Securities Regulation Daily Wrap Up, ENFORCEMENT—D. Utah.: 'Sanctions are not warranted': SEC asks for leniency for false statements in crypto case, (Jan 18, 2024)

By Anne Sherry, J.D.



The SEC was ordered to explain why it should not be sanctioned for making false assertions in a crypto enforcement case.

Defendants in an SEC enforcement case argue that the Commission should be sanctioned for making false statements to obtain an ex parte temporary restraining order. The district court in Utah has dissolved the TRO and ordered the SEC to show cause why it should not be sanctioned. In response, the SEC wrote that it admits and regrets the error but that sanctions are not warranted because its staff did not act in bad faith and its actions fall short of the Rule 11 misconduct standard (*SEC v. Digital Licensing Inc.*, January 16, 2024).

The enforcement action. Early last August, the SEC announced that it had obtained the TRO, a temporary asset freeze, and other emergency relief against Utah-based Digital Licensing Inc., the company's four principals, and 13 other defendants in connection with an alleged crypto asset fraud scheme. The SEC's complaint alleges that the defendants raised at least $49 million via an unregistered, fraudulent offering of Digital Licensing's (d/b/a DEBT Box) "node software licenses." According to the complaint, the real projects and assets supporting the value of DEBT Box tokens are a sham.

The TRO is issued. In applying for the TRO, the SEC argued for a relaxed legal standard. Accordingly, the pleading omitted to argue three of the four prongs for issuing a TRO: that there would be irreparable harm without a TRO, that the balance of harms weighed in its favor, and that a TRO was in the public interest. At the ex parte hearing in July 2023, the court required the Commission to argue the three missing prongs, but allowed counsel to make these arguments orally rather than submit a new written application.

Concerning irreparable harm, the SEC's counsel stated, "even in the last 48 hours defendants have closed additional bank accounts, and I believe the number, I don't have it in front of me, was around 33 bank accounts have been closed." The court took this to mean that the defendants had closed 33 bank accounts in the previous 48 hours, which, coupled with the SEC's allegation that the defendants had "taken action to block SEC investigative staff from viewing their social media sites," was the most persuasive evidence of immediate, irreparable harm.

The court issued the TRO, freezing the assets of the defendants and relief defendants and requiring them to repatriate funds. The court also appointed a receiver over DEBT Box and its subsidiaries and affiliates.

The TRO is dissolved. In September 2023, two groups of defendants and relief defendants moved to dissolve the TRO. They disputed the representation about account closures "in the last 48 hours," providing documents showing that there had been no account closures since January 2023 and that most of the closures were initiated by the banks. The defendants also argued that the SEC's description of a June 2023 YouTube video pulled statements out of context to give the misleading impression that DEBT Box had moved operations to Abu Dhabi in a hurry. In fact, all DEBT Box shares had been transferred to a UAE company more than a year prior.

Opposing the motion to dissolve the TRO, the Commission continued to maintain that the defendants were transferring investor funds overseas and criticized the defendants for not addressing the evidence—arguments the court said in its order to show cause "are entirely without merit and misstate the record." The SEC tacitly

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acknowledge the lack of evidence of closed accounts but did not acknowledge its attorney's statement to the contrary. The Commission also failed to acknowledge that when it requested the TRO, it had reason to know that a large deposit had actually been made into a domestic, not overseas, account.

The court dissolved the TRO as improvidently granted and asked the receiver and defendants to work on winding down the receivership.

The SEC's response. The SEC's response to the order to show cause acknowledges that the Commission and its attorneys fell short. It says that it is taking measures to prevent such errors in the future, including transferring oversight of the case to its Denver office and conducting mandatory training for Enforcement Division staff. However, the SEC submits that its staff did not intend to mislead. "Rather, in their haste to prepare applications for emergency relief and to argue irreparable harm, staff made errors in accurately presenting and contextualizing the evidence they had gathered."

The agency explains that the statement about the bank accounts resulted from a miscommunication between SEC attorneys. The 48-hour timeline was not the timeline of the account closures, but the timeline of SEC investigators' calls to the banks during which they learned of the closures. And while one of the investigative attorneys was at the hearing and immediately recognized that the trial attorney misspoke, she did not have trial experience and was concerned about interrupting the hearing. She did not correct the trial attorney afterwards because she did not think the statement was material.

The SEC further explained that its representations about moving investor funds overseas should have been identified as inferences rather than representations with direct factual support. Similarly, the statements that the defendants had blocked the SEC on social media were based on staff's observations and conjectures, not on direct evidence.

The Commission maintains, though, that the errors do not warrant sanctions, either under Rule 11 or the court's inherent authority. Rule 11 sanctions should only be applied in rare cases under a standard of objective unreasonableness. While the SEC's statements were inferences that lacked direct factual support, the factual bases for those inferences were not so unreasonable as to violate Rule 11. As for the court's inherent authority to impose sanctions, the SEC submits that the record would not support the required finding of bad faith. The agency did not intend to mislead, and it did not make the statements for an improper purpose, like harassment.

The defendants speak. Several groups of defendants filed statements in reply to the SEC's response. DEBT Box, its four principals, and several relief defendants argue that the SEC should be sanctioned because it knew that it lied and concealed the truth for months, damaging the defendants, third parties, and token holders. The TRO completely disrupted the DEBT Box platform in over 130 countries and for approximately 300,000 users, many of whom were never involved with the single node software licenses that are the subject of the SEC's enforcement action.

The reply attaches declarations from investors who lost hundreds of thousands in value when the SEC shut DEBT Box down. The individual DEBT Box defendants describe how the freezing of their personal and related business accounts and their encounters with federal law enforcement disrupted their finances, frightened their families, and harmed their reputations.

The defendants note that while the SEC claims that there was no bad faith, the agency does not defend why it violated its duty of candor to the court by failing to correct its statements until the order to show cause. "Indeed, had the DEBT Box Defendants, not the SEC, been the ones engaged in lying and knowingly suppressing the truth for more than two months, it is highly improbable that the SEC would deem the apologies of the DEBT Box Defendants or additional ethics training for them to be a sufficient remedy," they write. This group of defendants and relief defendants requests an order dismissing the action against them with prejudice.

Another group of defendants led by iX Global, LLC, the alleged MLM through which the software licenses were

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promoted, limited its reply to addressing why sanctions are still necessary despite the SEC's response. If the court decides to impose sanctions, the defendant group asked to submit additional information in support of the harms suffered. Another individual defendant incorporated iX Global's reply by reference in a separate filing that describes the prejudice caused to him and his family.

The iX Global group challenges the SEC's response as continuing to make statements without presenting necessary context. For example, the response states that U.S. bank account balances decreased by over $49 million to leave a balance, as of May 2023, of less than a million dollars. But the reply protests that "those are expenses over a two-year period, made in the ordinary course of business, made in large part to U.S. citizens and businesses including to the IRS to pay taxes on funds received." Most of the transactions predate the period during which the SEC alleges that DEBT Box partnered with the iX Global defendants. "The fact that the SEC is continuing to claim that payments to the IRS in January 2023 is evidence that 'Defendants are *currently* in the process of attempting to relocate assets and investor funds Overseas' (emphasis added) is troubling."

The defendants also place the case within what they see as a larger pattern of SEC misconduct in actions against digital assets generally. They cite several court decisions finding that the Commission acted arbitrary and capriciously and contrast Commissioner Peirce's statements to the same effect with Chair Gensler's apparent prejudice against the industry. "The SEC has denied rulemaking for the digital asset industry through a notice and comment procedure, and is an agency which believes if it is not losing cases then it is not bringing enough cases," the reply states. Sanctions, including dismissal with prejudice and monetary reimbursement of business losses, are needed to deter repeated misconduct.

The case is No. 23-cv-0482.

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Companies: Digital Licensing d/b/a Debt Box; IX Global

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