

CLIENT BRIEF | Self-Reporting May Help Token Issuers Avoid SEC Civil Penalties

March 19, 2019 | Last month, the SEC announced it had settled an enforcement action against Gladius Network LLC for failing to register its initial coin offering, a violation of Section 5 of the Securities Act of 1933. The settlement, which was devoid of civil penalties, underscores two key points: a) the offer and sale of distributed ledger or blockchain tokens can be considered sales of securities and, as such, must be registered unless a valid exemption from registration is available; and b) cooperation and self-reporting can aid in minimizing penalties to companies.

In 2017, Gladius conducted an offering of its tokens to raise capital. Although the offering was widely publicized through social media, it was never registered with the SEC. Gladius stated that tokens would be available for purchase worldwide, including in the United States, and ultimately raised \$12.7 million.

Whether tokens are securities for purposes of SEC regulation has been the subject of intense controversy. *SEC v. W.J. Howey Co.* (328 U.S. 293 [1946]) represents the seminal test for determining whether an instrument is a security. Under this measure, a security must include: (1) an investment of money (2) in a common enterprise (3) with an expectation of profits from the efforts of others.

Digital tokens take the form of either security tokens (those that meet the *Howey* test) or utility tokens. Utility tokens are generally an investment in the future products or services that a company will offer and, consequently, are not subject to securities laws. As an example, Filecoin raised \$257 million by selling utility tokens that provided purchasers future access to Filecoin's decentralized cloud storage platform when it was developed. Filecoin is an example of a relatively clear distinction; others are often more complicated.

Following its offering, Gladius concluded that its digital tokens were, in fact, securities. In 2018, Gladius self-reported its unregistered offering and publicly "expressed an interest in taking prompt remedial steps," according to SEC communications. The company agreed to a consent order, returned funds to investors, and registered the tokens as securities under the Securities Exchange Act of 1934.

Significantly, the SEC imposed no civil penalty on Gladius. The Commission stated that it "did not impose a penalty because the company self-reported the conduct, agreed to compensate investors and . . . register the tokens as a class of securities."

The circumstances under which a token is deemed a security will continue to be a topic of debate, but *Gladius* is a clear indication that self-reporting and cooperation can only prove beneficial.

For more information about maintaining compliance amid the growing use of distributed ledger technology and digital currency, please contact Geoff Morgan or Jessica Fairchild.