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5 Hidden Lessons In Mayweather, Khaled ICO Actions: Part 1

By **John Reed Stark** (January 2, 2019, 2:21 PM EST)

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Never in the history of securities regulation has there been more distortion, spin and deception than in the crazy, mixed up world of initial coin offerings.

Imagine an entire industry rising up where just about everything related to that industry is blatantly unlawful and often flat-out fraudulent. That is the nature of the ICO space and that is why it is critical to disregard much of the ICO noise and instead, focus on official government pronouncements relating to ICOs, especially enforcement actions taken by the U.S. Securities and Exchange Commission.

Consider the recent announcement that professional boxer Floyd Mayweather and superstar music producer DJ Khaled pumped up ICOs without telling investors they were getting paid a promotional fee to do so.

The enforcement actions themselves came as no surprise. In fact, I **predicted** the coming of SEC enforcement actions against Khaled and Mayweather several months ago in the article, "Ten Crypto-Caveats Floyd Mayweather and DJ Khaled Should Have Heard From Their Lawyers," published in The Harvard Law School Forum on Corporate Governance and Financial Regulation. But what I did not predict was that the Khaled/Mayweather settled SEC enforcement administrative orders would provide such indispensable insight into the views of the SEC enforcement staff and the SEC commissioners regarding ICOs.

Specifically, within the Khaled and Mayweather SEC orders, the SEC offers five critical takeaways, which every purveyor of ICOs and every fintech legal practitioner should keep in mind:

1. **ICOs Constitute the Sale of Securities.** Despite all the misguided hoopla, the preliminary injunction decision in the SEC Blockvest enforcement action does not portend a weakening or abating of the SEC's view of ICOs. From the SEC's perspective, every ICO falls into one of three categories: registered, exempt or unlawful — and every ICO the SEC has ever seen typically falls squarely into the third "unlawful" category. End of story.

2. **Promotion Bans Are the New Thing.** The Khaled and Mayweather enforcement actions evidence the genesis of a new SEC enforcement weapon, the "promotion bar," which is not derived from any statute and appears to be a new SEC "equitable" invention.

3. **Disgorgement Gets Some New Life.** The Khaled and Mayweather enforcement actions have given new meaning to, and injected new life into, the traditional SEC enforcement remedy of disgorgement.

4. **Beware ICO "Finders."** The Khaled and Mayweather enforcement actions send a stern warning not only to ICO promoters but also to so-called "finders," the international legion of ICO peddlers who receive transaction-based compensation for any generated ICO-related sales.

5. **YouTube ICO Promoters, the SEC Man Cometh.** With the proliferation and hype surrounding the ICO marketplace, it is not surprising that ICO-related informercials have become programming staples on YouTube. These YouTube advertisements raise a range of SEC regulatory issues, from prohibited stock promotions and illegal stock sales to flat-out fraud, deceit and chicanery. The purveyors of these YouTube videos are on the SEC's radar and the SEC's Khaled and Mayweather orders signal that the days of YouTube ICO and other crypto-financing promotions may be numbered.

This two-part series discusses these five imperative takeaways gleaned from the Khaled/Mayweather SEC enforcement actions, harkening a grim future for the ICO marketplace and perhaps an end to the ongoing disinformation campaign by ICO promoters, affiliates and other interested parties. First, some background.

Section 17(b) of the Securities Act

The SEC charged Khaled and Mayweather with violations of Section 17(b) of the Securities Act of 1933 ((Section 17(b) is a little-known and rarely used federal statute, enacted a year or so before the SEC was even created.)

Section 17(b) addresses the age-old fraud scheme known as "touting," which is when paid shills promote stocks with the appearance of being objective — when they are not objective at all. Section 17(b) mandates that if a person is paid to promote a security, then they must disclose the nature, source and amount of that compensation. Section 17(b) essentially prohibits the publication of paid-for descriptions of securities without full disclosure of the compensation arrangement.

There is very little legislative history surrounding Section 17(b) except that it was "particularly designed to meet the evils of the tipster sheet, as articles in newspapers or periodicals that purport to give an unbiased opinion but which opinions in reality are bought and paid for." But despite the lack of legislative history, ICO promotional efforts, whether conducted via social media outlets, YouTube videos or just a megaphone, all raise serious concerns about securities violations of Section 17(b).

Unchanged since its enactment in 1933, with no rules or regulations ever promulgated thereunder, the SEC started out charging Section 17(b) to combat touting fraud in a variety of mediums, including brochures, newsletters and radio talk shows — wherever touters attempted to disguise their paid promotions as independent, objective analysis.

But that all changed in the early 1990s, when the internet grew into an important tool for investors and unlawful touting of securities began to spread in cyberspace, including websites, newsletters, spams (electronic junk mail), and then online message boards, discussion forums and now, social media. Since then, the SEC has dusted off Section 17(b) on a variety of occasions.

For instance, in the late 1990s, the SEC initiated a series of Section 17(b) internet "sweeps," the first in October 1998 and the next in February 1999. These coordinated anti-touting roundups, led then by the SEC's Office of Internet Enforcement, consisted of more than 25 separate enforcement actions against more than 50 individuals and companies, garnering tremendous publicity at the time, and virtually eliminating the unlawful online promotion practice entirely, while simultaneously stunting the growth of unlawful securities offerings as well.

What makes Section 17(b) such a powerful statutory weapon is that it is a strict liability statute.

Strict liability exists when a defendant is liable for committing an action regardless of what their intent or mental state was when committing the action. This means that a Section 17(b) violation does not require a finding of fault (such as negligence or tortious intent). The SEC need only prove that the ICO promotion occurred without the proper disclosure and that the defendant was responsible for the act of the publication.

In other words, even though Khaled and Mayweather (or apparently, their lawyers) likely never even heard of Section 17(b), Khaled and Mayweather could still be found guilty nonetheless.

The Khaled and Mayweather SEC Enforcement Actions

On Nov. 29, 2018, the SEC enforcement staff charged Khaled and Mayweather with violations of Section 17(b). Specifically, the SEC alleged that Mayweather failed to disclose promotional payments from three ICO issuers, including $100,000 from Centra Tech Inc. With respect to Khaled, the SEC alleged that Khaled failed to disclose a $50,000 payment from Centra Tech, which he touted on his social media accounts as a "game changer." Mayweather's promotions included a message to his Twitter followers that Centra's ICO "starts in a few hours. Get yours before they sell out, I got mine."

A post on Mayweather's Instagram account predicted he would make a large amount of money on another ICO and a post to Twitter said: "You can call me Floyd Crypto Mayweather from now on." The SEC order found that Mayweather failed to disclose that he was paid $200,000 to promote the other two ICOs.

Without admitting or denying the findings, Mayweather and Khaled agreed to pay disgorgement, penalties and interest. Mayweather agreed to pay $300,000 in disgorgement, a $300,000 penalty and $14,775 in prejudgment interest. Khaled agreed to pay $50,000 in disgorgement, a $100,000 penalty and $2,725 in prejudgment interest. In addition, Mayweather agreed not to promote any securities, digital or otherwise, for three years, and Khaled agreed to a similar ban for two years (more on these bans later). Mayweather also agreed to continue to cooperate with the investigation.

Mayweather and Khaled's promotions came after the SEC issued its DAO Report in 2017 warning that coins sold in ICOs may be securities and that those who offer and sell securities in the U.S. must comply with federal securities laws. In April 2018, the commission filed a civil action against Centra’s founders, alleging that the ICO was fraudulent. The U.S. Attorney's Office for the Southern District of New York filed parallel criminal charges.

A New Era for Section 17(b)

These first-of-their-kind SEC actions ushered in a new era of Section 17(b) enforcement, this time targeting ICO promoters. SEC Enforcement Division Co-Director Stephanie Avakian stated the following about the Khaled and Mayweather enforcement actions:

> These cases highlight the importance of full disclosure to investors. With no disclosure about the payments, Mayweather and Khaled's ICO promotions may have appeared to be unbiased, rather than paid endorsements.

SEC Enforcement Division Co-Director Steven Peikin similarly warned:

> Investors should be skeptical of investment advice posted to social media platforms, and should not make decisions based on celebrity endorsements. Social media influencers are often paid promoters, not investment professionals, and the securities they’re touting, regardless of whether they are issued using traditional certificates or on the blockchain, could be frauds.

The SEC's investigation, which is continuing, was supervised by the Cyber Unit, a specialized group of enforcement staff dedicated to cyber-related frauds such as ICOs. This is not the first SEC specialized unit to manage cybercrimes.

From 1998 to 2009, before being merged with the SEC’s Office of Market Intelligence, the SEC created the Office of Internet Enforcement, the SEC's first specialized cyber group. OIE led a broad range of SEC enforcement actions, initiatives and investigations, many filed parallel to criminal prosecutions. The original cyber group faced a similar threat in the form of unlawful touting and unlawful offerings conducted via the internet and came out swinging against those frauds, leading five internet fraud sweeps in its first two years.

Clearly, ICOs and other cryptocurrency issues have become the primary focus of the SEC’s new cyber group, and if history is at all telling, should similar ICO promotions continue, charging crypto-related Section 17(b) cases will be prominent among the reactivated cyber group’s continuing prosecutorial maneuvers.

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Given the SEC's formation of its own specialized squadron, whose principle function is to investigate and prosecute cyber and crypto-related frauds, ICO purveyors should be sounding the alarm — and should also read carefully the Khaled and Mayweather orders, because there are five critical messages, albeit somewhat hidden and nuanced, contained therein.

Message 1: Blockvest Was Not a Harbinger of Any Kind — The Headlines Were "Fake News"

On Nov. 27, 2018, in a matter involving an allegedly fraudulent ICO by a company called Blockvest, Judge Gonzalo Curiel of the U.S. District Court for the Southern District of California denied the SEC's motion for a preliminary injunction against the promoters of the Blockvest ICO.

For ICO true believers, exuberance was in the air as news banners proclaimed that for the first time in history, a U.S. federal judge held that an ICO was not a security and therefore outside of SEC jurisdiction. Some examples of the headlines:

- "Judge to SEC: You Haven't Shown This ICO Is a Security Offering" (The Recorder)
- "US Court Dismisses SEC's Claims That Blockvest Sold Unregistered Securities," (BTC EThereum.com)
- "Monumental: Federal Court Rules Case in Favor of Crypto ICO Against SEC" (CCN)
- "SEC Fails to Show Court Blockvest Tokens Are Securities" (Bitcoin.com)
- "Not So Fast: Court Rules Against SEC, Finding It Did Not Prove Blockvest Sold Tokens as Securities." (Fenwick.com)
- "SEC Handed Setback on Whether Digital Tokens Are Securities" (Bloomberg)

The only problem with the above headlines and so many other headlines just like them: They are all dead wrong, and given the Khaled and Mayweather actions, sending an ill-advised and imprudent message about ICOs.

The SEC Blockvest TRO

News about the SEC's Blockvest enforcement matter first came to light on Oct. 11, 2018, when the SEC announced that it had obtained a temporary restraining order halting a planned ICO of digital tokens called "BLVs." The order also halted ongoing "pre-ICO" sales by the company, Blockvest LLC, and its founder, Reginald Buddy Ringgold III.

The unsealed SEC complaint alleged that Blockvest falsely claimed its ICO and its affiliates received regulatory approval from various agencies, including the SEC. According to the SEC's complaint, Blockvest and Ringgold, who also goes by the name Rasool Abdul Rahim El, were using the SEC seal without permission, a violation of federal law, and falsely claiming their crypto fund

was "licensed and regulated."

The complaint also alleged that Ringgold promoted the ICO by creating a fictitious regulatory agency, the "Blockchain Exchange Commission," or "BEC," which he claimed "regulates" the "blockchain digital asset space," supposedly to "protect" digital asset investors. But the SEC alleges that BEC is not a regulator at all. It falsely conjures similarities to the SEC: Its logo is similar to the SEC's; its mission statement is cribbed from the SEC's own; and its offices share the same address as the SEC headquarters. The Blockvest website allegedly linked directly from the BEC seal to the SEC's website. Ringgold allegedly promoted the Blockvest offering and the BEC side by side, further conveying a false veneer of legitimacy to the Blockvest ICO.

Blockvest and Ringgold also allegedly misrepresented Blockvest's connections to Deloitte, a well-known accounting firm, and continued their fraudulent conduct even after the National Futures Association sent them a cease-and-desist letter to stop them from using the NFA's seal and from making false claims about their status with that organization.

Judge Curiel issued the TRO, freezing the defendants' assets and granting other emergency relief. A hearing was eventually scheduled for Nov. 16, 2018, to consider continuing the asset freeze and

issuance of a preliminary injunction.

The SEC's complaint charges Blockvest and Ringgold with violating the antifraud and securities registration provisions of the federal securities laws. The complaint seeks injunctions, return of ill-gotten gains plus interest and penalties, and a bar against Ringgold to prohibit him from participating in offering any securities, including digital securities, in the future or making misrepresentations about regulatory approval.

Judge Gonzalo Curiel Denies the SEC's Preliminary Injunction Request

On Nov. 27, 2018, Judge Curiel denied the SEC's request to continue the TRO and extend that order into a preliminary injunction — and set the case for trial. Judge Curiel held that, at this stage of the case, the SEC had not shown that the BLV tokens were securities under the Howey test, a decades-old test established by the U.S. Supreme Court for determining whether certain transactions are investment contracts and thus securities.

The Howey Test

In a typical ICO, virtual coins or tokens are distributed by a company to the public in exchange for another cryptocurrency or fiat currency. These coins or tokens come with particular rights, such as a right to access to a future service once the ICO is launched, a right to redeem the token for a currency or service, or a right to receive future profits from the company (like a dividend).

To determine how traditional securities regulation applies to ICOs, the four-pronged Howey test, derived from the 1946 Supreme Court decision in SEC v. W.J. Howey Co., states that a security is an investment contract in which a person (1) invests their money; (2) in a common enterprise; (3) with an expectation of profits; (4) based on the efforts of the promoter or a third party. In order to be considered a security, an offering must meet all four prongs.

Rather than prospectuses, token issuers put out so-called "white papers" describing the platform, software or product they are trying to build, and then investors buy those tokens typically using widely accepted cryptocurrencies (like bitcoin and ethereum) or fiat currencies like the U.S. dollar. These issuers also often employ promoters and facilitators to generate interest, excitement and participation in the ICO.

Historically, the courts and the SEC have taken an extremely broad view of whether any kind of investment is a security. Indeed, the definition of "security" under Section 2(a)(1) of the Securities Act of 1933 (and the nearly identical definition under Section 3(a)(10) of the Exchange Act of 1934) includes not only a number of specific types of financial instruments, such as notes, bonds, debentures and stock, but also broad categories of financial instruments, such as evidences of indebtedness and investment contracts. The definition of security was crafted to contemplate not only known securities arrangements at the time, but also to encompass any prospective instruments created by those who seek the use of the money of others on the promise of profits.

The DAO 21(a) Report

On July 25, 2017, the SEC provided important initial guidance on its views of whether ICOs are securities when it released a Section 21(a) report of investigation on its findings regarding the token sale by the DAO. The SEC's report of investigation found that tokens offered and sold by a "virtual" organization known as "The DAO" were securities and therefore subject to the federal securities laws.

In making this determination, the SEC focused on whether the efforts of others were "the undeniably significant ones ... that affect the failure or success of the enterprise." The SEC found that the so-called curators of the DAO played the requisite role. The curators held themselves out as experts in, among other matters, the blockchain protocol, determined which projects would be voted on by DAO token holders, addressed security issues, and more generally held itself out in marketing materials as a group that investors could rely on for their managerial efforts.

The SEC also concluded that the voting rights of the DAO token holders were limited, noting, "[e]ven if an investor's efforts help to make an enterprise profitable, those efforts do not

"[e]ven if an investor's efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter's significant managerial efforts or control over the enterprise." The SEC concluded that the voting rights of DAO token holders was largely "perfunctory." Since they could only vote on projects approved by the curators, token holders did not receive sufficient information to vote in a meaningful way, and there were no means to obtain additional information.

Equally important, the SEC also noted that the widely dispersed DAO token holders could not identify and effectively communicate with each other, that there was a large number of them, and that they could not be deemed to be in a position to effectuate meaningful control.

The SEC message to the purveyors of ICOs was clear: ICOs are very likely selling plain old shares of stock fancifully masquerading as tokens — and their offer and sale would need to be registered under the Securities Act or qualify for an exemption from registration.

If the token offering is exempt from registration, the offering must adhere to a range of important restrictions, including: that the sale be made to accredited investors; that the tokens be subject to limitations on resales or transfers; and that there be no general solicitation involved. Regardless of whether the offering is registered or exempt, careful consideration would also have to be given to ensuring that prospective investors receive sufficient disclosure about the offering, including associated risks.

Blockvest Fights Back

Blockvest asserted that its offering was not an ICO, but was rather a "pre-ICO" for a group of 32 "test" investors, and the BLV tokens were only designed for testing its platform. Judge Curiel seemed to buy into this notion, stating:

> While defendants claim that they had an expectation in Blockvest's future business, no evidence is provided to support the test investors' expectation of profits.

The SEC responded to Blockvest's defense by noting that various individuals wrote "Blockvest" or "coins" on their checks and were provided with a Blockvest ICO white paper describing the project and the terms of the ICO. But Judge Curiel still found that, without further discovery, there remained disputed issues of fact which could only be properly determined at trial, stating:

> Plaintiff and Defendants provide starkly different facts as to what the 32 test investors relied on, in terms of promotional materials, information, economic inducements or oral presentations at the seminars, before they purchased the test BLV tokens. Therefore, because there are disputed issues of fact, the Court cannot make a determination whether the test BLV tokens were "securities" under the first prong of *Howey*. [Emphasis in original] ... As to the second prong of Howey, Plaintiff has not demonstrated that the test investors had an "expectation of profits." While Defendants claim that they had an expectation in Blockvest's future business, no evidence is provided to support the test investors' expectation of profits. "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment ... or a participation in earnings resulting from the use of investors' funds. ... At this stage, without full discovery and disputed issues of material facts, the Court cannot make a determination whether the BLV token offered to the 32 test investors was a security. Thus, Plaintiff has not demonstrated that the BLV tokens purchased by the 32 test investors were "securities" as defined under the securities laws.

What investors actually believed about Blockvest will undoubtedly be revealed during trial. Granted, if Blockvest's assertions are true i.e. that the investors had no expectation of any profit, then ruling that the tokens are not securities might make sense. But given the hundreds of pages the SEC filed in a slew of declarations, websites, chat transcripts, videos and other SEC evidence set forth meticulously in the SEC complaint, this assertion not only defies common sense, it is laughable. Based on my experience, no one invests in an ICO without the expectation that they will make some sort of profit — why else invest? It would be like buying a company's stock solely to receive a discount on its products, and not a very attractive investment principle.

Blockvest Essentially Consents to the Preliminary Injunction

What so many commentators have missed in their analysis of Blockvest is that Blockvest and Ringgold essentially consented to the preliminary injunction, leaving Judge Curiel with little reason to grant a motion mandating that the defendant do something that they have already agreed to do. Judge Curiel notes:

> While there is evidence that Ringgold made misrepresentations shortly after the complaint was filed and prior to having retained counsel, Ringgold, with counsel, now asserts he will not pursue the ICO and will provide SEC's counsel with 30 days' notice in the event they decide to proceed. By agreeing to stop any pursuit of the ICO, Plaintiff does not oppose the preliminary injunction concerning compliance with federal securities laws. Therefore, Plaintiff has not demonstrated a reasonable likelihood that the wrong will be repeated. Because Plaintiff has not demonstrated the two factor test to warrant a preliminary injunction, the Court *denies* Plaintiff's motion for preliminary injunction. (Emphasis in original)

What Does the Blockvest Ruling Actually Mean?

Nothing in Judge Curiel's ruling prohibits the SEC from taking Blockvest and Ringgold to trial. Rather it just means that the SEC did not meet the high burden required to receive a preliminary injunction of proving (1) a prima facie case of previous violations of federal securities laws, and (2) a reasonable likelihood that the wrong will be repeated.

Judge Curiel simply determined that, at this stage, without full discovery regarding the disputed issues of material facts, he could not decide whether the BLV tokens were securities. Moreover, since Blockvest and Ringgold agreed to stop the ICO and provide 30 days' prior notice to the SEC if they ever intended to move forward with their ICO, Judge Curiel decided no reasonable likelihood that the wrong would be repeated. As a result, Judge Curiel denied the SEC's motion for a preliminary injunction.

Despite what many of the Blockvest-related headlines imply, this was not a victory for the ICO industry or a setback for the SEC. Judge Curiel's ruling does not mean that the SEC is going to reconsider its current ICO enforcement posture. In fact, a close reading of the Khaled and Mayweather orders reveals that the SEC is not concerned in the least about the Blockvest preliminary injunction decision, and that the SEC continues to view ICOs as securities.

In the Khaled and Mayweather orders, there is no discussion of Howey, not even a mention or reference. That the promoted ICOs are securities is presumed. If the SEC was concerned about ICOs and the Howey test, the SEC would have made sure the Khaled and Mayweather orders contained a discussion of Howey's multiple prongs. The SEC, instead, opted to state in a conclusory manner that the ICOs were securities. On Feb. 6, 2018, testifying before the Senate Banking, Housing and Urban Affairs Committee, SEC Chairman Jay Clayton stated, "I believe every ICO I have ever seen is a security ... ICOs should be regulated like securities offerings. End of story."

Clearly, Clayton has not changed his mind; rather he is just beginning to dig in, and anyone thinking the Blockvest decision will somehow slow down his continuing ICO enforcement onslaught is sorely mistaken.

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This concludes part one of this two-part series. Please be sure to read part two, which will: (1) discuss the four remaining critical crypto lessons gleaned from the Mayweather and Khaled settled SEC administrative orders; and (2) provide some final thoughts, predictions and suggestions going forward.

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