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Regulators Step Up Enforcement on Crypto Firms

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After a several month lull that led some to question the SEC's focus on crypto enforcement, this week saw a spate of enforcement activity involving crypto assets: several SEC enforcement actions, an SEC trading suspension order, the first FINRA cryptocurrency enforcement action, and a preliminary court decision consistent with the view that ICO tokens may be (and perhaps often are) securities. These actions give life to SEC Chairman Clayton's **statement** that "to the extent something is a security, we should regulate it as security."

A Continued Focus on Intermediaries

Two of this week's enforcement actions involve allegations that intermediaries offering and selling ICO tokens were acting as unregistered broker-dealers. First, the SEC found that TokenLot, LLC, a self-described "ICO Superstore," facilitated the sale of nine digital tokens as part of ICOs and secondary market transactions of approximately 145 digital tokens after those issuers' ICOs had occurred. The SEC concluded that certain of these digital tokens were securities and, thus, charged TokenLot with violations of the Securities Exchange Act for illegally acting as an unregistered broker-dealer. In a separate action, FINRA charged Timothy Ayre, who at the time of the conduct was registered with a FINRA member broker-dealer but acting outside of that capacity, with violations of the Securities Act, Securities Exchange Act, and FINRA rules in connection with the public offering and sale of cryptocurrency securities tied to a public company of which Ayre was president and a director.

The SEC also issued a cease-and-desist order against Crypto Asset Management LP (**CAM**), a digital asset hedge fund manager, which had raised an investment fund to invest in digital assets. The fund was marketed as the "first regulated crypto asset fund in the United States" and, according to the SEC order, was marketed in a

general solicitation through CAM's website. The SEC charged CAM for failing to register its digital asset fund as an investment company under the Investment Company Act of 1940 and with violations of Securities Act registration requirements and Advisers Act anti-fraud provisions.

Each of these actions is based on a fundamental, and by now well-accepted, principle: many types of digital assets may be, and likely are, securities. There are several additional observations to be drawn from these actions:

- The SEC, and now FINRA, are acting on recent warnings from Chairman Clayton to intermediaries involved in unlicensed crypto asset activities involving securities.**[1]** We believe that regulators are likely to continue to focus on intermediaries involved in these activities and that these activities are likely to be subject to particular scrutiny, whether for potential fraudulent conduct or, increasingly, for other types of securities law violations.
- In TokenLot, one of the agreed-upon undertakings is for TokenLot to "retain an independent third party to destroy TokenLot's remaining inventory of digital assets." This, to us, appears to be an approach unique to digital asset securities and a potentially unprecedented remedy in an SEC enforcement matter. Typically there is an interest in preserving, rather than destroying value, in order to gather assets to benefit harmed investors. In this case, the SEC may believe that because the digital assets are unregistered securities, they did not want to facilitate their further resale. Given the extent of unregistered digital asset securities tokens that have been sold during the wave of ICOs, this remedy may portend what the SEC may require in future enforcement actions.
- The Ayre case constitutes the first regulatory action, to our knowledge, that confirms that a digital token tied to, or that references, a security is itself a security. HempCoin, which was also listed on crypto exchanges, was designed to be equivalent to 0.1 shares of the common stock of the public company controlled by Ayre.
- CAM involved a hedge fund manager that had been operating digital asset funds outside the United States and that was seeking to engage in the same activity inside the United States. As many market participants have discovered, the U.S. regulations that may apply to crypto asset activities, including asset management, are often significantly different from those in other jurisdictions and also can be significantly more restrictive.

Trading Suspended for Bitcoin Tracker One and Ether Tracker One

In an order issued Sunday night, the SEC **temporarily suspended** U.S. trading in Bitcoin Tracker One and Ether Tracker One, two crypto-linked financial instruments issued by a Swedish public company and listed on the NASDAQ/OMX exchange in Stockholm. In its order, the SEC states that these financial instruments, which were not U.S. exchange-listed but have been trading on the OTC Markets trading system, were the subject of misleading disclosure because they were described in broker-dealer application materials as "Exchange Traded Funds," in other public sources as "Exchange Traded Notes" and in the issuer's offering materials as "non-equity linked certificates."

The EDNY's Preliminary Views on Digital Tokens as Securities

United States v. Zaslavskiy involves allegations brought by the SEC that the owner of two companies, REcoin Group Foundation LLC and Diamond Reserve Club, fraudulently induced investors to purchase purported cryptocurrency tokens or coins promoted in connection with the planned ICOs of those companies. The defendant sought to dismiss the case, asserting that the purported tokens or coins at issue in the case are not securities under the longstanding *Howey* test and that Section 10(b) and Rule 10b-5 of the Securities Exchange Act were unconstitutionally vague as applied to the activities in question in this case.

Judge Dearie of the Eastern District of New York on Wednesday **denied** the motion to dismiss in its entirety. Judge Dearie observed that "stripped of the 21st-century jargon," the government's indictment "charges a straightforward scam, replete with the common characteristics of many financial frauds."**[2]** The court noted that, given that the case was before it on the defendant's motion to dismiss, a determination on the question of whether Zaslavskiy offered investments in securities under the *Howey* test was premature. Nonetheless, the court provided a detailed analysis of the REcoin and Diamond investments under the *Howey* test in coming to the conclusion that a reasonable jury could indeed conclude that such investments were securities under *Howey* and its progeny. The court also concluded that the securities laws were not unconstitutionally vague as applied to this context.

Zaslavskiy's activities may have been an allegedly straightforward scam for which the *Howey* analysis is not novel, but other ICO cases currently in the pipeline—both civil and criminal—are sure to pose closer questions. This decision, and its detailed

review of the status of the ICO tokens under the *Howey* test, may serve as a guidepost for those cases, as they progress.

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[1] SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017) (**link**) ("On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities."); SEC Chairman Jay Clayton, Opening Remarks at the Securities Regulation Institute (Jan. 22, 2018) (**link**) ("Market professionals, especially gatekeepers, need to act responsibly and hold themselves to high standards. To be blunt, from what I have seen recently, particularly in the [ICO] space, they can do better.").

[2] Among other things, Zaslavskiy is alleged to have offered to investors the opportunity to purchase crypto tokens hedged with diamonds, with investments structured in a way to provide "minimum growth of 10% to 15% a year."