

The SEC's Looming Initial Exchange Offering Sweep: Part 2

By **John Reed Stark** (May 31, 2019, 3:55 PM EDT)

So-called initial exchange offerings, or IEOs, are all the rage in the cryptocurrency financial marketplace — but probably not for much longer. The U.S. Securities and Exchange Commission has noticed the recent uptick in IEO transactions and will likely soon take aim at the purveyors of IEOs, especially the cryptocurrency trading platforms marketing IEO deals within U.S. borders or to U.S. investors.

This two-part series analyzes the SEC's jurisdiction over, and potential enforcement actions against, the purveyors of IEOs, forecasting a grim future for promoters, affiliates and other interested parties participating in IEO transactions, and perhaps an end to any U.S. IEO fundraising campaigns by cryptocurrency trading platforms.



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Part one provided some background on IEOs, explaining the typical structure and orchestration of IEOs, then discussed and applied the SEC's broker-dealer registration requirements to IEOs. Given the 100% lack of broker-dealer registration by the cryptocurrency trading platforms peddling IEOs, part one also forecasted an SEC IEO sweep in the future.

But engaging in unregistered broker-dealer activity is not the only worry for cryptocurrency trading platforms offering IEOs. They may have also failed to register with the SEC as a securities exchanges. Therefore, part two discusses and applies the SEC's exchange registration requirements to IEOs — and given the 100% lack of exchange registration by the cryptocurrency trading platforms peddling IEOs, predicts dire consequences. Part two will conclude with some final thoughts going forward.

IEOs and Unregistered Exchanges

Put simply, a securities exchange is a company that creates the opportunity for potential buyers and sellers of a security to come together for trading — and per the SEC, cryptocurrency tokens are securities. Hence, the need to register under Section 6 of the Exchange Act, or operate pursuant to an appropriate exemption (such as an alternative trading system that complies with Regulation ATS — which requires, among other things, registration as a broker-dealer and filing of a Form ATS with the SEC).

Actual SEC exchanges are heavily regulated, and provide an array of investor protections inherent with their registration. For instance, registered exchanges: 1) mandate that investors funds and securities be handled appropriately; 2) ensure that investors understand the risks involved in purchasing the often illiquid and speculative securities that or traded on a cryptocurrency exchange; 3) make buyers aware of the last prices on securities traded over a cryptocurrency exchange; and 4) provide adequate disclosures regarding their trading policies, practices and procedures.

Entities providing exchange-like services must also: carefully handle access to, and control of, investor funds; maintain meticulous records of certain communications; insure robust cybersecurity; install a vigorous culture of compliance under a formalized and detailed compliance program; and provide all users with a broad range of adequate protection and fortification.

SEC exchanges are also subject to routine and for-cause examinations. The federal regulatory framework governing registered national securities exchanges and exempt markets is designed to protect investors, and guard against fraudulent and manipulative trading practices.

Hence, SEC exchange registration is an extraordinarily robust regulatory requirement — which is why there are only a small handful of actual SEC-registered exchanges, and why this group is an exclusive fraternity of responsible and rock-solid financial institutions.

While cryptocurrency trading platforms often refer to themselves as “exchanges,” they bear little resemblance to the traditional securities exchanges currently operating within U.S. markets, such as the New York Stock Exchange or the NASDAQ. This inappropriate (and perhaps even unlawful) nomenclature is disturbing to say the least.

Along these lines, the SEC staff has previously published an explicit warning that many online cryptocurrency trading platforms appear to investors as SEC-registered and regulated marketplaces when they are not. The SEC became so concerned about this problem that they issued an unusual official statement, stating on March 18, 2018:

Many platforms refer to themselves as "exchanges," which can give the misimpression to investors that they are regulated or meet the regulatory standards of a national securities exchange. Although some of these platforms claim to use strict standards to pick only high-quality digital assets to trade, the SEC does not review these standards or the digital assets that the platforms select, and the so-called standards should not be equated to the listing standards of national securities exchanges. Likewise, the SEC does not review the trading protocols used by these platforms, which determine how orders interact and execute, and access to a platform's trading services may not be the same for all users. Again, investors should not assume the trading protocols meet the standards of an SEC-registered national securities exchange. Lastly, many of these platforms give the impression that they perform exchange-like functions by offering order books with updated bid and ask pricing and data about executions on the system, but there is no reason to believe that such information has the same integrity as that provided by national securities exchanges.

EtherDelta

The SEC has already begun its efforts at policing unregistered exchanges in the cryptocurrency marketplace, and IEO purveyors should take heed. Specifically, on Nov. 8, 2018, the SEC settled charges against Zachary Coburn, the founder of EtherDelta, a digital token trading platform, marking its first SEC enforcement action based on findings that such a platform operated as an unregistered national securities exchange.

According to the SEC's order, EtherDelta is an online platform for secondary market trading of ERC20 tokens, a type of blockchain-based token commonly issued in ICOs. The order found that Coburn caused EtherDelta to operate as an unregistered national securities exchange.

EtherDelta provided a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders and a “smart contract” run on the Ethereum blockchain. EtherDelta's smart contract was coded to validate the order messages, confirm the terms and conditions of orders, execute paired orders and direct the distributed ledger to be updated to reflect a trade.

Over an 18-month period, EtherDelta's users executed more than 3.6 million orders for ERC20 tokens, including tokens deemed securities under the federal securities laws. The SEC charged that EtherDelta offered trading of various digital asset securities and failed to register as an exchange or operate pursuant to an exemption.

SEC Enforcement Division co-director Stephanie Avakian noted at the time: "EtherDelta had both the user interface and underlying functionality of an online national securities exchange and was required to register with the SEC or qualify for an exemption."

Without admitting or denying the findings, Coburn consented to the order and agreed to pay \$300,000 in disgorgement plus \$13,000 in prejudgment interest and a \$75,000 penalty. The SEC's order recognized

Coburn's cooperation, which the commission considered in determining not to impose a greater penalty.

Looking Ahead

Just when it seemed there might be a slowdown to the audacity, distortion, spin and deception of the crooked world of ICOs, up crops one more wholly unregulated crypto-casino fund-raising mutation — the IEO.

It's almost insulting. First off, IEOs represent yet another blatant attempt to hijack a similar-sounding acronym — IPO — in an effort to lure investors seeking to get rich quick. However, just like ICOs, the IEO has not a single

element in common with the IPO (other than the first and last letters of its acronym).

IPOs are thoroughly and fastidiously regulated by the SEC, enforcing a strict and elaborate set of legal requirements and mandating a rigorous formal process for how they are carried out. In contrast, ICOs and IEOs are investments offered in a virtually unregulated space, where there exists tremendous opportunity for investor loss due to fraud, manipulation, insider trading, hacking and a broad range of chicanery, with little recourse after the fact.

For example, researchers from the University of Texas found that manipulation in the cryptocurrency market is rampant, and that much of the run-up in Bitcoin's price during 2017 was due to manipulation orchestrated by the Hong Kong exchange Bitfinex. Given its complete and utter lack of oversight and meaningful licensure, the cryptocurrency marketplace is not just the Wild West — it's anarchy.

Don't get me wrong: The blockchain technology on which cryptocurrencies are based may turn out to be the most exciting, disruptive, transformative and efficiency enhancing breakthrough since sliced bread. But aside from complex issues of privacy, security, ethics and simple practicality, blockchain technology remains embryonic; has still yet to be proven; and happens to reside amid an economic ecosystem rife with fraud, deceit, dishonesty and thievery.

Consider blockchain's most celebrated accomplishment — bitcoin. Much of bitcoin's value, outside of mere speculation, is derived solely from its ability to facilitate criminal activity. Need a fake I.D., bottle of opiates, a cache of credit card numbers or a thousand social security numbers? Need a way to collect a ransomware payment? Need to fund terrorist-related activities? Need to hire a hitman? Need to finance an election tampering scheme? Cryptocurrencies like bitcoin have become the payment of choice for these, and a slew of other, criminal enterprises.

Moreover, just because some mythical engineer has discovered a potentially revolutionary manner to engage in and verify commercial transactions (e.g., replacing a traditional corporate entry recorded in an intermediary institution's centralized ledger with a virtual entry recorded on a blockchain's decentralized distributed ledger), it does not mean U.S. regulators like the SEC should abandon their critical regulatory mandate of investor protection.

In the history of financial innovation, modernization and invention, there has always existed one constant: Whatever the product, fraudsters and con artists will attempt to exploit its excitement and enthusiasm in an effort to steal from investors. Hence, the June 6, 1934, creation of the SEC with its exhaustive compendium of onerous and sticky regulations, policing U.S. securities markets while simultaneously fostering economic growth and capital prosperity.

Cryptocurrency fanatics argue that the SEC, with its antiquated regulatory framework, is stifling technologically driven transformation. But policing ICOs, IEOs and the like does nothing of the sort. In stark contrast, the SEC's cryptocurrency enforcement efforts ensure that U.S. securities markets remain the most efficient, most admired, most respected and most sought after in the world.

So-called "fintech" developments might very well provide promising investment opportunities for institutional and Main Street investors alike, and might even make the world a better place, but only when kept in check by the SEC, whose mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

Suppress SEC oversight and enforcement of new-fangled, high-tech concoctions like IEOs, and prepare for a return to the investor carnage of the Dutch Golden Age of February 1637, and the devastation of tulipmania and the Semper Augustus bulb. Not a beneficial outcome for anyone, to say the least.

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