

The SEC's ICO “Path to Compliance”: the Eradication of the Decentralized Creation and Issuance of Digital Assets

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The SEC's View of ICO's in Q4 2018

- ▶ The sale of a token that does not implicate securities laws : private token sale v. sale of an unregistered security. *Hinman*
- ▶ The nature of a digital asset may evolve from a security to a token (toward or away from a security). *Clayton (April 2018)*
- ▶ The nature and use of tokens may change over time in such a way that they fall outside the regulatory purview of securities laws. *Hinman*
- ▶ There is a way for issuers of unregistered securities to become compliant with securities laws after issuing tokens deemed to be securities. *Paragon; AirFox; & Blockvest*

SEC's Key Indicia to Determine Whether the Sale of Tokens Constitutes the Sale of Securities

- ▶ Broad v. targeted solicitation; targeting crypto-investors v. potential actual token users;
- ▶ Promises of returns on investment v. purchaser use, deployment, or holding;
- ▶ No ability to use the tokens immediately upon purchase/receipt v. ability to immediately deploy;
- ▶ Reliance on the issuer to increase the value of the token v. value derived from dApp, platform, or protocol use; and
- ▶ Issuer's promise to create, facilitate, or maintain secondary markets for the tokens v. no issuer involvement in creating or managing secondary markets.

See CarrierEQ, Inc., Rel. No. 33-10575 (Nov. 16, 2018); Paragon Coin, Inc., Rel. No. 33-10574 (Nov. 16, 2018)

The “Path to Compliance” in *Paragon* and *AirFox*

- ▶ Create a Claim Form and claim process to reimburse purchasers;
- ▶ File a Form 10;
 - ▶ For companies who have over \$10,000,000 in assets or
 - ▶ 2,000 holders (equity or tokens) of record or 500 holders who are unaccredited investors
- ▶ Notify potential claimants;
- ▶ Maintain Exchange Act registrations and filing requirements under 13(a);
- ▶ Submit to the SEC a monthly report on claim reports received;
- ▶ Submit to the SEC a final report of its handling of all the claims to the SEC; and

What does the Claim Form include?

- ▶ Information of the token purchasers' potential claims, including the right to sue “to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if [the purchaser] no longer owns the security”
- ▶ An address where token purchasers can submit Claim Forms

Paragon and AirFox - Implications

- ▶ Assumes issuers satisfy 12(g) of the Exchange Act
 - ▶ \$10MM in assets
 - ▶ 2,000 holders of *equity*
- ▶ Reporting Company
 - ▶ Must file 8K, 10K, and 10Q
- ▶ Sarbanes Oxley
 - ▶ Audit committee requirements;
 - ▶ CEO/CFO requirements;
 - ▶ Prohibition on director and executive officer loans;
 - ▶ Restrictions on improper influence on conduct of audits;
 - ▶ Bonus forfeiture in case of accounting restatements due to misconduct;
 - ▶ Bar on service as a D&O for persons found guilty of federal securities law violations;
 - ▶ Prohibition of insider trading during employee plan blackout periods; and
 - ▶ Whistleblower protections.
- ▶ Centralized oversight v. decentralized (peer-to-peer) compliance via smart contract/token requirements

Other Implications

- ▶ This “path to compliance” ignores the fundamental reason for the “**tokenized economy**,” which is to develop a *decentralized method for independent actors to transact via the internet in a peer-to-peer manner*—via blockchain recordation and confirmation of transactions—that is free from institutionalized oversight and centralized control, and is independently verifiable, immutable, and more efficient and secure than current transaction structures and methods.

Issues with the “Path to Compliance”

- ▶ Who do you reimburse?
- ▶ How do you determine the process of granting or denying claims?
- ▶ Are there alternatives to reimbursement?
- ▶ How do you determine “2,000 holders of record”?
 - ▶ This is a standard for “shareholders”—asset holders have no “equity” rights and likely no voting rights. Token/Asset sold to be used and consumed in a dApp platform, or protocol as “gas”.

Going Forward: Alternative Remedies the SEC Could Require

- ▶ Creation of standards and an opportunity for issuers to convert tokens into a sufficiently decentralized currency;
- ▶ Reimbursement;
- ▶ Other registration requirements; and
 - ▶ Reg D
 - ▶ Reg S
 - ▶ Reg CF
- ▶ Creation of standards for what constitutes a “digital asset” and/or “digital currency” that enable issuers to design and deploy tokens against these standards.

Keeping the SEC Accountable – *Blockvest* (Nov. 27, 2018)

- ▶ At present, a “moving target” and “guidance” are not necessarily consistent with case law;
- ▶ Existing case law does not mention a timing or geographic limit or requirement for utility; and
- ▶ The potential or ability for resale (or resale for a profit) does not in itself satisfy the *Howey Test*.

See *SEC v. Blockvest, LLC et al.*, Case No.: 18CV2287-GPB(BLM) (Nov. 27, 2018)

The SEC's "path to compliance" is expensive and time consuming and subject to *traditional, centralized burdens and oversight.*

85 years after the creation of U.S. securities regulations; instead of forcing new technology into old financial frameworks, perhaps now is the time to create a new framework that can provide purchaser protection while still allowing new technology to emerge and grow.





Any Questions?



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THANK YOU!