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5 Hidden Lessons In Mayweather, Khaled ICO Actions: Part 2

By **John Reed Stark** (January 3, 2019, 2:08 PM EST)

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Hoping for some new guidance from the U.S. Securities and Exchange Commission on crypto-financing and initial coin offerings? Look no further than the recently settled Khaled and Mayweather SEC administrative enforcement actions. It's all there, in plain English, though it may take a bit of reading between the lines.

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 consider as official SEC guidance:

- **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: 1) registered; 2) exempt; or 3) unlawful — and every ICO the SEC has ever seen typically falls squarely into the third "unlawful" category. End of story.

- **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.

- **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.

- **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.

- **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, which foretell a grim future for the purveyors of ICOs and other crypto-financing enterprises. **Part one** provided some background and a discussion of the first of the five takeaways cited above. Part two, below, discusses the remaining four messages, and then offers some thoughts, predictions and suggestions going forward.

Message 2: The SEC Has a New Enforcement Weapon — The Promotion Bar

Perhaps never before seen in an SEC enforcement action, at the tail end of each of the Khaled and Mayweather consent orders is an equitable remedy, framed as an undertaking, where each defendant promises for a fixed period of time never to promote any sort of investment. Khaled's promise is for two years and Mayweather's is for three years. This "promotion bar" has no statutory basis, but the SEC has imposed it upon Khaled and Mayweather nonetheless.

Specifically, Khaled undertook to:

> for a period of two (2) years from the date of this Order, forgo receiving or agreeing to receive any form of compensation or consideration, directly or indirectly, from any issuer, underwriter, or dealer, for directly or indirectly publishing, giving publicity to, or circulating any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security, digital or otherwise, for sale, describes such security.

Mayweather similarly undertook to:

> for a period of three (3) years from the date of this Order, forgo receiving or agreeing to receive any form of compensation or consideration, directly or indirectly, from any issuer, underwriter, or dealer, for directly or indirectly publishing, giving publicity to, or circulating any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security, digital or otherwise, for sale, describes such security.

The explicit authorization to bar an individual from otherwise legal conduct was first given to the SEC by Congress in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. For the first 50 years of its history, the SEC relied on courts' broad equitable powers to obtain bars and, as a group of securities lawyers at Clyde Snow & Sessions noted after studying the issue, initially used the remedy sparingly.

After the financial crisis, however, the SEC began crafting conduct-based bars with increasing creativity and demanding them with accelerating frequency. These bars provide greater flexibility for the SEC to target specific areas of misconduct. Generally, the SEC has used conduct-based bars largely in settled resolutions outside of the analytical framework established by judges.

By their very nature, conduct-based bars seek to enjoin conduct that is not itself a violation of securities laws. But conduct-based bars do not enjoy the same clear statutory basis as officer and director bars, securities industry bars or penny stock bars. Along these lines, per the team at Clyde Snow & Sessions, the SEC began to stray from its statutory roots, and obtained orders barring individuals from:

- Offering mortgage-backed securities;
- Soliciting investors to purchase or sell securities;
- Conducting classes, workshops or seminars about securities trading; and

- Offering or selling securities from any entity controlled by the defendant.

The SEC has also been creative concerning the curbing of day-trading abuses in the early 2000s, going so far as to impose (via consent) a five-year bar against an individual, curtailing his so-called day-trading practices.

But the Khaled and Mayweather promotion bars have taken the use of conduct-based bars to a new level. The remedy of a promotion bar, which encumbers the First Amendment right of free speech, is a leap forward by the SEC and a clear signal of the gravity of ICO-related misconduct.

Even during the SEC's Section 17(b) sweeps and SEC microcap fraud sweeps of the late 1990s, the SEC never sought or obtained stock promotions bars for the miscreants involved (including for those prosecuted criminally in parallel prosecutions by the U.S. Department of Justice).

The closest analogy to the SEC's new promotions bars dates back to Jan. 5, 2000, when the SEC filed civil charges against Yun Soo Oh Park (popularly known as "Tokyo Joe"), creator of a stock touting website which had garnered an almost fanatical following during an era when stock-picking websites were too often criminally entangled with microcap stock companies and had emerged as a serious threat to main street investors. "Tokyo Joe" allegedly charged investors up to $200 a month for a daily diet of stock touts and trading advice, and took in $1.1 million in the 12-month period ending in June 1999.

Without admitting or denying wrongdoing, Park eventually settled with the SEC, paying $324,934 in ill-gotten gains and $429,696 in civil penalties, and via consent decree, agreed to a court order that permanently enjoined him from violating federal securities laws. Park also consented to a virtual scarlet letter, promising to post a link from his website to the court order against him for 30 days.

At the time, the mandated posting that the SEC imposed upon Park seemed more like an aberration rather than the start of something new. But now, given the Khaled and Mayweather SEC orders, perhaps not so much. The SEC views ICO abuses as a plague — the same way the SEC viewed bogus stock-picking websites as a plague back in the 1990s. Along those lines, it appears that the SEC is once again ticked off and getting resourceful.

Message 3: The SEC Has Broadened its Powers of Disgorgement

Disgorgement is the repayment of ill-gotten gains that is imposed on wrongdoers by the courts. Funds that were received through illegal or unethical business transactions are disgorged, or paid back, with interest to those affected by the action.

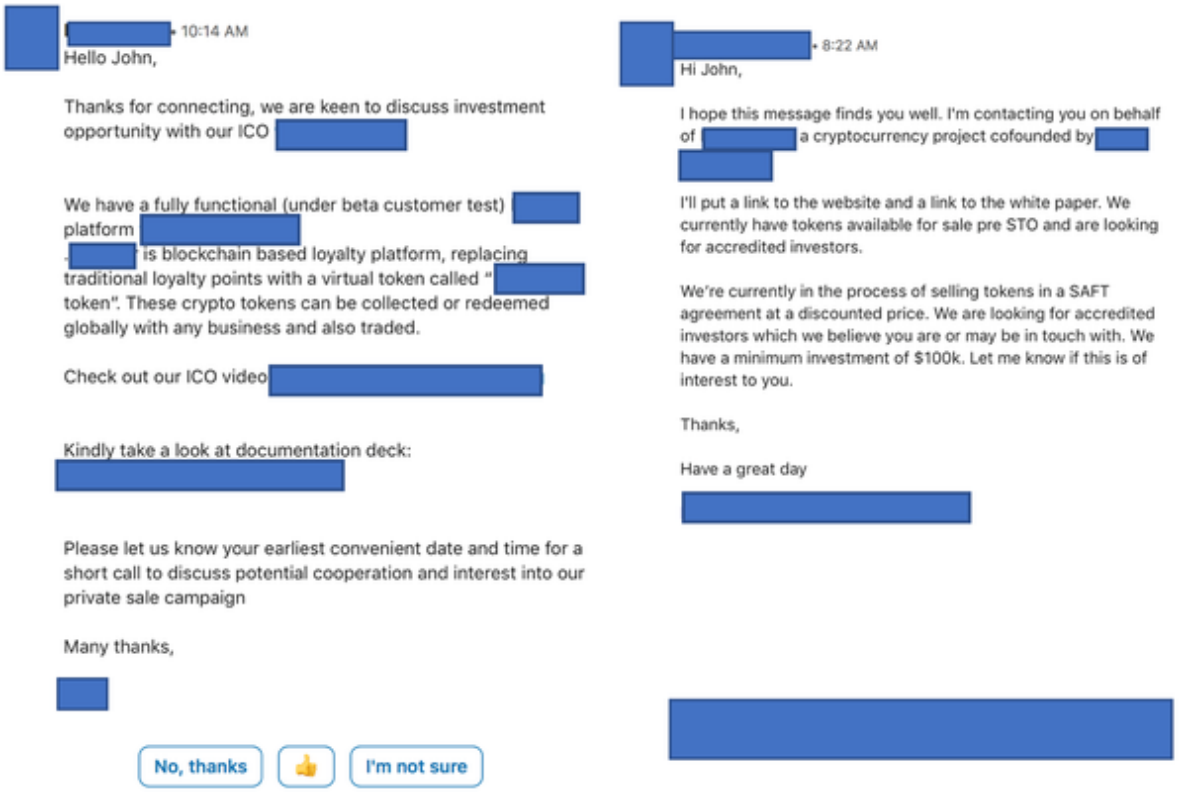
Disgorgement is not a remedy typically associated with stand-alone Section 17(b) violations, because there exists no impacted investor or other victim to whom the disgorgement can be "paid back." For example, in the SEC's Section 17(b) sweeps and microcap fraud sweeps of the late 1990s, the SEC never sought disgorgement of the monies paid to promoters for touting. Rather, the SEC only sought disgorgement awards where there were actual victims, such as when a defendant unlawfully profited from stock trading, where the seller of the stock was considered the victim of the scheme.

However, in the settled orders against Khaled and Mayweather, each undertook to pay disgorgement of the compensation they received from the ICO issuers (Khaled agreed to pay $300,000 and Mayweather agreed to pay $50,000). So who did the SEC decide should receive the $300,000 Khaled earned and the $50,000 Mayweather earned? Not the ICO issuers, but rather, the U.S. Treasury.

By remitting Khaled and Mayweather's disgorgement to the U.S. Treasury, which is remedial rather than punitive, the SEC turns the notion of disgorgement on its head. This is a sea change for disgorgement, and yet another aggressive and innovative effort by the SEC to enhance its ICO crackdown, while sending a strong message to the ICO marketplace.

Message 4: Beware ICO "Finders" — You're Next

The Khaled and Mayweather enforcement actions were not only a shot across the bow against ICO promoters, but also against so-called ICO "finders," the international legion of ICO peddlers who are conducting unlicensed broker-dealer activity relating to ICO-related sales. I typically receive a few of these pitches each week, sometimes via email and sometimes via LinkedIn. Here are two of them:



[redacted] 10:14 AM

Hello John,

Thanks for connecting, we are keen to discuss investment opportunity with our ICO [redacted]

We have a fully functional (under beta customer test) [redacted] platform [redacted] is blockchain based loyalty platform, replacing traditional loyalty points with a virtual token called "[redacted] token". These crypto tokens can be collected or redeemed globally with any business and also traded.

Check out our ICO video [redacted]

Kindly take a look at documentation deck:
[redacted]

Please let us know your earliest convenient date and time for a short call to discuss potential cooperation and interest into our private sale campaign

Many thanks,

[redacted]

No, thanks | 👍 | I'm not sure

[redacted] 8:22 AM

Hi John,

I hope this message finds you well. I'm contacting you on behalf of [redacted] a cryptocurrency project cofounded by [redacted]

I'll put a link to the website and a link to the white paper. We currently have tokens available for sale pre STO and are looking for accredited investors.

We're currently in the process of selling tokens in a SAFT agreement at a discounted price. We are looking for accredited investors which we believe you are or may be in touch with. We have a minimum investment of $100k. Let me know if this is of interest to you.

Thanks,

Have a great day

[redacted]

[redacted]

I am not rendering any sort of opinion on the actual investment pitched in these emails, but these kinds of solicitations are troubling.

For starters, the sales team behind these emails might think of themselves as "finders" and not required to register with any federal agency. However, what they are likely missing is that the existence of a "finder's exemption" from the SEC's broker-dealer registration requirements has always been more fiction than fact.

The confusion all dates back to 1991, when SEC staff issued a no-action letter stating that singer Paul Anka was not required to register as a broker-dealer, despite his assistance with a distribution of limited partnership interests in a Canadian hockey team (the Senators). In return for his referrals, Anka was entitled to receive a 10 percent commission on sales to any person whom he recommended.

SEC no-action letters involve situations where an individual or entity is not certain whether a particular product, service or action would constitute a violation of the federal securities law — and then requests a "no-action" letter from the SEC staff. Most no-action letters describe the request, analyze the particular facts and circumstances involved, discuss applicable laws and rules, and, if the staff grants the request for no action, concludes that the SEC staff would not recommend that the commission take enforcement action against the requester, based on the facts and representations described in the individual's or entity's request.

The no-action relief is provided to the requester based on the specific facts and circumstances set forth in the request. In some cases, SEC staff may permit parties other than the requester to rely on the no-action relief to the extent that the third party's facts and circumstances are substantially similar to those described in the underlying request. In addition, the SEC staff reserves the right to change the positions reflected in prior no-action letters.

With respect to the Anka no-action letter, the no-action position was narrowly tailored to allow Anka only to provide a list of names and telephone numbers of possible investors, and to have no further contact or involvement in the transaction. But, as Latham and Watkins has noted in their client advisories, the SEC has since indicated that they would not issue the Anka letter today.

"Finder" Registration Requirements

One of the more critical federal and state regulatory registration requirements relating to an ICO is that of broker-dealer activity. Specifically, Section 15(a)(1) of the Securities Exchange Act of 1934 makes it unlawful for a person to "effect a transaction in securities" or "attempt to induce the purchase or sale of, any security" unless they are registered as a broker or dealer under the rules and regulations of FINRA, the regulatory organization designated by the SEC to license and regulate broker-dealers.

The ramifications for failure to register as a broker-dealer are severe, even criminal. Section 29(b) of the Exchange Act provides that every contract made in violation of any provision of the broker-dealer registration requirements "shall be void" as to rights of persons who made or engaged in the performance of such contract. It results in the underlying purchase of securities becoming a voidable transaction that gives the investor a right of rescission, so for purchasers losing money on the investment, there is an instantaneous and simple claim to get a refund of their investment.

Moreover, Section 20(e) of the Exchange Act, under which the SEC may impose aiding-and-abetting liability on any person that knowingly or recklessly provides substantial assistance in a violation of the Exchange Act, creates additional potential liability. Finally, merely retaining and permitting an unlicensed intermediary to help facilitate or effect a securities transaction (such as an ICO) may be a violation of federal and many state laws and may subject the issuer to possible civil and criminal penalties.

In accordance with these fairly stringent requirements, when a person is at all engaged in facilitating or helping conduct an ICO (like sending me an ICO solicitation), the person may be required to register as a broker-dealer with the SEC. For instance, many ICO promoters and affiliates negotiate payment of "success fees" upon completion of an ICO-related transaction, or arrange for some other iteration of transaction-based compensation. Even if the arrangement conceals the true intent of the relationship, payment of transaction-based compensation — i.e., a commission or some form of compensation that varies with the size or type of the resulting investment — is treated by the SEC as a nearly-conclusive indication that a person is engaged in the securities business, and should be registered as a broker-dealer.

The Venable law firm analyzed the issue of finders intensely, and notes that there is very little that a finder may do without crossing the line into activities that may trigger the requirement to register as a broker-dealer. While the SEC has consistently viewed transaction-based compensation as the "hallmark" of broker-dealer activity, the Venable law firm cites the following other factors as typical of broker activity, where the person involved may need to be a registered broker-dealer. This extensive list, based on prior SEC regulatory pronouncements, speeches, no-action letters, etc., demonstrates the wide breadth of Section 15(a):

- Participates in discussions and negotiations between the issuer and the potential investors;
- Assists in structuring transactions;
- Engages in "pre-screening" potential investors to determine their eligibility to purchase securities;
- Engages in "pre-selling" the issuance to gauge the level of interest;

- Conducts or assists with the sale of securities;
- Provides advice regarding the value of securities;
- Locates issuers on behalf of investors;
- Solicits new clients;
- Disseminates quotes for securities or other pricing information;
- Actively (rather than passively) finds investors;
- Sends private placement memoranda, subscription documents and due diligence materials to potential investors;
- Advises on portfolio allocations to accommodate an investment;
- Provides analyses of potential investments; and
- Provides potential investors with confidential information identifying other investors and their capital commitments.

Thus, when pitching an ICO — even as simple as a LinkedIn email solicitation — the ICO could become immediately and irrevocably tainted.

Broker-dealers are supposed to serve as gatekeepers, to protect investors in the marketplace, and are required to "observe high standards of commercial honor and just and equitable principles of trade" in the conduct of their business, including determining if an investment is "suitable" for a customer and maintaining meticulous records of communications, representations, transactions and other important information. Broker-dealers are also subject to SEC and FINRA examination, together with a broad range of regulations and rules of conduct.

One final note: The SEC considers the principle of gatekeeper registration sacrosanct, broadly construing the broker-dealer laws while narrowly construing the few permitted exceptions. So-called ICO finders will find little sympathy from SEC staff, no matter how well-intentioned or poorly advised.

Message 5: YouTube ICO/Crypto Promoters, Your Days May be Numbered

With the proliferation of, and the hype surrounding, the ICO/crypto marketplace, it is not surprising that ICO-related informercials have been sprouting up all over YouTube. With respect to ICO-related YouTube promotions and advertising, the SEC can assert their jurisdiction anytime — and take enforcement action when appropriate.

In fact, the SEC has historically policed aggressively securities violations occurring over YouTube,

whether relating to stock promotions, Ponzi schemes, pyramid schemes or any other get-rich-quick video pitch. The SEC has even gone so far as suspending trading in the stock of companies who touted their stock over infomercial-like promotional videos on YouTube.

For instance, on March 20, 2008, the SEC suspended trading in the securities of three companies that had not adequately disclosed information to investors, and that have been the subject of spam e-mail campaigns and promotional videos on YouTube.

The videos often repeated information in the companies' press releases, and are posted to coincide with traditional spam e-mail campaigns. The SEC issued an order finding that each of the companies subject to the trading suspension — NeoTactix Corporation (NTCX), Graystone Park Enterprises Inc. (GPKE) and Younger America Inc. (YNGR) — had inadequately disclosed their assets, business operations and current financial condition.

A Side Note on Settled SEC Administrative Orders

It is important to note that the Khaled and Mayweather SEC enforcement actions are not actual federal cases, but are instead, settled SEC administrative actions. This means that with respect to both the Khaled and Mayweather matters:

- No Article III judge approved the SEC settlements, or ever even considered either matter;
- The SEC Office of the Secretary actually signed the orders (Brent Fields, who is appointed by the SEC chairman);
- Neither matter was adjudicated in any way by an SEC administrative law judge, which means no discovery, no court rulings, no trial, etc.; and
- The SEC enforcement staff drafted the order, which the secretary then signed, perhaps with a few edits or perhaps with no edits at all.

But having said the above, the Khaled and Mayweather orders offer an official SEC enforcement division pronouncement relating to the future of ICOs. Moreover, most seasoned SEC lawyers would agree that settled SEC administrative actions have important precedential value — and typically command careful and thoughtful analysis and consideration.

Looking Ahead

The SEC formally launched its cryptocurrency regulatory efforts with a July 25, 2017, Investor Bulletin warning investors about ICOs, and, issued that same day, the 21(a) Report of Investigation explaining how ICOs are unlawful.

During the ensuing months, SEC chairman Jay Clayton launched his own "crypto-tour," asserting repeatedly that cryptocurrency tokens looked like securities and were susceptible to fraud and chicanery by insiders, management and better-informed traders and market participants. Over and over again, Clayton explained to everyone who asked, including Congress, "I believe every ICO I have ever seen is a security. ... ICOs should be regulated like securities offerings. End of story."

But the most telling of all of Clayton's ICO-related proclamations came when he and none other than Senator Elizabeth Warren metaphorically joined hands. (Yes, that Senator Warren, the one who opposed Clayton's nomination, and who pretty much combats most everything any Republican in Washington, D.C., has ever wanted to do.) Witness this awkward exchange during a February 2018 hearing on cryptocurrencies:

Warren: “In 2017, companies raised more than $4 billion in ICOs. How many of those ICOs registered with the SEC?”

Clayton: “Not one.”

Warren: “As of today, how many companies have registered for upcoming ICOs?”

Clayton: “Not one.”

Warren: “Why?”

Clayton: “I don’t think the gatekeepers that we rely on to assist us to ensure our securities laws are followed have done their job. ... What ICOs do is they take the disclosure-like benefits of a private placement and then add to it the public general solicitation and retail investor promise of a secondary market without registering with us. And folks somehow got comfortable that this was new, and it was OK and it was not a security and just some other way to raise money. Well, I disagree.”

Warren: “So it is new, but it’s not OK, and it’s not another way to raise money?’

Clayton: “Correct.”

The Khaled and Mayweather actions not only reinforce the chairman’s concerns and viewpoints exponentially, but the matters also roll out a new arsenal of ICO-fighting weaponry, like the promotions bar and the launching of disgorgement 2.0. Despite the headlines and continuing ICO

euphoria, the SEC has not stymied or otherwise adjusted its ICO dragnet because of the Blockvest decision. Quite to the contrary.

Moreover, like the Section 17(b) sweeps of the 1990s, which in one fell swoop put an end to most of the unlawful touting perpetrated over the internet, the Khaled and Mayweather actions could do the same for using social media to promote ICOs and stop the practice dead in its tracks.

As for the future, my take is that the SEC will soon set its sights on the global mass of: 1) so-called finders who are receiving transaction-based compensation to peddle ICOs and other crypto-related related investments; and 2) crypto-touting YouTubers, whose shameless infomercials, masquerading as CNBC-esque news shows, are emerging as a genuine threat to retail investors.

Just like charging promoters with Section 17(b), charging finders with Section 15(a) (failure to register as a broker-dealer) is a matter of strict liability — and, for the SEC, enforcing strict liability statutes is like shooting fish in a barrel.

In addition to being so easily prosecuted, ICO finders and YouTubers are also easy to catch. By opting to exploit YouTube and other social media platforms for their financial gain, ICO sponsors, promoters and affiliates actually provide enforcement staff with a cost-free, readily available and extraordinarily resplendent view into ICOs as they unfold — enabling, in many cases, the enforcement division to stop violations before investors' savings are lost.

Indeed, unlike bitcoin users such as ransomware attackers, dark web drug dealers and terrorists, cryptocurrency financiers want to be found. They require a wide audience to review their information, invest in their offerings and participate in their transactions. Culprits are easier to surveil, easier to track and, ultimately, easier to catch. This may yet prove to be the most profound change brought by social media on the field of securities regulation. Far from tying regulators' hands, social media in particular has evolved into the virtual rope that many cyber-wrongdoers use to hang themselves.

In the meantime, perhaps ICO promoters, operators and other crypto-related supporters will take heed of the Khaled and Mayweather SEC enforcement actions and clean up their acts. But then again, given their hysteria, fanaticism and worldwide misinformation campaign, I am not betting on it.

John Reed Stark is the president of John Reed Stark Consulting LLC, a data breach response and digital compliance firm. Formerly, Stark served for almost 20 years in the Enforcement Division of the U.S. Securities and Exchange Commission, including 11 years as the chief of its Office of Internet Enforcement. He is the author of "The Cybersecurity Due Diligence Handbook."

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