SEC Chairman Issues Statement on Cryptocurrencies and Initial Coin Offerings

Friday, December 15, 2017

On December 11, 2017, SEC Chairman Jay Clayton issued a Statement on Cryptocurrencies and Initial Coin Offerings (the “Statement”) reflecting his own views on cryptocurrencies and initial coin offerings (“ICOs”) and their relationship to federal securities laws. The Chairman’s Statement follows three separate public enforcement actions brought by the SEC since September 2017 involving ICOs.

Chairman Clayton’s remarks are noteworthy in the following respects:

- First, the Chairman made clear the SEC will continue to vigorously police and bring enforcement actions related to unregistered ICOs. The Chairman’s Statement strongly suggests that more SEC enforcement actions regarding ICOs may soon follow.
- Second, the Chairman made it clear that, in his view, most ICOs involve the offer and sale of securities and are subject to the federal securities laws, while noting that, to date, no ICO has been registered with the SEC. These aspects of the Chairman’s statement reinforce the expectation that more SEC enforcement actions regarding ICOs are likely.
- Third, the Chairman noted that, to date, the SEC has not approved for listing and trading any exchange-traded products holding cryptocurrencies or related assets.
- Fourth, the Chairman sent a clear warning to promoters, trading platforms, and market professionals about certain “troubling” practices associated with certain ICO offerings and about relying on creative arguments to avoid application of the securities laws. The Statement sends a clear signal to market participants and market professionals regarding the standards of conduct the SEC expects them to follow.
- Fifth, the Chairman urged potential investors to exercise caution and provided a series of questions to assist investors in evaluating cryptocurrency and ICO investments.

Chairman Clayton addressed his comments to two groups: (1) “Main Street” investors, and (2) market professionals, such as broker-dealers, investment advisors, exchanges, lawyers, and accountants. Noting the rapid growth of the cryptocurrency and ICO markets, as well as the many questions that accompany such growth, the Chairman used the Statement to identify separate considerations relevant to the two groups.

Main Street Investors – Heightened Risk

The Statement emphasized the heightened risk investors face in the cryptocurrency and ICO markets. After informing investors about the absence of ICO registrations or any cryptocurrency-based exchange-traded products approved for listing and trading on U.S. securities exchanges, the Chairman cautioned that the cryptocurrency and ICO markets afford “substantially less investor protection than” traditional securities markets and present “correspondingly greater opportunities for fraud and manipulation.” He urged investors to “exercise extreme caution,” and be aware of the risk of loss, particularly if an investment opportunity sounds too good to be true. Chairman Clayton further stated that the cross-border aspect of cryptocurrency and ICO markets amplifies the risk that the SEC and other market regulators may have limited ability to pursue bad actors or recover funds. The Chairman’s Statement urged Main Street investors to “ask questions and demand clear
answers” about investing in cryptocurrencies and ICOs and provided sample questions for investors to ask before investing in such products.

**Market Professionals – Legal Compliance**

The Chairman acknowledged that ICOs – “whether they represent offerings of securities or not – can be effective ways for entrepreneurs and others to raise funding, including for innovative projects.” He concluded, however, that where such activity involves an offering of securities, compliance with the securities laws is required.

Chairman Clayton urged market professionals to avoid semantic arguments that “elevate form over substance,” and criticized the attempts of certain market professionals to classify tokens or coins issued in ICOs as “not securities.” The Chairman noted that “simply calling something a ‘currency’ or a currency-based product does not mean that it is not a security.” He stated that where the substance reveals the tokens or coins to contain the hallmarks of a security under U.S. law, U.S. securities laws must be followed. Chairman Clayton urged market professions to act responsibly and be guided by “the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.”

With respect to cryptocurrencies, the Chairman emphasized that before launching a cryptocurrency, the promoter must demonstrate that the currency or product is not a security or comply with applicable registration and other requirements under U.S. securities laws. The Chairman also warned market professionals that their cryptocurrency activities should not undermine their know-your-customer and anti-money laundering obligations.

With respect to ICOs, the Chairman cautioned market professionals to determine whether securities laws apply before promoting the offer or sale of ICOs, and warned trading platforms against operating unregistered exchanges or broker-dealers in violation of the Securities Exchange Act of 1934. He deemed it “especially troubling” when promoters emphasize the secondary market trading potential of digital tokens and the potential for tokens to increase in value based on the efforts of others—“key hallmarks of a security and a securities offering.”

The issuance of the Statement by Chairman Clayton and the issues he identified in the Statement send a strong signal that senior SEC leadership is duly concerned about investor harm in connection with ICOs and cryptocurrencies, plans to step up its enforcement activity in these areas, and is unlikely to show leniency with regard to securities law violations in these areas going forward.

*In the Statement, Chairman Clayton described cryptocurrencies as items purporting to have “inherent value (similar, for instance, to cash or gold) that are designed to enable purchases, sales and other financial transactions” and are intended to provide many of the same functions as fiat currencies, such as the U.S. dollar, without the backing of a government or other body. He described ICOs as offers to investors to exchange fiat currency or cryptocurrency for a digital asset designated as a coin or token, where the proceeds of the ICOs are used by companies and individuals to raise capital for their businesses and projects.

© 2017 Covington & Burling LLP