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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Blockvest Reversal Makes Clear That ICOs Are Securities

By **John Reed Stark** (February 22, 2019, 2:17 PM EST)

John Reed Stark

In an ICO Saint Valentine's Day massacre, Judge Gonzalo Curiel of the United States District Court for the Southern District of California reconsidered and reversed his November 2018 Blockvest decision, sending a powerful message about the illegality of so-called initial coin offerings.

As an early critic of Curiel's original Blockvest opinion (before he reversed himself last week), I now feel vindicated, and have written this article to discuss the details of his extraordinary turnabout. But before we get to Curiel's unusual ICO death blow, let's start from the beginning of this intriguing legal course of events.

Some Background

Companies and individuals are increasingly considering initial coin offerings as a way to raise capital or participate in investment opportunities. While these digital assets and the technology behind them may present a new and efficient means for carrying out financial transactions, they also bring increased risk of fraud and manipulation, because the markets for these assets are less regulated than traditional capital markets. In fact, ICO markets are barely regulated at all.

Moreover, as U.S. Securities and Exchange Commission Chairman Jay Clayton has stated, tokens and offerings that feature and market the potential for profits based on the entrepreneurial or managerial efforts of others contain the hallmarks of a security under U.S. law. Along these lines, the SEC has been on an ICO enforcement rampage, bringing slew of cases against ICO promoters, typically alleging charges of out-and-out fraud as well as a failure to register with the SEC.

Judge Curiel's Original Blockvest Decision

On Nov. 27, 2018, in a matter involving an allegedly fraudulent ICO by a company called Blockvest, Judge Curiel denied an SEC 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," (BTCEthereum.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)

- “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 were all dead wrong then, and they are even more dead wrong now.

Back in December, just after Curiel's initial decision, in an article about the Khalid and Mayweather SEC enforcement actions, I wrote about this ICO "fake news," decrying the misleading headlines, scratching my head at the judge's curious decision and criticizing ICO promoters for their self-serving propaganda. My take was that Curiel had erred, that ICO promoters were misreading the decision and that the resultant optimism was sorely misguided.

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 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 the 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 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 Curiel Denies the SEC’s Preliminary Injunction Request

On Nov. 27, 2018, Curiel denied the SEC’s request to continue the TRO and extend that order into a preliminary injunction — and set the case for trial.

He 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 vs. 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 a "virtual" organization know as the DAO. The SEC's report found that tokens offered and sold by 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 themselves 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 that “[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 were 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 importantly, 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's 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 needs to be registered under the Securities Act, or needs to qualify for an exemption from registration. In other words, painting stripes on a horse does not make it a zebra.

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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 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. ... 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.

What investors actually believed about Blockvest will undoubtedly be revealed during trial. Granted, if Blockvest's assertions were true, i.e., that the investors had no expectation of any profit, then ruling that the tokens were not securities might have made sense. But given the hundreds of pages the SEC filed in a slew of declarations, websites, chat transcripts, videos and other evidence set forth meticulously in the SEC complaint, this assertion not only defied common sense — it was laughable.

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 Consented to the Preliminary Injunction

What so many commentators missed in their analysis of the initial Blockvest decision was that Judge Curiel believed that Blockvest and Ringgold had arguably consented to the preliminary injunction, leaving him with little reason to grant a motion mandating that the defendant do something that they have already agreed to do. Curiel noted:

> 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."

What Did the Blockvest Ruling Actually Mean?

While arguably flawed. nothing in Curiel's ruling prohibited the SEC from taking Blockvest and Ringgold to trial. Rather, it just meant that the SEC had not met the hefty 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.

Curiel simply determined that, at that particular stage (in November 2018), without full discovery regarding the disputed issues of material facts, he could not decide whether the BLV token were securities. Moreover, since Blockvest and Ringgold had agreed to stop the ICO and provide 30

securities. Moreover, since Blockvest and Ringgold had agreed to stop the ICO and provide 30 days' prior notice to the SEC if they ever intended to move forward with their ICO, Curiel decided no reasonable likelihood that the wrong would be repeated. As a result, he denied the SEC's motion for a preliminary injunction.

Despite what many of the Blockvest-related headlines implied, this was not a victory for the ICO industry or a setback for the SEC. Most importantly, Curiel's ruling did not mean that the SEC was going to reconsider its current ICO enforcement posture.

Judge Curiel's Reversal

On Feb. 14, 2019, in a stunning and extraordinary reversal from his November decision, Curiel sent shockwaves through the ICO industry. Specifically, he granted the SEC's bid for a preliminary injunction against Blockvest after the SEC asked him to reconsider, based upon, "a [now] prima facie showing of Blockvest's past securities violation and newly developed evidence which supported the conclusion that there is a reasonable likelihood of future violations."

In his decision, Curiel turned his attention away from the "32 test investors" and the "pre-ICO" arguments of his original decision, and focused instead on a straightforward analysis of the offer proposed by Blockvest to all potential investors.

Applying this analysis to Section 17(a) of the Securities Act, Curiel stated unequivocally that Blockvest's promotion of digital tokens met the definition of a security established under Howey: "The court concludes that the contents of defendants' website, the white paper and social media posts concerning the ICO of the BLV tokens to the public at large constitute an 'offer' of 'securities' under the Securities Act."

Per Curiel, Blockvest's website and white paper urged people to pay for BLV tokens with digital or other currency, and the website said any funds raised would be pooled together in what could be considered a common enterprise. Noting that all of the aspects of the Howey test had been met, Curiel wrote: "Finally, as described on the website and white paper, the investors in Blockvest would be 'passive' investors and the BLV tokens would generate 'passive income.'"

Why Curiel did not apply the above analysis in his original order is not clear. He stated: "The Court did not directly address this alternative theory in its original order and based upon the additional submitted briefing concludes that Defendants made an 'offer' of unregistered securities which violated Section 17 (a). "

In any case, the judge cured his error and moved on, with a very thoughtful and thorough

application of Section 17(a) to all of Blockvest's various promotional efforts, which were exhaustively documented by the SEC in its court filings.

Reasonable Likelihood That the Wrong Will Be Repeated

In my December 2019 article, I was dumbfounded by Curiel's disregard of the seemingly egregious evidence of Blockvest's alleged fraud amid the reams of inculpatory documents submitted to the court by the SEC. How had such an outrageous cache of evidence not convinced Curiel of the likelihood of future violations by Blockvest?

Apparently, Curiel took a closer look at the SEC's meticulous filings of suspicious evidence — and he agreed with me. Specifically, he backtracked on his prior analysis and now recognized the likelihood of future harm by Blockvest, stating:

> In the instant motion, the Court grants a partial reconsideration and concludes that Plaintiff has presented a prima facie case of violations of Section 17(a), which creates an inference that Defendants will likely violate the securities law in the future if not enjoined. ... The misrepresentations on Defendants' website postings include falsely claiming their ICO has been "registered" and "approved" by the SEC, falsely claiming their ICO has been approved or endorsed by the CFTC and the NFA by utilizing their logos and seals, falsely asserting they are "partnered" with and "audited by" Deloitte, and falsely creating a fictitious regulatory agency, the BEC, with a fake government seal, logo, and mission statement that are nearly identical to the SEC's seal, logo and mission statement. Ringgold does not dispute that these false representations were on the website; instead, he claims that mistakes were made. ... The Court recognizes

> on the website; instead, he claims that mistakes were made. ... The Court recognizes that Defendants could have reasonably made a mistake as to their SEC filings as they had hired a compliance attorney; however, the Court questions Defendants' mistake concerning the creation of fictitious agency, BEC, utilizing a nearly identical seal, logo and mission statement as the SEC to provide a false appearance that the ICO had regulatory approval and was safe.

Curiel also noted with dismay that Blockvest had attempted to file certain documents which Blockvest's counsel had apparently previously refused to file for fear of violating Rule 11 of the Federal Rules of Civil Procedure (i.e. concerns that the documents contained information or arguments which were not grounded in fact). Moreover, Blockvest's counsel had submitted a motion to withdraw. These facts exacerbated the judge's view of the potential for future violations by Blockvest, and he stated:

> [I]n the motion to withdraw as counsel, defense counsel explained that the firm found it necessary to terminate representation due to, inter alia, Defendants instructing defense counsel to file certain documents that counsel could not certify under Federal Rule of Civil Procedure 11.6. ... In fact, when defense counsel declined to file the documents, Defendants attempted to file such documents with the Court without counsel's permission or signature and the documents were rejected by the Court Clerk. ... While Defendants have been notified of defense counsel's intention to withdraw as well as the pending motion to withdraw as counsel, they have yet to find substitute counsel. In light of the Court's order granting defense counsel's motion to withdraw as counsel, the Court has concerns whether Defendants will resume their prior alleged fraudulent conduct.

Looking Ahead

Despite the initial headlines and continuing ICO euphoria, the SEC did not stymie or otherwise adjust its ICO dragnet because of the initial Blockvest decision. Rather, the SEC dug in and redoubled its efforts — and Judge Curiel noticed. In fact, Curiel deserves a lot of credit for his willingness to reconsider his initial decision, for his open mind and for his reflective opinion.

Now that Curiel has eliminated the confusion spawned from his original decision, the SEC will clearly stay the course of the guidance SEC staff first issued on July 25, 2017, during the genesis of their ICO regulatory efforts, codified in the SEC Investor Bulletin warning investors about ICOs, and the SEC 21(a) report of investigation explaining how ICOs are unlawful.

As for SEC chairman Jay Clayton? He must be particularly pleased with Curiel's reversal. Curiel resoundingly reinforced Clayton's view of ICOs, which Clayton had already shouted from the rooftops during his 2017-18 personal crypto-tour. Back then and ever since, Clayton has asserted that cryptocurrency tokens look like securities and are susceptible to fraud and chicanery by insiders, management and better-informed traders and market participants. Indeed, Clayton told 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."

Thanks to Judge Curiel we all received a surprise Valentine's Day gift. The stars in the ICO regulatory sky are once again aligned, the SEC enforcement division has an even clearer path and mandate to police ICOs and we can all sleep a little better.

Perhaps ICO promoters, operators and other crypto supporters will take heed from Curiel's Blockvest decision reversal and clean up their acts. But then again, given ICO purveyors' fanaticism and worldwide misinformation campaign, I am (still) 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.