SEC Debuts Roadmap for Resolving Illegal ICOs

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In a pair of settled enforcement actions announced on November 16 in which it concluded that initial coin offerings conducted by **Paragon Coin, Inc.** and **AirFox** were illegal unregistered securities offerings, the SEC imposed an agreed-upon remedy that it will likely seek to use as the template for resolving its backlog of investigations into recent ICOs. Significantly, both ICOs took place after the SEC issued its July 2017 **Section 21(a) report** addressing a crypto-token offering by The DAO, where **the SEC warned the market** that some ICOs may violate the federal securities laws.

Neither Paragon nor AirFox agreed to conduct a "rescission offer" whereby the company would offer to repurchase the illegally offered tokens and any investor who declined the offer would retain freely tradable tokens (a remedy that **Google** undertook shortly after its IPO in order to resolve claims that certain pre-IPO compensatory equity grants were made in violation of the registration provisions of the Securities Act of 1933). Instead, each company agreed to distribute a "claim form" to all token purchasers offering return of the consideration paid, plus interest, in exchange for tender of the tokens, or offering damages to token purchasers who no longer hold their tokens. Purchasers of tokens located outside the United States are apparently not excluded from participation. Each company was also fined $250,000 and required to register its token as a security and become an SEC-reporting company for at least one year.

The orders do not provide much new insight into the SEC's analysis for whether an ICO involves a securities offering that must be conducted pursuant to registration under the Securities Act or an exemption therefrom. In each case, the question of whether the ICO was a securities offering was not really a close call under the approach favored by the SEC. Both companies used a token sale to raise capital for the development of a nascent business enterprise (a cannabis "ecosystem" in Paragon's case and a mobile phone airtime and data "ecosystem" in AirFox's); both companies encouraged investors to expect profits from their token purchases if managements' entrepreneurial efforts panned out; both companies sought to list their tokens on cryptocurrency exchanges; and AirFox in particular aimed its marketing efforts at digital currency investors rather than at people who would be likely to make use of its "ecosystem."

The orders leave significant questions unaddressed. The orders do not indicate how or whether the SEC will adapt its disclosure and reporting regime to accommodate the registration of a crypto asset or a crypto-asset issuer. The orders are silent on how the issuers are to calculate the consideration to be returned, which was originally paid in a variety of digital currencies that may now be worth much more or less than at the time of purchase (although we note that a **draft of AirFox's claim form** indicates that claims will be paid in U.S. dollars based on the value at time of purchase). Nor do the orders indicate whether token holders who decline the repurchase offer will hold tokens that are immediately freely tradable under the federal securities laws.

But regardless of whether a token is theoretically tradable, a holder would be left with a security that today lacks an organized trading venue in the United States, meaning that a U.S. holder would face a substantial liquidity problem if he or she wanted to sell, and likely meaning that the token itself would have much less market value than if it were not a security. Presumably the companies will lay out these risks explicitly in their claim forms or in other disclosure documents and most holders will tender. The ultimate message to the hundreds of companies that may have conducted illegal ICOs in the past few years seems to be that the SEC will force you to unwind the transaction, force you to file public company reports, and fine you to boot.

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