

## OPINION

# State, SEC begin to take action against cryptocurrencies

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Cryptocurrencies and Initial Coin Offerings present new and exciting opportunities for entrepreneurs and investors. But the regulatory environment, which is transitioning from murky to skeptical, makes engaging in them fraught with peril.

Companies thinking about jumping into the cryptocurrency foray would do well to take notice of the increasing attention being paid by regulators.

Below we discuss a recent complaint filed by the Massachusetts Securities Division and enforcement actions by the Securities and Exchange Commission, and reflect on what this means for

the future.

In the end, ancient advice remains sound amid even the newest technology: Look before you leap.

### In the Matter of Caviar and Bensonoff

As a recent example of regulatory and enforcement activity in this space, the Massachusetts Securities Division Enforcement Section filed a complaint against the company Caviar and its founder, Kirill Bensonoff, for violations of the Massachusetts Uniform Securities Act in connection with an ongoing Initial Coin Offering, or ICO.

This is Secretary of State William F. Galvin's first enforcement action related to an ICO and follows on the heels of a December 2017 announcement that the division would conduct a sweep of Massachusetts entities engaging in ICOs. The complaint offers a useful blueprint for how the division is thinking about ICOs and where it sees significant legal problems.

According to the complaint, Caviar is a Cayman Islands corporation, and Bensonoff conducts Caviar's business from his Brookline home. The division alleges that Caviar is merely a shell: It has no actual place of business in the Cayman Islands and was organized in an attempt to avoid U.S. securities registration requirements.

Importantly for those considering

ICO as a business avenue, both Caviar and Bensonoff are charged, among other things, with offering a security without either registration or an exemption from registration (more on this analysis below).

The securities at issue are "Caviar tokens," which allegedly will represent an interest in a mixed pool of real estate and blockchain assets to be managed by Caviar.

The division states that it views this ICO as a means to finance the creation of a hedge fund, and that the Caviar tokens act as freely transferable shares in that hedge fund.

It further alleges that Bensonoff and Caviar have engaged in general solicitation of Caviar tokens since October 2017 and continue to engage in such solicitation as of the date of the complaint.

These facts, the division asserts, are consistent with how securities act and are marketed, in violation of the Uniform Securities Act.

### Inadequate security

Although Caviar.io, the website where Caviar tokens can be purchased, represents that the token sale is not available in the United States (as did Bensonoff in a sworn statement), the complaint alleges that the procedures Caviar undertook to prevent sales to Massachusetts investors are inadequate.

Quite apart from the extensive marketing of the tokens in social media, the division alleges that the identity verification process can be easily bypassed. Similar to news reports concerning successful efforts to bypass biometric security technology (such as using a photo to bypass the face recognition security of Windows Hello), a

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state inspector apparently used a cartoon character's name and a picture taken from Google images as a passport photo to bypass Caviar's identity verification process.

### Are cryptocurrencies securities? Applying the 'Howey Test'

The division applied the familiar "Howey Test" factors (from *SEC v. Howey*, 328 U.S. 293 (1946)) to find the Caviar tokens to be securities.

The factors listed in the complaint were that:

- the purchasers invest money in a common enterprise;
- the purchasers reasonably expect to profit from their investments; and
- the purchasers reasonably expect to derive that profit from the efforts of Caviar and Bensonoff.

The factors, and their application to

the ICO at issue here, are important to understand when considering possible enforcement actions.

**1. Investing money.** Alleging that the purchasers invest money in a common enterprise, the division notes two key facts: that Caviar accepts investments in either cryptocurrency or fiat currency, and that the funds raised will be pooled together and profits will be shared pro rata, such that the investors will share in the profits and risks of the pooled investment fund.

**2. Reasonably expect to profit from investment.** Alleging that the purchasers reasonably expect to profit from their investment, the division notes several facts, including: that the Caviar tokens were advertised as an opportunity for investors to realize a profit; that several sections of Caviar's website made statements related to investors receiving returns based on their token holdings; and that a presentation was shared on multiple Caviar social media accounts that stated that it is Caviar's mission to, among other things, maximize return on investment.

**3. Reasonably expect to profit from efforts of Caviar and Bensonoff.** In finding that the purchasers reasonably expect to derive profit from the efforts of Caviar and Bensonoff, the Securities Division notes: (i) Caviar and Bensonoff claim that the pooled assets will be regularly rebalanced based on a proprietary "Intelligent Predictive Model" designed to forecast the growth of a cryptocurrency as compared to Bitcoin; (ii) a video linked on the Caviar website boasts that investors need to do nothing but hold the tokens to get Ether dropped into their Ethereum wallets every quarter; and (iii) investors are given no voting rights or other form of control over the management of Caviar.

Caviar claims to have raised over \$3.1 million through its ICO. Galvin's office seeks to require Caviar and Bensonoff to cease and desist from further conduct in violation of

federal and state securities laws, offer rescission to all investors from whom they have received funds, disgorge all profits made from the ICO, and pay an administrative fine.

### Following in the footsteps of the SEC

The Massachusetts Securities Division's complaint against Caviar and Bensonoff is the latest in increasing law enforcement oversight of ICOs.

The SEC's new cyber unit, for example, has also recently begun to crack down on ICOs, shutting down two in December. The latest target was Munchee, Inc., a California-based developer of an iPhone application for people to review restaurant meals.

The SEC's enforcement activity follows several policy statements and warnings regarding ICOs. The

Munchee order was issued the same day that SEC Chairman Jay Clayton issued renewed warnings to both main street investors and market professionals regarding ICOs and cryptocurrencies.

The Munchee ICO involved the sale of digital tokens to be issued on a blockchain. Munchee hoped to raise \$15 million through the sale. The SEC caught wind of the ICO and halted it after approximately 40 sales because it determined that the ICO constituted the unlawful sale of unregistered securities.

Like the Massachusetts Securities Division in its complaint against Caviar and Bensonoff, the SEC has emphasized that the test for determining whether a coin or token is a security for federal securities registration purposes is no different from the test applicable to other potential securities. The key question is whether the investor had a reasonable expectation of deriving profits from the entrepreneurial or managerial efforts of others.

In determining that Munchee's coins constituted securities, the SEC cited efforts by Munchee to increase the value of the tokens and make them available for sale on secondary markets. Munchee also made statements on social media and on podcasts suggesting that the tokens would increase in value.

Importantly, the SEC emphasized that even if tokens had a practical use at the time of the offering, it would not preclude them from being a security.

Munchee started selling tokens on Oct. 31, and by Nov. 1 the SEC had contacted Munchee, leading to the end of the ICO. Munchee also agreed to return all proceeds it had received to token purchasers. In exchange for Munchee's cooperation, the SEC did not take further punitive action.

### What the future holds

Both the Massachusetts action and the SEC's enforcement against ICOs are a wake-up call that companies considering ICOs must tread carefully.

SEC Chairman Clayton's ICO policy statement notes that while not all ICOs implicate securities registration requirements, a large majority of them involve the sale of securities and require registration and asks that the Division of Enforcement "police this area vigorously."

Massachusetts' actions in the Caviar case portend more enforcement activities at the state level, regardless of what the SEC might do. Companies seeking to launch an ICO are well-advised to consult with legal counsel to avoid some of the common mistakes made by companies seeking to exploit this new financing technique.

This is especially so in light of Chairman Clayton's speech on Jan. 22, in which he stated forcefully that "[m]arket professionals, especially gatekeepers [such as lawyers], need to act responsibly and hold themselves to high standards."

Treading cautiously in this space is advisable for the foreseeable future. **MLW**

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