section 2(a)(1) of the Securities Act of 1933 (Securities Act) and (ii) those securities were neither registered nor exempt from registration under Section 5 of the Securities Act. Both AirFox and Paragon issued unregistered tokens in spite of an earlier warning from the SEC that certain tokens, coins or other digital assets can be considered securities under the federal securities laws and, consequently, issuers who offer or sell such securities must register the offering and sale with the SEC or qualify for an exemption.[2] The cases follow the SEC's first non-fraud registration case, Munchee, Inc., in which the SEC halted a coin sale by means of cease-and-desist order and no monetary penalties were imposed.

In 2017, AirFox raised approximately \$15 million worth of digital assets to finance its development of a token-denominated "ecosystem," and Paragon raised approximately \$12 million worth of digital assets to develop and implement its business plan related to the cannabis industry. After reviewing the nature of these tokens, the SEC concluded that they were securities under the *Howey* test, thereby making those offerings subject to the requirements of Section 5 of the Securities Act and related rules.

The resolution of these charges has been suggested as a "model for companies that have issued tokens in ICOs . . . to seek to comply with the federal securities laws," according to Steven Peiken, Co-Director of the SEC's Enforcement Division. The remedy has three parts. First, both Airfox and Paragon agreed to pay monetary penalties of \$250,000 each. Second, in a nod to the statutory remedies provided by Section 12(a)(1) of the Securities Act, both companies agreed to distribute a "claim form" to their respective investors whereby purchased tokens could be exchanged for the amount of consideration paid plus interest and, for those investors no longer in possession of their purchased tokens, damages. The "claim form" approach was agreed to over another potential remedy used by other companies in the past, a "rescission offer" in which the companies would offer to repurchase issued tokens and, in the event an investor declined that offer, such investor would hold freely tradable tokens. Third, perhaps most significantly, both companies agreed to register the tokens as securities under the Exchange Act and file periodic reports with the SEC, thereby granting investors the disclosure protections of the securities laws in deciding whether to put their securities. It is likely that compliance with this regime will likely impose significant compliance burdens, particularly on smaller issuers. It

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remains to be seen whether other ICO issuers who have conducted unregistered securities offerings will opt for this remedy following discussions with the SEC.

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[1] See SEC Release No. 10574 and Release No. 10575.

[2] See Report of Investigation Pursuant To Section 21(a) Of The Securities Exchange Act of 1934: The DAO (Exchange Act Rel. No. 81207) (July 25, 2017)). See also [www.securitiesregulationmonitor.com/Lists/Posts/Post.aspx?List=f3551fe8-411e-4ea4-830c-d680a8c0da43&ID=297&Web=97364e78-c7b4-4464-a28c-fd4eea1956ac](http://www.securitiesregulationmonitor.com/Lists/Posts/Post.aspx?List=f3551fe8-411e-4ea4-830c-d680a8c0da43&ID=297&Web=97364e78-c7b4-4464-a28c-fd4eea1956ac).



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