Updates
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SEC and FINRA Target Cryptocurrency Hedge Fund Manager and Broker-Dealers in New Wave of Digital Asset Enforcement Proceedings

In a flurry of enforcement activity in the digital asset space, the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization for broker-dealers, announced three new enforcement actions addressing digital asset practices last month: *In the Matter of Crypto Asset Management, LP and Timothy Enneking*; *In the Matter of TokenLot, LLC, Lenny Kugel, and Eli L. Lewitt*; and *Department of Enforcement v. Timothy Tilton Ayre*. These actions are consistent with the warning shots the SEC fired in the 2017 DAO Report[1] and subsequent enforcement actions regarding the need for offers and sales of tokenized securities to comply with the federal securities laws.

As Stephanie Avakian, Co-Director of the SEC's Enforcement Division stated in the press release concerning *TokenLot*, the "U.S. securities laws protect investors by subjecting broker-dealers and other gatekeepers to SEC oversight, including those offering ICOs and secondary trading in digital tokens . . . [and the SEC] continue[s] to encourage those developing digital asset trading businesses to contact the SEC staff . . . for assistance in analyzing registration and other securities law requirements."

This update summarizes each case and the lessons to be drawn from them. As explained in more detail below, key takeaways include the following:

- Private funds investing in digital assets are not immune from SEC scrutiny
- Token trading platforms need to register as broker-dealers if they trade digital assets that are "securities"
- Companies facing SEC enforcement actions in the digital asset space may be required to undertake novel obligations, such as hiring independent entities to take possession of and destroy digital assets
- Taking prompt action may help mitigate penalties

*In the Matter of Crypto Asset Management, LP*

In its first-ever enforcement action finding a violation of the registration provisions of the Investment Company Act of 1940 (the 1940 Act) by a hedge fund manager based on its investments in digital assets, the SEC found that Crypto Asset Management, LP (CAM or the Manager) offered a fund, the Crypto Asset Fund, LLC (the Fund), that operated as an unregistered investment company while falsely marketing it as the "first regulated crypto asset fund in the United States."

According to the SEC, CAM, a California-based hedge fund manager, and its sole principal, Timothy Enneking, raised more than $3.6 million over a four-month period in late 2017 while falsely claiming that the fund was regulated by the SEC and had filed a registration statement with the agency. By engaging in an unregistered, non-exempt public offering and investing more than 40 percent of the Fund's assets in digital asset securities, the SEC said that CAM caused the Fund to operate as an unregistered investment company. The SEC also found that CAM and Enneking had no pre-existing relationships with numerous investors in the Fund and engaged in "general solicitation" of investors through the Manager's website, social media and interviews with traditional media outlets. CAM did not register the Fund with the SEC under the 1940 Act, nor did it qualify for an exemption from registration.

After being contacted by the SEC staff, the Manager immediately halted the offering of the Fund and undertook a review of the Manager's website, marketing materials and offering procedures. In addition, the Manager verified the accredited status of investors who invested in the Fund. Further, the Manager made a rescission offering to each of those investors and, as part of the recession offer, disclosed previous misstatements to

investors and prospective investors. Although these steps were taken immediately, the SEC censured the Manager and Enneking and, as a part of their settlement with the SEC, ordered that they jointly and severally pay a $200,000 civil money penalty. In a press release, C. Dabney O'Riordan, Co-Chief of the SEC's Enforcement Asset Management Unit, stated that "[h]edge funds seeking to ride the digital asset wave continue to proliferate . . . investment advisers must be sure that the funds they offer adhere to the applicable registration obligations and must accurately represent their funds' regulatory status to investors."

*In the Matter of TokenLot*

In the SEC's first case charging an unregistered broker-dealer for selling digital securities post-DAO Report, the SEC announced that TokenLot, LLC, a self-described "ICO Superstore," and its owners settled charges that they acted as unregistered broker-dealers.

According to the SEC, Michigan-based TokenLot and its owners and operators, Lenny Kugel and Eli L. Lewitt, promoted TokenLot's website as a way to purchase digital tokens during initial coin offerings (ICOs) and also to engage in secondary trading. TokenLot received orders from more than 6,100 retail investors and handled more than 200 different digital tokens, which the SEC found included securities. TokenLot, Kugel, and Lewitt earned "transaction-based compensation" of approximately $112,000 based upon the percentage of the proceeds raised in the ICOs they handled, subject to a guaranteed minimum commission. While the SEC concluded that TokenLot "advertised and sold securities, in the form of digital tokens," it did not specify which digital assets it was referring to, nor did it analyze why the tokens were securities.

The SEC found that the activities required TokenLot, Kugel, and Lewitt to be registered with the SEC as broker-dealers, which they were not. In response to the SEC's investigation, TokenLot voluntarily began winding down and refunding investors' payments for unfilled orders. TokenLot, Kugel, and Lewitt were charged with violating the securities registration provisions under Section 15(a) of the Securities Exchange Act and Sections 5(a) and (c) of the Securities Act in connection with their conduct. In an accompanying press release, Steven Peikin, Co-Director of the SEC's Enforcement Division, noted that "[t]he penalties in this case reflect the prompt cooperation and remedial actions by *TokenLot*, *Kugel*, and *Lewitt*, . . . [who] provided valuable information to Commission staff, stopped the conduct, and refunded money to investors."

TokenLot, Kugel, and Lewitt agreed to pay $471,000 in disgorgement plus $7,929 in interest. Further, in an unusual step, they will retain an independent third party to inventory and destroy TokenLot's remaining digital assets;[2] however, the SEC did not specify whether this includes destroying digital assets such as Bitcoin and Ether (which are not securities, according to the SEC). Kugel and Lewitt also agreed to pay penalties of $45,000 each and agreed to industry and penny stock bars with the right to reapply after three years. During this period, they are also prohibited from working with registered investment companies.

*FINRA Department of Enforcement v. Timothy Tilton Ayre*

On the same day that the SEC announced its two crypto-related enforcement actions, FINRA filed a regulatory enforcement complaint against Timothy Tilton Ayre, charging him with securities fraud and the unlawful distribution of an unregistered cryptocurrency security called HempCoin. This case is FINRA's first disciplinary action involving cryptocurrencies.

FINRA alleges that, from January 2013 through October 2016, Ayre attempted to lure public investment in his worthless public company, Rocky Mountain Ayre, Inc. (RMTN) by issuing and selling HempCoin—which he publicized as "the first minable coin backed by marketable securities"—and by making fraudulent, positive statements about RMTN's business and finances. FINRA also alleged that in June 2015, Ayre bought the rights to HempCoin and repackaged it as a security backed by RMTN common stock. Ayre marketed HempCoin as "the world's first currency to represent equity ownership" in a publicly traded company and promised investors

that each coin was equivalent to 0.10 shares of RMTN common stock. Investors mined more than 81 million HempCoin securities through late 2017 and bought and sold the security on two cryptocurrency exchanges. FINRA charged Ayre with the unlawful distribution of an unregistered security because he never registered HempCoin and no exemption to registration applied. In addition, FINRA alleged that, from January 2013 through October 2016, Ayre defrauded investors in RMTN by making materially false statements and omissions regarding the nature of RMTN's business, failing to disclose his creation and unlawful distribution of HempCoin, and making multiple false and misleading statements in RMTN's financial statements. In the end, this action is less about the applicability of securities laws to tokenized assets and more about the alleged conduct of the principal involved.

Key Takeaways and Considerations

**Private Funds Investing in Digital Assets Are Not Immune From SEC Scrutiny.** The SEC's action against CAM demonstrates that managers of private funds investing in digital assets are not outside the purview of the federal securities law and the SEC. A manager should carefully consider how federal and state securities laws apply to a fund, to the digital assets being traded by the fund and to the manager, and recognize that a fund may need to rely on multiple exemptions from registration under different statutes. Considerations for funds and managers include:

- Does the fund need to register with the SEC or can it rely on an applicable exemption (e.g., Rule 506(b), Sections 3(c)(1) or 3(c)(7), etc.)?[3]
- Does the manager or sponsor of the fund meet the definition of "investment adviser"?[4] If so, is it required to register with the SEC or a state?[5] Is there an exemption the manager can rely on (e.g., Exempt Reporting Adviser)?[6]
- Are the digital assets the fund invests in "securities" under federal and state law?[7] Does the manager have a procedure in place to evaluate each investment to determine whether it is a security under federal and state law?
- Has the fund or the fund's manager made any applicable filings (e.g., Form D, Form ADV, etc.)?
- Does the manager's website openly discuss and offer the fund (i.e., general solicitation)? Has the manager or anyone associated with the fund made any untrue or misleading statements, either on the fund's website, on social media or during a conference? Has the manager or anyone associated with the fund made any public statements about the fund that could be considered "general solicitation"?

**Token Trading Platforms.** The SEC's action against TokenLot was its first enforcement action against a token-trading platform, as well as its first action against an unregistered broker-dealer. Coupled with FINRA's complaint against Ayre, the actions demonstrate the risks that exist when digital assets are deemed to be securities. In particular, any token-trading platform or token trader that earns transaction-based compensation, which includes success fees, commissions or any fee contingent on the outcome, can be found to be a broker-dealer. Like the investment funds discussed above, broker-dealers must register with the SEC or qualify for an applicable exemption. Therefore, if there is a risk that the respective digital assets are securities, it is critical for any token-trading platform or token trader to evaluate whether broker-dealer registration is required. Considerations include:

- What is the compensation structure for the token trading platform or token trader? Does it earn a flat fee? Or does it earn transaction-based income (e.g., a commission)?
- Does it qualify for one of the applicable exemptions from broker-dealer registration?
- If it must register as a broker-dealer, has it made any necessary filings (e.g., Form BD) or registered with FINRA to become a member? Do the relevant managers and/or employees have the necessary series qualifications (e.g., Series 7, Series 65, Series 66, etc.)?

**Some Digital Tokens Are "Securities."** In both SEC actions, the SEC determined that at least some of the digital tokens involved were securities. In the *TokenLot* Order, the SEC noted that investors could pay "for the digital tokens using other digital assets, such as Bitcoin and Ether," and that the digital tokens that TokenLot "promoted and sold . . . included securities." In the *Crypto Asset Management* Order, the SEC also found that the Fund invested in, held and traded "certain digital assets that were investment securities." In neither case, however, did the SEC identify which tokens were securities or provide any analysis about why those digital assets were securities. Although the SEC did not announce any actions with respect to the digital tokens themselves, it must be considered whether the SEC is pursuing actions against the creators of the individual tokens that were traded by TokenLot and deemed to be securities.

**Unprecedented and Novel Steps by Regulators.** As the SEC continues enforcement efforts against companies associated with unregistered offerings, companies may be required to undertake novel obligations on top of any penalties imposed, such as hiring independent entities at the company's expense to take possession of and destroy digital assets like in the *TokenLot* Order.

**Taking Prompt Action May Help Mitigate Penalties.** Both SEC actions acknowledged the parties' prompt remedial actions. The *TokenLot* Order even stressed that the remedial actions were factors in the commission deciding not to impose greater penalties. Thus, companies in the digital asset space and their counsel should consider prompt remedial action when issues are identified and certainly if contacted by the SEC.

**Token Trading Platforms Acquiring Registered Broker-Dealers.** The SEC and FINRA's enforcement actions against broker-dealers come in the wake of several digital asset trading platforms taking affirmative actions in 2018 to comply with broker-dealer laws and regulations. As reported by *Bloomberg* and other news sources, several platforms are either registering as broker-dealers themselves or have recently acquired existing broker-dealer firms that are already registered as broker-dealers and ATSs. As demonstrated by the *TokenLot* and *Ayre* enforcement actions, such developments may reduce regulatory risk for those who wish to host token trading platforms or generally enter the business of trading digital assets while increasing opportunity for new business products.

Conclusion

The SEC and FINRA actions are noteworthy developments in the regulation of digital assets even though they did not provide clarity on whether any given digital asset is a security. The actions demonstrated the regulators' willingness to enforce securities laws against various types of actors involved in the buying and selling of digital assets. Private fund managers and private funds that invest in digital assets may face consequences for failing to comply with registration requirements. Moreover, the SEC showed its willingness to forge new remedies in the digital asset context by requiring TokenLot to hire an independent intermediary to take possession of and destroy its tokens. The SEC actions also illustrate how companies that take prompt remedial action when contacted by the SEC may reduce the severity of the sanctions they receive.

For questions about these developments and how they might apply to you or your business, please contact experienced counsel.

**ENDNOTES**

[1] In the DAO Report, the SEC determined the DAO tokens were "securities" under the Securities Act of 1933 (Securities Act) after applying the *Howey Test* to evaluate whether the tokens were an investment contract and thus a "security." The DAO Report thus confirmed the long-standing analytical framework used to gauge whether a digital coin or token is a "security." The following post on the *Virtual Currency Report* provides more detailed information on the DAO Report and its implications for market participants. J. Dax Hansen, et al.,

*Blockchain and Digital Token Update: SEC Releases Investigative Report and Investor Bulletin*, Virtual Currency Report (July 26, 2017), https://www.virtualcurrencyreport.com/2017/07/blockchain-and-digital-token-update-sec-releases-investigative-report-and-investor-bulletin/.

[2] Normally, the SEC does not destroy property, but there are a number of government regulations that permit the destruction of property to avoid a "danger," and "danger" is broadly interpreted and can include a swindle.

[3] Generally, the Securities Act requires the offer and sale of securities must either be registered with the SEC or comply with an applicable exemption from registration. Sponsors of private funds typically avoid registration and offer their securities pursuant to the private placement exemption under Rule 506(b) of Regulation D, which prohibits any form of general solicitation or general advertising to market the fund interests. A fund that engages primarily in investing, reinvesting and trading in securities, and whose own securities are offered to the investing public must either register with the SEC as an "investment company" or qualify for an exemption from registration. Sponsors of private funds typically seek to qualify for an exemption from the Investment Company Act of 1940 pursuant either to Section 3(c)(1) or Section 3(c)(7), each of which requires the fund to not make a public offering and limit investors to those who meet certain wealth thresholds.

[4] Section 202(a)(11) of the Investment Advisers Act of 1940 (the Advisers Act) defines "investment adviser" to mean "any person who, for compensation, engages in the business of advising others, . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . ." An investment adviser meeting this definition is required to register with the SEC or a state or find an applicable exemption from registration.

[5] *See, e.g.*, S. Rep. No. 1760, 86th Cong., 2d Sess. 7 (1960), which specifies that the antifraud provisions in Section 206 of the Advisers Act apply to registered and unregistered investment advisers (even if a person is not required to register with the SEC, the person may be subject to the anti-fraud provisions of the Advisers Act, as well as the laws of various states).

[6] The SEC and many states provide an exemption from registration as an investment adviser, commonly referred to as an "exempt reporting adviser." An "exempt reporting adviser" is an adviser solely to private funds and manages less than $150 million. An exempt reporting adviser is not required to adopt a comprehensive compliance program pursuant to Rule 206(4)-7 or to comply with most other rules under the Advisers Act. An exempt reporting adviser, however, is still subject to the anti-fraud provisions of the Advisers Act. An exempt reporting adviser, therefore, should adopt reasonable compliance policies, procedures and oversight to avoid the appearance of a violation of the anti-fraud provisions or the adviser's fiduciary duty to clients. Further, exempt reporting advisers are not subject to the full registration process, but still must file a truncated Form ADV with the SEC and update it at least annually.

[7] An investment adviser is a fiduciary and this fiduciary duty applies to the investment adviser's entire relationship with its clients, including advice on digital assets that may not be securities.

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