

# The SEC's Looming Initial Exchange Offering Sweep: Part 1

By **John Reed Stark** (May 30, 2019, 4:04 PM EDT)

Another SEC crypto-crackdown is in the works with a brand new target: the so-called initial exchange offering, or IEO. But what the heck is an IEO?

Not to be confused with initial coin offerings, or ICOs, an IEO is a crypto-financing model offered and administrated via a cryptocurrency trading platform on behalf of a company (typically some form of startup) that seeks to raise funds with its newly issued cryptocurrency digital tokens. Each IEO negotiates its unique terms, deals and conditions with the various cryptocurrency trading platforms.

In an IEO, cryptocurrency platforms essentially become the counterparties in the entire token offering process, enabling crypto projects to launch their offering directly on the platform (as opposed to ICOs, where the counterparties are the fundraising company's development team that creates or "mints" the tokens). The tokens sold in an IEO are distributed to investors by the cryptocurrency platform itself (as opposed to ICOs, where the fundraising company's development team distributes the tokens).



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IEO token purchasers typically create an account on the cryptocurrency trading platform where the IEO is conducted. They then fund their digital wallets with tokens typically issued by the cryptocurrency platform, and use those tokens to buy the fundraising company's tokens. After the cryptocurrency platform's customers purchase the fundraising company tokens directly from the trading platform, their "coins" are then "listed" on the cryptocurrency trading platform after the IEO ends.

Token issuers typically pay a listing fee to the cryptocurrency platform along with a percentage of the tokens sold during the IEO. In connection with the IEO, the cryptocurrency trading platform might provide marketing, due diligence and other facilitation services relating to the newly issued coin.

The popularity of IEOs has increased significantly in the past few months, and the cryptocurrency marketplace is abuzz with the financial possibilities of the IEO phenomenon. While no official IEO data exists, Coinschedule claims to record cryptocurrency market movements, and reports significant IEO growth, with close to \$175 million of IEOs orchestrated in March and April of 2019.

According to Coindesk, the "IEO ecosystem's" most famous IEO platform is the Launchpad division of Binance. Per Coindesk:

Launchpad originally started in August 2017, and reopened with the BitTorrent offering that facilitated \$7.2 million in sales with the exchange's native BNB token in January 2019. Since then, Binance has launched four new projects and is marching ahead with at least one a month as it simultaneously develops a decentralized exchange (DEX). ... Meanwhile, in contrast to Binance's Launchpad, KuCoin's comparable Spotlight division will launch its third IEO on May 28, featuring the CHROMA token issued by the software-as-service startup ChromaWay, which already garnered \$11 million in a private token sale last year.

But while it seems that IEOs have captivated a new cadre of cryptocurrency enthusiasts and other digital financiers, IEOs have also captured the attention of the U.S. Securities and Exchange Commission.

Speaking recently at CoinDesk's Consensus 2019 conference, Valerie Szczepanik, associate director of the SEC's Division of Corporation Finance and senior advisor for digital assets and innovation (often referred to as

SEC's Division of Corporation Finance and senior advisor for digital assets and innovation (often referred to as the SEC's "Crypto-Czar") expressed concern about IEOs.

Szczepanik explained that if an IEO issuer or any of the IEO buyers are based in the U.S., cryptocurrency trading platforms that facilitate token sales for a fee likely meet the legal definition of broker-dealers, and must follow the registration and licensing requirements for broker-dealers, alternative trading systems or national securities exchanges. Szczepanik warned:

Most obviously, cryptocurrency trading platforms seeking to list these tokens for a listing fee or bring buyers to the table for issuers are probably engaging in broker-dealer activity. ... If they are not registered, they will find themselves in trouble in the U.S., if they have a U.S. issuer or U.S. buyers, if they are operating on the U.S. market.

Szczepanik is a seasoned and respected SEC veteran, with over 20 years of SEC enforcement experience, and is not known to make empty threats. Purveyors, promoters and others associated with IEOs conducted in U.S. markets and involving U.S. investors had best prepare themselves for an SEC IEO enforcement onslaught.

This two-part series analyzes the SEC's jurisdiction over, and potential enforcement actions against, the purveyors of IEOs. Part one discusses and applies the SEC's broker-dealer registration requirements to IEOs — and given the 100% lack of broker-dealer registration by the cryptocurrency trading platforms peddling IEOs, predicts an SEC IEO sweep in the future.

Part two discusses and applies the SEC's exchange registration requirements for IEOs — and given the 100% lack of exchange registration by the cryptocurrency trading platforms peddling IEOs, predicts similarly dire consequences.

### **IEO Broker-Dealer Registration Requirements**

At its core, an IEO is basically an ICO that is run through a cryptocurrency trading platform which serves as the intermediary conducting the sale. So to understand IEOs, we must understand ICOs.

In a typical ICO, a company (generally the issuing entity) receives fiat currencies (such as U.S. dollars or euros) or crypto-assets (such as bitcoin or Ether) in exchange for certain rights embodied in crypto-asset digital tokens. These rights may include the right to access to a future service once the ICO is launched; the right to redeem the token for a currency or service; or the right to receive future profits from the company (like a dividend).

After a few years of ICO-related SEC litigation, emergency orders and asset freezes, whether ICOs are securities is no longer a question: Their legal classification as securities is now axiomatic. Indeed, 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 (whether it resides on a cryptocurrency platform or otherwise) falls squarely into the third "unlawful" category.

Along these lines, IEO facilitators and intermediaries such as token platforms and promoters are trading securities for compensation, and would likely need to comply with broker-dealer registration requirements. 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 consequences for failure to register as a broker-dealer can be severe, even criminal. In addition, 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 IEO) may be a violation of federal and many state laws, and may subject the IEO issuer (i.e., the fundraising entity) to possible civil and criminal penalties, including imprisonment. In accordance with these requirements, those collecting IEO listing fees, marketing fees, facilitation fees or any other iteration of transaction-based compensation to help conduct an IEO, would likely trigger broker-dealer registration.

Even if the IEO arrangement conceals the true intent of the relationship between the funding company and the cryptocurrency trading platform, 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. Failure to register under such circumstances can render the IEO immediately and irrevocably tainted (more on that later).

While the SEC has consistently viewed transaction-based compensation as the “hallmark” of broker-dealer activity, there are a broad range of other kinds of transaction-related conduct that can trigger broker-dealer registration. The Venable law firm has catalogued these other factors which the SEC would view as typical of broker activity. Venable’s extensive list, based on prior SEC regulatory pronouncements, speeches, no-action letters, etc., demonstrates the extraordinarily wide breadth of Section 15(a), and includes:

- Participating in discussions and negotiations between the issuer and the potential investors;
- Assisting in structuring transactions;
- Engaging in "prescreening" potential investors to determine their eligibility to purchase securities;
- Engaging in "preselling" the issuance to gauge the level of interest;
- Conducting or assisting with the sale of securities;
- Providing advice regarding the value of securities;
- Locating issuers on behalf of investors;
- Soliciting new clients;
- Disseminating quotes for securities or other pricing information;
- Actively (rather than passively) finding investors;
- Sending private placement memoranda, subscription documents and due diligence materials to potential investors;
- Advising on portfolio allocations to accommodate an investment;
- Providing analyses of potential investments; and
- Providing potential investors with confidential information identifying other investors and their capital commitments.

By skirting broker-dealer registration requirements, cryptocurrency trading platforms hawking IEOs are not adhering to a financial services regulatory framework meticulously calibrated to protect investors. For instance, broker-dealers 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 its customer, and maintaining meticulous records of communications, representations, transactions and other important information.

Broker-dealers are also subject to SEC and FINRA examinations, together with an exhaustive laundry list of regulations and rules of conduct, as well as a rigorous training, testing and certification process.

### **IEO Services: Prima Facie Broker-Dealer Behavior**

The vast array of broker-dealer activity by cryptocurrency trading firms offering IEOs is astounding — which, for the SEC, makes investigating and charging IEO broker-dealer registration cases like shooting fish in a barrel.

Transaction-based-compensation arrangements in IEO offerings are multifaceted, including listing fee arrangements and other transaction-related payments at the outset and throughout the IEO process. Also, the cryptocurrency trading platform’s own token is typically the instrument used to participate in the sale, providing an additional source of profit opportunities.

In addition, the manner in which cryptocurrency trading platforms manage, package and market IEOs make the SEC’s broker-dealer registration case even stronger (if that were possible). For example, in a typical IEO, cryptocurrency trading platforms boast of unique liquidity and marketing services, such as: 1) easy access to a large potential purchaser base; 2) help with crypto-asset distribution; 3) an advertising boost from being promoted on the exchange’s social media; and 4) an immediate listing on the crypto-asset exchange post-IEO.

Cryptocurrency trading platforms also tout their internal due diligence vetting of IEO issuers and their highly professional “know your customer” services as a critical benefit to engaging their facilities. Cryptocurrency platforms go so far as to hawk the “security and safety” of their respective IEOs, committing themselves to rejecting certain ineligible projects that may pose risks to investor’s assets, thus creating “a safer crypto investment environment.”

### **The SEC’s Pending IEO Sweep**

The stars seem perfectly aligned for the SEC to target IEO purveyors and expel them from U.S. markets.

Broker-dealer registration is one of the more critical federal and state regulatory registration requirements, because broker-dealers serve as gatekeepers to protect investors in the marketplace. Thus, the SEC considers the principle of gatekeeper registration sacrosanct, broadly construing the broker-dealer laws while narrowly construing the few permitted exceptions.

IEO broker-dealer violations are also strict liability in nature, requiring little in the way of scienter, conspiracy or even motive. Section 15(a) does not require a finding of fault (such as negligence or tortious intent), so the SEC need only prove that the IEO broker-dealer activity occurred without the proper registration and that the defendant was responsible, regardless of what anyone in the process honestly believes or testifies.

The SEC has an entire division dedicated to broker-dealer registration; will not hesitate to enforce broker-dealer registration provisions; and enjoys an extremely low legal threshold to insure victory in any broker-dealer registration enforcement action — key indicators for a successful SEC IEO enforcement program.

### **Rescission Rights**

IEO promoters, issuers and others involved in the IEO process could be compelled to return investor proceeds to any disgruntled IEO investors.

Purchasing an investment is not like buying a pair of shoes at Zappos. You can’t return the investment for a refund if you don’t like the fit. That is, unless you bought tokens in an IEO — and cryptocurrency trading platforms and IEO promoters should prepare themselves for IEO rescission demands. Thanks to a range of U.S. securities statutes, rules and regulations, IEO token subscribers may have so-called “rescission rights.”

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, and perhaps even more.

Rescission rights essentially amount to a “put option” for an IEO investment — i.e., IEO token purchasers would have the right to sell their tokens back to IEO sponsors and obtain a full refund, plus interest from the company and sometimes its officers and directors. It all boils down to a fairly straightforward legal analysis:

- Even if an IEO is somehow SEC-registered or structured to be SEC-exempt, the IEO is still likely offering what the law would deem “securities;”
- Anyone connected to an IEO who is marketing securities (for example, receiving any form of transaction-based compensation) must be registered with the SEC as a broker-dealer;
- If there is any unregistered person or entity connected to the IEO and marketing the IEO, then the unregistered broker-dealer actions have permanently and irrevocably tainted the IEO; and
- Once an IEO becomes irrevocably and permanently tainted, per SEC rules and regulations, investors are entitled to rescission, that is, a refund of their initial investment.

## **TokenLot**

When asked about IEOs, Szczepanik also cited the first SEC enforcement action involving a cryptocurrency trading platform violating the SEC’s broker-dealer activity requirements — TokenLot, a self-proclaimed “ICO superstore — as “instructive in this regard,” explaining:

[Just like in an IEO], TokenLot was a platform that was assisting to bring buyers to ICOs. ... In that case, there was an enforcement action charging the platform with acting as an unregistered broker-dealer and participating in the distribution in violation of the registration provisions.

According to the SEC’s order, filed on Sept. 11, 2018, TokenLot, Lenny Kugel and Eli Lewitt promoted TokenLot’s website as a way to purchase digital tokens during ICOs, and to engage in secondary trading. TokenLot’s profits included trading profits and a percentage of the TokenLot’s ICO raise.

As with IEOs, TokenLot advertised through social media, email newsletters and other paid online advertising, and received marketing fees from issuers in return for promoting the issuers’ digital tokens on its website.

The SEC emphasized the central role that TokenLot played in effecting sales, including that investor funds were transmitted to digital asset wallets controlled or maintained by TokenLot. (The SEC was also making good on a promise to crackdown on digital wallet services, in its March 7th, 2018, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets.)

The SEC charged TokenLot, Kugel and Lewitt for failure to register with the SEC as broker-dealers. Without admitting or denying the SEC’s findings, TokenLot, Kugel and Lewitt consented to the SEC’s order, and agreed to pay \$471,000 in disgorgement, plus \$7,929 in interest, and to retain an independent third party to destroy TokenLot’s remaining inventory of digital assets. Kugel and Lewitt also agreed to pay penalties of \$45,000 each, and agreed to industry and penny stock bars and an investment company prohibition with the right to reapply after three years.

This concludes part one of this two-part series. Please be sure to read part two, which will: (1) discuss and apply the SEC’s exchange registration requirements to IEOs, and (2) provide some final thoughts, predictions and suggestions going forward.

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