

CLIENT ALERT

# Cryptocurrency Update: SEC Chairman Clayton's Statement Urging Caution With Cryptocurrencies and ICOs; SEC Cease-and-Desist Order Against ICO

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## AUTHORS

**Conrad G. Bahlke** | **Paul J. Pantano, Jr.** | **Rita M. Molesworth** | **Neal E. Kumar** | **Artyom Rogov**

On December 11, Securities and Exchange Commission Chairman Jay Clayton issued a public statement aimed at retail investors and advisors to retail investors in which he urged caution for those investing in cryptocurrencies or Initial Coin Offerings ("ICOs").<sup>1</sup> In his Statement, Chairman Clayton emphasized that there is substantially less investor protection with respect to cryptocurrencies and ICOs than in traditional securities markets, with resulting greater opportunity for fraud and manipulation, and that the trading may occur on systems and platforms outside the United States such that invested funds may quickly travel overseas, which may hinder the ability of the SEC to effectively pursue bad actors or recover funds. The Statement also lists a number of questions that retail investors should ask before investing in cryptocurrencies or ICOs. The questions include whether the company raising funds has a clear business plan, whether promoters are licensed to sell the product and whether they have been paid, what the money is going towards and whether it can be used to cash out other investors, what rights come with the investment, how and when an investor can sell his or her investment and whether the offering has been structured to comply with the securities laws.

Notwithstanding these cautions, the Statement includes language receptive to ICOs as a form of fundraising. Chairman Clayton stated that he believes that ICOs ". . . whether they represent offerings of securities or not – can be effective ways for entrepreneurs and others to raise funding, including for innovative products." However, he noted that ICOs that merely

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<sup>1</sup> A copy of the December 11, 2017 public statement by SEC Chairman Clayton (the "Statement") is available [here](#).

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“replac[e] a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger” are in substance securities and must follow the securities laws.

Chairman Clayton also emphasized his view that recent attempts to avoid having tokens classified as securities by highlighting the utility characteristics of proposed ICOs are not effective. Chairman Clayton dismissed this as elevating form over substance and stated that structuring a token to “provide some utility does not prevent the token from being a security.” According to Chairman Clayton, a key hallmark of whether a token is a security is if the token or offering incorporates features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others. Another key hallmark, according to Chairman Clayton, is whether purchasers are “sold on” the potential for tokens to increase in value with the ability to lock in those increases by reselling on a secondary market. Chairman Clayton stated that “by and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements,” and accordingly encouraged the Division of Enforcement to continue to carefully police this area.

Moreover, Chairman Clayton issued warnings for several other participants. For those promoting tokens or ICOs, they must first determine whether the securities laws apply, and if so, they must be licensed; those who operate systems and platforms that effect or facilitate transactions must be registered as exchanges or broker-dealers; and broker-dealers that allow purchases of cryptocurrencies or facilitate securities transactions must make sure they have robust anti-money laundering and know-your-customer monitoring in place.

In response to the Statement released by Chairman Clayton, CFTC Chairman J. Christopher Giancarlo released a statement in which he commended Chairman Clayton for encouraging investors and market participants to recognize the potentially high level of volatility and risk in these markets.<sup>2</sup> Chairman Giancarlo also urged advisors to recognize the legal responsibilities they have regarding cryptocurrencies and ICOs.

In line with Chairman Clayton's statement that the SEC would be vigilant in policing tokens and ICOs, the SEC also filed a cease-and-desist order against Munchee Inc. (the “Company”), a California-based company, to warn the Company that the ICO in which it was engaging constituted an unregistered securities offering and sale.<sup>3</sup> The Company launched an ICO in which it was selling digital tokens to retail investors to raise \$15 million in capital for its blockchain-based food review service. The Company halted its ICO after being contacted by the SEC and refunded investor proceeds.

The business plan of the Company was to use the funds to improve an existing iPhone app on restaurant meal reviews and to create an ecosystem in which the Company and others would use the tokens as a form of payment. The Company would pay tokens to users to write food reviews, users would be able to use the tokens to make “in-app” purchases and advertisers would be able to buy ads with the tokens.

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<sup>2</sup> A copy of the December 11, 2017 CFTC statement by CFTC Chairman Giancarlo is available [here](#).

<sup>3</sup> A copy of the December 11, 2017 SEC press release (the “Release”) is available [here](#).

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According to the Release, the Company and other promoters emphasized that investors could expect that efforts by the Company and others would lead to an increase in the value of the tokens. Also, the Company stated that it would take steps to create and support a secondary market for the tokens. The SEC concluded that due to these efforts, investors in the Company had a reasonable belief that their investment in tokens could generate a return on their investment, and thus the token can be a security. The SEC noted that its discussion in the DAO Report of Investigation demonstrates that a token can be a security based on, among other facts and circumstances, whether investors' profits are to be derived from the managerial and entrepreneurial efforts of others.

Notably, the SEC did not impose a penalty on the Company. In the Release, the SEC stated that because the Company "stopped the ICO quickly, immediately returned the proceeds before issuing tokens, and cooperated with the investigation," the SEC did not fine the Company. The SEC also stated that it will continue to "scrutinize the market vigilantly for improper offerings that seek to sell securities to the general public without the required registration or exemption."

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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**Conrad G. Bahlke**

212 728 8233

cbahlke@willkie.com

**Paul J. Pantano, Jr.**

202 303 1211

ppantano@willkie.com

**Rita M. Molesworth**

212 728 8727

rmolesworth@willkie.com

**Neal E. Kumar**

202 303 1143

nkumar@willkie.com

**Artyom Rogov**

212 728 8477

arogov@willkie.com

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