

Recent Crackdown Highlights SEC's Growing Crypto Scrutiny

By **Haima Marlier and Nitesh Daryanani** (August 19, 2021, 5:12 PM EDT)

The U.S. Securities and Exchange Commission brought three enforcement actions concerning digital assets in rapid succession in a week, underlining that the Division of Enforcement is as committed to crypto enforcement under SEC Chair Gary Gensler as it was under former Chair Jay Clayton.

These actions come on the heels of Gensler's Aug. 3 speech before the Aspen Security Forum.[1] Gensler's views were clear: "Right now, we just don't have enough investor protection in crypto. Frankly, at this time, it's more like the Wild West." [2]

Many digital tokens are unregistered securities because they are investment contracts under the test the U.S. Supreme Court established in 1946 in *SEC v. Howey Co.*[3] Securities that trade on crypto trading platforms, including decentralized finance, or DeFi, platforms and the platforms themselves must be registered with the SEC, Gensler said.

The three recent enforcement actions include:

- *SEC v. Uulala Inc. et al*, an action settled on Aug. 4 in the U.S. District Court for the Central District of California, alleging both registration and antifraud violations against an issuer and its two founders for raising more than \$9 million through an unregistered offering of digital assets; [4]
- In the Matter of *Blockchain Credit Partners et al.*, an administrative proceeding, settled Aug. 6, against an issuer and two individuals that marks the first SEC enforcement action in the DeFi space; [5] and
- In the Matter of *Poloniex LLC*, an administrative proceeding, settled Aug. 9, against an unregistered crypto exchange. [6]

A summary of each of these actions follows the takeaways.

Takeaways: A Week in the Wild West

1. The SEC is focused on digital assets that function like investment contracts.



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In case there was any doubt before, it is now clear that the SEC continues to view unregistered digital asset offerings, including initial coin offerings, or ICOs, with suspicion under the Howey test. Uulala and Blockchain Credit Partners represent the SEC's latest enforcement actions taking the position that digital tokens are investment contracts, similar to the allegations against Kik Interactive Inc. and Telegram Group Inc. settled in 2020.[7]

Indeed, during his speech, Gensler agreed with Clayton's view that "every ICO I have seen is a security." [8]

2. Registration violations may be compounded by allegations of fraud.

The SEC will not hesitate to investigate and prosecute alleged fraud in connection with unregistered digital asset offerings, which can lead to increased civil penalties for defendants, including individuals.

In both Uulala and Blockchain Credit Partners, the SEC scrutinized the defendants' statements about their technology, operations and financial performance to bring fraud charges. The fraud charges led to individual civil penalties that ranged from \$50,000 to close to \$200,000 per individual defendant.

3. The SEC can move relatively quickly in the crypto space.

In Blockchain Credit Partners, the settlement came 18 months after the issuer commenced operations and just six months after it ceased operations.

4. The SEC has its eye on digital asset trading platforms.

Platforms must comply with the registration requirements of Section 5 of the Securities Exchange Act,[9] or risk enforcement action if the SEC determines that a digital asset trading on its platform is a security.

Gensler believes that "[t]he test to determine whether a crypto asset is a security is clear." [10] But Commissioners Hester Peirce and Elad Roisman have called on the SEC to provide clear insight — outside the enforcement context — into the SEC's investment contract determinations.[11]

In the meantime, crypto trading platforms must rely on the SEC's past enforcement actions to make informed decisions about the digital assets that can be traded on their platforms.

5. Regulatory clarity is key to foster innovation in the crypto industry.

Despite Gensler's calls for rulemaking in the crypto space,[12] Peirce continues to express frustration at what she perceives as the slow pace of crypto regulations and other clarity from the SEC.

Peirce is in favor of a narrow regulatory safe harbor against registration violations to foster innovation, reflected in her dissent when Unikrn Inc. was ordered to permanently disable its blockchain-based token and its integrated product offerings, and pay a \$6.1 million civil penalty representing substantially all the company's assets, for the sole charge of conducting an unregistered offering.[13]

In Poloniex, Peirce dissented from the SEC's decision to charge the company for failing to register as an exchange or as an alternative trading system while the SEC is yet to fully develop a framework for regulated entities to interact with digital assets.[14]

Summary of Recent Crypto Enforcement Actions

Uulala

The day after Gensler's speech, the SEC announced settled charges against Uulala and two of its founders.[15]

The SEC alleged that the defendants raised more than \$9 million between December 2017 and January 2019 from investors through an unregistered offering of digital assets called UULA tokens. As it has in other crypto enforcement actions,[16] the SEC alleged that the UULA tokens were investment contracts and, therefore, securities, but that Uulala neither registered the securities with the SEC nor qualified for a registration exemption.

The SEC also charged the defendants with fraud, alleging that they made material misrepresentations regarding the company's supposedly proprietary and patent pending decentralized database technology, algorithms and financial performance. The defendants settled violations of Sections 5 and 17(a) of the Securities Act and Section 10(b) of the Exchange Act.[17]

They paid a collective \$542,768 in civil penalties, including individual penalties assessed at around \$193,000 and \$50,000 for each individual defendant, and were ordered to permanently disable all UULA tokens in their possession or control, publicly disclose the judgment on social media channels, and issue requests to remove the tokens from any further trading on digital asset platforms, among other relief.

Blockchain Credit Partners

Two days later, the SEC announced a \$13 million settlement in its first enforcement action in the realm of decentralized finance against Blockchain Credit Partners and two individuals.[18]

According to the SEC, between February 2020 and February 2021, the defendants raised more than \$30 million by selling digital tokens using smart contracts[19] built on a blockchain, a DeFi[20] platform. The defendants issued two types of tokens: one that purported to pay 6.25% interest and one that would give holders certain voting rights, a share of surplus profits and the ability to profit from secondary market token sales.

The SEC alleged that the tokens were investment contracts under the Howey test and that the issuer therefore sold unregistered securities without a registration exemption. The SEC also alleged that the defendants misled investors about the operations and financial performance of their business, DeFi Money Market.

They claimed that DeFi Money Market would pay the interest and profits by using investors' assets to buy income-generating real-world assets, like car loans. In reality, the price volatility in digital asset markets created risk that DeFi Money Market's income from real-world assets would be insufficient to cover the appreciation of investors' digital assets.

Instead of disclosing this fact to investors, the defendants misrepresented that DeFi Money Market held overcollateralized car loans while using their personal assets and another company's funds to redeem token investors.

The defendants settled violations of Sections 5(a), 5(c), and 17(a) of the Securities Act and Section 10(b) of the Exchange Act; agreed to pay almost \$13 million in disgorgement and \$125,000 in individual civil penalties for each defendant; and undertook that they would not participate in digital offerings for at least five years, maintain the assets currently held in the smart contracts and allow investors to redeem their tokens at will.

Poloniex

On Aug. 9, the SEC announced a \$10 million settlement with Poloniex in connection with the operation of its digital asset trading platform called Poloniex Trading Platform.[21]

Alleging that the platform was an exchange as defined in Section 3(a)(1) of the Exchange Act,[22] and that certain of the digital assets that traded on the platform were investment contracts and therefore securities, the SEC charged Poloniex for failing to register as a national securities exchange or to operate pursuant to an exemption from such registration.

The SEC alleged that Poloniex's aggressive approach to expansion and the promise of business rewards resulted in its decision to offer trading of digital assets that were at medium risk of being considered securities under the Howey test. Poloniex settled violations of Section 5 of the Exchange Act, and agreed to pay almost \$9 million in disgorgement and a civil penalty of \$1.5 million.[23]

In a public dissent following the settlement, Peirce expressed sympathy for market participants who may be surprised by the SEC's guns-blazing approach for registration violations, given what she believes to be a nascent and narrow regulatory framework for registered exchanges to hold and transact digital assets.[24]

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[1] Gary Gensler, Chair, U.S. Sec. and Exch. Comm'n, Remarks Before the Aspen Security Forum (August 3, 2021), available at: <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03>.

[2] Id.

[3] SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (an investment contract exists when money is invested in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others).

[4] SEC v. Uulala, Inc., et al., No. 5:21-cv-01307 (C.D. Cal.), available at: <https://www.sec.gov/litigation/litreleases/2021/lr25157.htm>.

[5] In the Matter of Blockchain Credit Partners d/b/a DeFi Money Market, Gregory Keough, and Derek Acree, AP File No. 3-20453 (August 6, 2021), available

at: <https://www.sec.gov/litigation/admin/2021/33-10961.pdf>.

[6] In the Matter of Poloniex, LLC, AP File No. 3-20455 (August 9, 2021), available at: <https://www.sec.gov/litigation/admin/2021/34-92607.pdf>.

[7] SEC v. Telegram Grp. Inc., et al., No. 19 Civ. 9439 (S.D.N.Y.), available at: <https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf>; SEC v. Kik Interactive Inc., No. 19-cv-5244 (S.D.N.Y.), available at: <https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf>.

[8] Gensler at Aspen Security Forum, *supra* note 1.

[9] Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. 15 U.S.C. § 78e.

[10] Gary Gensler, Chair, U.S. Sec. and Exch. Comm'n, Letter to Senator Elizabeth Warren (August 5, 2021), available at: https://www.warren.senate.gov/imo/media/doc/gensler_response_to_warren_-_cryptocurrency_exchanges.pdf.

[11] Hester M. Peirce and Elad L. Roisman, Commissioners, U.S. Sec. and Exch. Comm'n, Public Statement In the Matter of Coinschedule (July 14, 2021), available at: <https://www.sec.gov/news/public-statement/peirce-roisman-coinschedule>.

[12] Gensler at Aspen Security Forum, *supra* note 1; see also CNBC, SEC Chairman Gary Gensler says more investor protections are needed for bitcoin and crypto markets (May 7, 2021), available at: <https://www.cnbc.com/2021/05/07/sec-chairman-gary-gensler-says-more-investor-protections-are-needed-for-bitcoin-and-crypto-markets.html>.

[13] Hester M. Peirce, Commissioner, U.S. Sec. and Exch. Comm'n, Public Statement on SEC Settlement Charging Token Issuer with Violation of Registration Provisions of the Securities Act of 1933 (September 15, 2020), available at: <https://www.sec.gov/news/public-statement/peirce-statement-settlement-charging-token-issuer>; see also Haimavathi Marlier, Susan Gault-Brown, and Dario de Martino, Taming Unikrns? The SEC's Recent Digital Asset Offering Enforcement Actions (September 24, 2020), available at: <https://www.mofo.com/resources/insights/200924-unikrn-sec-digital-asset-enforcement-actions.html>.

[14] Hester M. Peirce, Commissioner, U.S. Sec. and Exch. Comm'n, Public Statement In the Matter of Poloniex, LLC (August 9, 2021), available at: <https://www.sec.gov/news/public-statement/pierce-statement-poloniex-080921>.

[15] Uulala, *supra* note 4.

[16] Telegram Grp. Inc. and Kik Interactive Inc., *supra* note 7.

[17] Section 5 of the Securities Act provides that all non-exempt securities must be registered with the SEC; Section 17(a) of the Securities Act prohibits fraud in the offer and sale securities; and Section 10(b) of the Exchange Act prohibits fraud in connection with the purchase or sale of any security. 15 U.S.C. §

77e, 77q, 78j.

[18] Blockchain Credit Partners, *supra* note 5.

[19] Smart contracts are programs running on the blockchain that can execute automatically when certain conditions are met. See The Coinbase Blog, *A Beginner's Guide to Decentralized Finance (DeFi)* (June 6, 2020), available at: <https://blog.coinbase.com/a-beginners-guide-to-decentralized-finance-defi-574c68ff43c4>.

[20] Decentralized finance generally refers to financial infrastructure that is based on blockchain and/or smart contracts, instead of intermediaries and centralized institutions. See Fabian Schär, *Decentralized Finance: On Blockchain- and Smart Contract-Based Financial Markets*, Federal Reserve Bank of St. Louis Review, Second Quarter 2021, pp. 153–74, available at: <https://doi.org/10.20955/r.103.153-74>.

[21] Poloniex, *supra* note 6.

[22] Exchange Act Rule 3b-16(a) provides a functional test to determine whether a trading system meets the definition of an exchange under Section 3(a)(1) of the Exchange Act: if such an organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, nondiscretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

[23] On August 10, 2021, a day after the Poloniex settlement was announced, the CFTC and FinCEN announced a consent order against five companies charged with operating the BitMEX cryptocurrency derivatives trading platform for failing to register under the Commodity Exchange Act of 1936 and for failing to implement an adequate anti-money laundering program. The CFTC's action against BitMEX, which culminated in a \$100 million civil penalty against the operators of the platform, underscores U.S. regulators' increased focus on cryptocurrency exchanges. See Commodity Futures Trading Commission, *Federal Court Orders BitMEX to Pay \$100 Million for Illegally Operating a Cryptocurrency Trading Platform and Anti-Money Laundering Violations* (August 10, 2021), available at: <https://www.cftc.gov/PressRoom/PressReleases/8412-21>.

[24] Peirce on Poloniex, *supra* note 14.