

# Statement on Digital Asset Securities Issuance and Trading

Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets

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In recent years, we have seen significant advances in technologies – including blockchain and other distributed ledger technologies – that impact our securities markets. This statement<sup>[1]</sup> highlights several recent Commission enforcement actions involving the intersection of long-standing applications of our federal securities laws and new technologies.

The Commission's Divisions of Corporation Finance, Investment Management, and Trading and Markets (the "Divisions") encourage technological innovations that benefit investors and our capital markets, and we have been consulting with market participants regarding issues presented by new technologies.<sup>[2]</sup> We wish to emphasize, however, that market participants must still adhere to our well-established and well-functioning federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain.

The Commission's recent enforcement actions involving AirFox, Paragon, Crypto Asset Management, TokenLot, and EtherDelta's founder,<sup>[3]</sup> discussed further below, illustrate the importance of complying with these requirements. Broadly speaking, the issues raised in these actions fall into three categories: (1) initial offers and sales of digital asset securities (including those issued in initial coin offerings ("ICOs")); (2) investment vehicles investing in digital asset securities and those who advise others about investing in these securities; and (3) secondary market trading of digital asset securities. Below, we provide the Divisions' views on these issues.

## **Offers and Sales of Digital Asset Securities**

The Commission has brought a number of actions involving offerings of digital asset securities. To date, these actions have principally focused on two important questions. First, when is a digital asset a "security" for purposes of the federal securities laws?<sup>[4]</sup> Second, if a digital asset is a security, what Commission registration requirements apply?<sup>[5]</sup> The importance of these and related issues is illustrated by several recent Commission enforcement actions involving digital asset securities. In particular, the remedial measures in two of these matters demonstrate a way to address ongoing violations by issuers that have conducted illegal unregistered offerings of digital asset securities.

Today, the Commission issued settled orders against AirFox and Paragon in connection with their unregistered offerings of tokens. Pursuant to these orders, AirFox and Paragon will pay penalties and also have undertaken to register the tokens as securities under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and to file periodic reports with the Commission. They have also agreed to compensate investors who purchased tokens in the illegal offerings if an investor elects to make a claim. The registration undertakings are designed to ensure that investors receive the type of information they would have received had these issuers complied with the registration provisions of the Securities Act of 1933 ("Securities Act") prior to the offer and sale of tokens in their respective ICOs. With the benefit of the ongoing disclosure provided by registration under the Exchange Act, investors who purchased the tokens from the issuers in the ICOs should be able to make a more informed decision as to whether to seek reimbursement or continue to hold their tokens.<sup>[6]</sup>

These two matters demonstrate that there is a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities.

## **Investment Vehicles Investing in Digital Asset Securities**

The Investment Company Act of 1940 ("Investment Company Act") establishes a registration and regulatory framework for pooled vehicles that invest in securities. This framework applies to a pooled investment vehicle, and its service providers, even when the securities in which it invests are digital asset securities.<sup>[7]</sup>

On Sept. 11, 2018, the Commission issued the Crypto Asset Management Order, finding that the manager of a hedge fund formed for the purpose of investing in digital assets had improperly failed to register the fund as an investment company. The order found that the manager engaged in an unlawful, unregistered, non-exempt, public offering of

the fund. By investing more than 40 percent of the fund's assets in digital asset securities and engaging in a public offering of interests in the fund, the manager caused the fund to operate unlawfully as an unregistered investment company. The order also found that the fund's manager was an investment adviser, and that the manager had violated the antifraud provisions of the Investment Advisers Act of 1940 ("Advisers Act") by making misleading statements to investors in the fund.

Investment vehicles that hold digital asset securities and those who advise others about investing in digital asset securities, including managers of investment vehicles, must be mindful of registration, regulatory and fiduciary obligations under the Investment Company Act and the Advisers Act.[8]

### **Trading of Digital Asset Securities**

Commission actions[9]and staff statements[10]involving secondary market trading of digital asset securities have generally focused on what activities require registration as a national securities exchange or registration as a broker or dealer, as those terms are defined under the federal securities laws.

### Exchange Registration

Advancements in blockchain and distributed ledger technology have introduced innovative methods for facilitating electronic trading in digital asset securities. Platforms colloquially referred to as "decentralized" trading platforms, for example, combine traditional technology (such as web-based systems that accept and display orders and servers that store orders) with new technology (such as smart contracts run on a blockchain that contain coded protocols to execute the terms of the contract). These technologies provide the means for investors and market participants to find counterparties, discover prices, and trade a variety of digital asset securities.

A platform that offers trading in digital asset securities and operates as an "exchange" (as defined by the federal securities laws) must register with the Commission as a national securities exchange or be exempt from registration. The Commission's recent enforcement action against the founder of EtherDelta, a platform facilitating trading digital assets securities, underscores the Division of Trading and Markets' ongoing concerns about the failure of platforms that facilitate trading in digital asset securities to register with the Commission absent an exemption from registration.[11]

According to the Commission's order, EtherDelta—which was not registered with the Commission in any capacity—provided a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders, and a smart contract run on the Ethereum blockchain. EtherDelta's smart contract was coded to, among other things, validate order messages, confirm the terms and conditions of orders, execute paired orders, and direct the distributed ledger to be updated to reflect a trade.[12] The Commission found that EtherDelta's activities clearly fell within the definition of an exchange and that EtherDelta's founder caused the platform's failure either to register as a national securities exchange or operate pursuant to an exemption from registration as an exchange.[13]

Any entity[14]that provides a marketplace for bringing together buyers and sellers of securities, regardless of the applied technology, must determine whether its activities meet the definition of an exchange under the federal securities laws. Exchange Act Rule 3b-16 provides a functional test to assess whether an entity meets the definition of an exchange under Section 3(a)(1) of the Exchange Act. An entity that meets the definition of an exchange must register with the Commission as a national securities exchange or be exempt from registration, such as by operating as an alternative trading system ("ATS") in compliance with Regulation ATS.

Notwithstanding how an entity may characterize itself or the particular activities or technology used to bring together buyers and sellers, a functional approach (taking into account the relevant facts and circumstances) will be applied when assessing whether a system constitutes an exchange.[15] The activity that actually occurs between the buyers and sellers—and not the kind of technology or the terminology used by the entity operating or promoting the system—determines whether the system operates as a marketplace and meets the criteria of an exchange under Rule 3b-16(a). For instance, the term "order" for purposes of Rule 3b-16 is intended to be broadly construed, and the actual activities among buyers and sellers on the system—not the labels assigned to indications of trading interest—will be considered for purposes of the exchange analysis.[16]

The exchange analysis includes an assessment of the totality of activities and technology used to bring together orders of multiple buyers and sellers for securities using "established non-discretionary methods"under which such orders interact.[17] A system "brings together orders of buyer and sellers" if, for example, it displays, or otherwise represents, trading interest entered on a system to users or if the system receives users' orders centrally for future processing and execution.[18]

A system uses established non-discretionary methods if it provides a trading facility or sets rules. For example, an entity that provides an algorithm, run on a computer program or on a smart contract using blockchain technology, as a means to bring together or execute orders could be providing a trading facility. As another example, an entity that

sets execution priorities, standardizes material terms for digital asset securities traded on the system, or requires orders to conform with predetermined protocols of a smart contract, could be setting rules. Additionally, if one entity arranges for other entities, either directly or indirectly, to provide the various functions of a trading system that together meet the definition of an exchange, the entity arranging the collective efforts could be considered to have established an exchange.

Entities using blockchain or distributed ledger technology for trading digital assets should carefully review their activities on an ongoing basis to determine whether the digital assets they are trading are securities and whether their activities or services cause them to satisfy the definition of an exchange. An entity engaging in these types of activities should also consider other aspects of the federal securities laws (and other relevant legal and regulatory issues) beyond exchange registration requirements.

#### Broker-Dealer Registration

An entity that facilitates the issuance of digital asset securities in ICOs and secondary trading in digital asset securities may also be acting as a "broker" or "dealer" that is required to register with the Commission and become a member of a self-regulatory organization, typically FINRA. Among other things, SEC-registered broker-dealers are subject to legal and regulatory requirements that govern their conduct in the marketplace and that provide important safeguards for investors.

Section 15(a) of the Exchange Act provides that, absent an exception or exemption, it is unlawful for any broker or dealer to induce or attempt to induce the purchase or sale, of any security unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act. Section 3(a)(4) of the Exchange Act generally defines a "broker" to mean any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(5) of the Exchange Act generally defines a "dealer" to mean any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. As with the "exchange" determination, a functional approach (taking into account the relevant facts and circumstances) is applied to assess whether an entity meets the definition of a broker or dealer, regardless of how an entity may characterize either itself or the particular activities or technology used to provide the services.<sup>[19]</sup>

The Commission's recent TokenLot Order illustrates the application of the broker-dealer registration requirements to entities trading or facilitating transactions in digital asset securities, even if they do not meet the definition of an exchange. According to the order, TokenLot was a self-described "ICO superstore" where investors could purchase digital assets, including digital asset securities, during or after an ICO, including in private sales and pre-sales. The parties' brokerage activities included marketing and facilitating the sale of digital assets, accepting investors' orders and funds for payment, and enabling the disbursement of proceeds to the issuers. They also received compensation based on a percentage of the proceeds raised in the ICOs, subject to a guaranteed minimum commission. TokenLot also acted as a dealer by regularly purchasing and then reselling digital tokens for accounts in TokenLot's name that were controlled by its operators.

#### **Conclusion**

The Divisions encourage and support innovation and the application of beneficial technologies in our securities markets. However, the Divisions recommend that those employing new technologies consult with legal counsel concerning the application of the federal securities laws and contact Commission staff, as necessary, for assistance. For further information, and to contact Commission staff for assistance, please visit the Commission's new FinHub page.

[1] This statement represents the views of the Divisions of Corporation Finance, Investment Management, and Trading and Markets. It is not a rule, regulation, or statement of the Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content.

[2] The Chairman of the Commission and the Director of the Division of Corporation Finance have also provided public statements on this subject. See, e.g., Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>; Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), available at <https://www.sec.gov/news/speech/speech-hinman-061418>.

[3] See CarrierEQ, Inc., Rel. No. 33-10575 (Nov. 16, 2018); Paragon Coin, Inc., Rel. No. 33-10574 (Nov. 16, 2018); Zachary Coburn, Rel. No. 34-84553 (Nov. 8, 2018) (settled order) (“Coburn Order”); Crypto Asset Management, LP and Timothy Enneking, Rel. No. 33-10544 (Sept. 11, 2018) (settled order) (“Crypto Asset Management Order”); and Tokenlot LLC, Lenny Kugel, and Eli L. Lewitt, Rel. No. 33-10543 (Sept. 11, 2018) (settled order) (“TokenLot Order”).

[4] On July 27, 2017, the Commission issued a report, which concluded that particular digital assets were securities and explained that issuers of digital asset securities must register offers and sales of such securities unless a valid exemption applies. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017) (“DAO Report”), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>. On Dec. 11, 2017, the Commission issued a settled order against an issuer named Munchee, Inc., making clear that a token may be a security even if it has some purported utility. Munchee, Inc., Securities Act Rel. No. 10445 (Dec. 11, 2017) (settled order) (“Munchee Order”). Together, the DAO Report and the Munchee Order emphasize that digital assets offered and sold as investment contracts (regardless of the terminology or technology used in the transaction) are securities.

[5] Of course, if a security is being offered or sold, the anti-fraud protections of the U.S. securities laws apply. The Commission has filed a number of enforcement actions involving digital assets, including those alleging fraudulent ICOs. See [https://www.sec.gov/spotlight/cybersecurity-enforcement-actions\(listing digital asset-related enforcement actions\)](https://www.sec.gov/spotlight/cybersecurity-enforcement-actions(listing%20digital%20asset-related%20enforcement%20actions)).

[6] As discussed herein, activities relating to the offer and sale of digital asset securities can also raise other legal and regulatory issues and considerations under the federal securities laws, including, for example, broker and dealer registration considerations.

[7] For a discussion of some questions that are relevant to registered investment companies that invest in certain digital assets, see Staff Letter to ICI and SIFMA AMG: Engaging on Fund Innovation and Crypto-related Holdings, available at <https://www.sec.gov/investment/fund-innovation-cryptocurrency-related-holdings>.

[8] In addition, pooled investment vehicles not only invest in securities but also are themselves issuers of securities. Although not addressed here, the requirements of the federal securities laws relating to an investment vehicle’s offer and sale of securities apply to the same extent when those securities use new technologies, such as blockchain, as when they do not.

[9] See, e.g. Coburn Order and TokenLot Order.

[10] See Divisions of Enforcement and Trading and Markets, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (March 7, 2018), available at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

[11] See *id.*

[12] Coburn Order at 6-7.

[13] As stated in the Coburn Order, the Commission’s findings were made pursuant to the respondent’s offer of settlement and are not binding on any other person or entity.

[14] The relevant legal and regulatory requirements discussed in this statement apply to natural persons or entities. However, for ease of reference, this statement generally refers only to entities.

[15] In its Regulation ATS adopting release, the Commission discussed what constitutes an exchange and provided examples illustrating various applications of Rule 3b-16. See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998), available at <https://www.gpo.gov/fdsys/pkg/FR-1998-12-22/pdf/98-33299.pdf>.

[16] See generally *id.* at 70844.

[17] See id. at 70852.

[18] See id. at 70852.

[19] There are other potential legal and regulatory issues and considerations under the federal securities laws for entities engaging in digital asset securities activities, including clearing agency and transfer agent registration considerations, among other things.