

# The SEC Goes after Cryptocurrency Issuers for Selling Unregistered Securities: *Howey* Doing?

By James D. Redwood

In sending a well-aimed shot across the bow last summer,<sup>1</sup> the SEC made it clearer than ever that it views the issuance of cryptocurrencies, through a blockchain transaction or otherwise, as constituting the offer and sale of a security which must meet the registration requirements of Section 5<sup>2</sup> of the Securities Act or an available exemption.<sup>3</sup> This should have come as no surprise to those who market digital coins, tokens, or other forms of virtual currency,<sup>4</sup> which the Commission had earlier warned would, sooner or later, come under scrutiny by federal regulators. Indeed, on July 25, 2017, the SEC stated the following:

These [registration] requirements of section 5 apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger [blockchain] technology.<sup>5</sup>

As a result of two recent SEC enforcement actions and two federal court decisions, the later has not merely become sooner. It has become now.

## I. Paragon

### A. Facts

On November 16, 2018, the Commission issued Cease-and-Desist proceedings against two entities that had offered and sold digital coins through blockchain technology.<sup>6</sup> In the first case, *In re Paragon Coin, Inc.*, the Commission alleged that Paragon, via a “White Paper” used to describe the terms of the ICO,<sup>7</sup> announced the offer of “ParagonCoins” or “PRG” to the general public without filing a registration statement under Section 5 of the ‘33 Act.<sup>8</sup> In order to arouse investor interest, Paragon offered 10 percent to 25 percent discounts on the offering price of the coins during a one-month “presale” period. The offering was conducted worldwide through websites and social media pages, including Paragon’s own website. According to the White Paper, a maximum of 200,000,000 PRG tokens would be sold, and the resulting cap on production would increase the value of the coins over time because of their scarcity. To increase their value further, Paragon stated in its White Paper that it planned to list the tokens on major exchanges in order to facilitate secondary market trading, but in fact the coins were never so listed.

Proceeds from the offering were to be used to develop and implement a “business model” that would include building an “ecosystem” around the tokens to enhance their appeal to investors. This business model would consist of raising capital in the public offering of ParagonCoins and PRG and using the proceeds to add blockchain technology to the cannabis industry. The promoters also promised to work toward the worldwide legalization of cannabis. Importantly, although Paragon told potential purchasers that they would be able to use the tokens to buy goods or services in the future after Paragon created the “ecosystem,” no one was ever able to purchase any good or service other than by pre-ordering certain Paragon merchandise. To keep the price of PRG stable, Paragon established a “Controlled Reserve Fund,” such that if the price of the tokens dropped significantly, the fund would repurchase them in an effort to stabilize the market price. In the alternative, if the token price shot up too rapidly, the fund would release tokens into the marketplace to bring the price down.

On internet forums, blogs, e-mails, and social media posts, Paragon stated that as its solutions were adopted throughout the cannabis industry, PRG owners who held their tokens as long-term growth assets would see them appreciate in value. The promoters also stated that the Paragon team possessed “a depth of experience across business, technology, blockchain, smart contracts, and the cannabis industry.”<sup>9</sup> In this and other ways, the White Paper drew a direct connection between Paragon’s ability to create the planned “ecosystem” and the future value of PRG tokens. These assertions as to the attractiveness and value of investing in ParagonCoins and PRG tokens, coupled with those relating to the expertise of Paragon personnel, among other items, led the SEC to conclude that the issuer had offered and sold securities in violation of ‘33 Act Section 5.

### B. Analysis

As digital coins or tokens are not among the specific items listed as securities in Securities Act Section 2(a)(1)<sup>10</sup> and Exchange Act Section 3(a)(10),<sup>11</sup> the Commission turned to the term “investment contract,” which appears under the definition of a security in both statutes and which has been described by the Supreme Court in the well-known *Howey* case.<sup>12</sup> Under *Howey*, an investment contract is “an investment of money in a common enterprise with a reasonable expectation of profits to be

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derived from the entrepreneurial or managerial efforts of others.”<sup>13</sup> Utilizing this multi-factor test, the Commission had no trouble in finding that the Paragon offering constituted the sale of an investment contract, and thus of an unregistered security.

With respect to the first prong of *Howey*, an investment of “money,” the Commission found that the investors in Paragon’s general solicitation purchased their tokens in exchange for other digital assets, namely Bitcoin, Ether, Litecoin, Dashcoin, Zcash, Ripple, Monero, Ethereum Classic, and Waves. That the currency used for the exchange of assets was digital rather than fiat appeared to be of no moment.<sup>14</sup> The offering ultimately raised the U.S. dollar equivalent in digital assets of \$12,066,000.

The Commission found, with regard to the second prong of *Howey*, namely that the purchasers must have a reasonable expectation of profits from their investment,<sup>15</sup> that the marketing of the ParagonCoins and PRG led the investors reasonably to believe that they would obtain “a future profit from buying PRG tokens if Paragon were successful in its entrepreneurial and managerial efforts to develop its business.”<sup>16</sup> Among other things, the SEC noted that investors were told that the proceeds of the offering would be used to build an “ecosystem” that would create demand for the tokens, that Paragon and its agents would pursue the listing of the coins on secondary market trading platforms, that they would utilize the Controlled Reserve Fund to stabilize the price of the tokens, and that they would limit the supply (and in fact over time “burn” excess tokens so as further to restrict the supply), all in order to increase the tokens’ value. Because of these representations, the investors could reasonably expect to partake of the anticipated enhancement of value resulting from these measures, and that was sufficient to meet the “expectation of profits” prong of the *Howey* test.<sup>17</sup>

Finally, with respect to the requirement that the efforts essential to the success (or failure) of the enterprise be the work of the promoters or third parties, as opposed to that of the investors, the SEC pointed out that it was Paragon that had the responsibility of creating the “ecosystem” and of taking all the other necessary steps to add value to the tokens (e.g., by increasing demand through the restriction of supply, by attracting investors through the promised application of Paragon’s blockchain technology to the highly popular cannabis industry, by stabilizing the price through the Controlled Reserve Fund, and by dangling forth the prospect of secondary market trading). The Commission thus viewed the ParagonCoin and PRG investors as mere passive participants in a scheme engineered by and under the complete control of Paragon and its agents. As a result, it found Paragon liable for having offered and sold investment contracts and thus securities in violation of Section 5.

## II. AirFox

### A. Facts

On the same day that it decided *Paragon*, the SEC issued a cease-and-desist order against another ICO issuer, AirFox.<sup>18</sup> AirFox stated in its White Paper and elsewhere that it was in the business of selling mobile technology to customers of prepaid mobile telecommunications operators. This technology would purportedly allow those customers to obtain free or discounted airtime or data by interacting with advertisements on their smartphones. To finance its business operations, AirFox offered and sold 1.6 billion “AirTokens” on the Ethereum blockchain. The offering raised the digital equivalent of around \$15 million from more than 2,500 investors, who were contacted on websites controlled by AirFox. These funds, according to the White Paper, were to be used to create and capitalize a new international ecosystem. This ecosystem would allow AirFox customers to avail themselves not only of the company’s existing technology (obtaining free or discounted airtime or data by interacting with smartphone ads), but would eventually enable them to transfer the AirTokens, engage in peer-to-peer microlending transactions and credit scoring, and use the AirTokens to buy and sell goods and services other than mobile data. With respect to this last inducement to buy the tokens, investors were told that the company would maintain their value by purchasing mobile data and other goods and services that could in turn be purchased by the token holders. There was no evidence that customer funds were ever put to any of these anticipated uses.

The White Paper also stated that the AirTokens would increase in value as a result of AirFox’s attempts to provide liquidity by making the coins eligible for secondary market trading. Interestingly, AirFox then demonstrated its apparent awareness of the securities laws by requiring potential purchasers to agree that they were acquiring the tokens as a medium of exchange for mobile airtime and not as an investment or a security, although whether in fact any of the buyers actually agreed to this is not clear from the SEC’s opinion. Not surprisingly, none of the promised functionality or new technology ever materialized, and the Commission ultimately concluded that the tokens were a security under *Howey*. Given AirFox’s repeated emphasis on enhancing the AirTokens’ value, the SEC determined that the motivation of the buyers was “based upon anticipation that the value of the tokens would rise through AirFox’s future managerial and entrepreneurial efforts.”<sup>19</sup> The purchasers “reasonably believed they could pursue . . . profits by holding or trading AirTokens, whether or not they ever used the AirFox App or otherwise participated in the AirToken ecosystem.”<sup>20</sup> AirFox further enticed investors to purchase the tokens by representing that the promoters had worked at “prestigious” universities. And, in addition to utilizing the White Paper and You Tube videos, AirFox pushed the sale

of the tokens on social media sites, blog posts, and message boards that were directed at individuals who were specifically interested in digital assets, thereby increasing the likelihood that they would be sold.

## B. Analysis

The Commission began its analysis of the legal issues involved in the AirFox ICO by reference to the DAO Report,<sup>21</sup> reiterating that “tokens, coins or other digital assets issued on a blockchain may be offerings of securities under the federal securities laws, and, if they are, issuers and others who offer or sell these securities in the United States must register the offering and sale with the Commission or qualify for an exemption from registration.”<sup>22</sup> The SEC then proceeded to apply *Howey*.

As was the case with *Paragon*, the purchasers in this case exchanged other digital assets for their AirTokens, providing sufficient consideration to meet the “investment of money” prong of the *Howey* test: “Such investment [of digital assets] is the type of contribution of value that can create an investment contract.”<sup>23</sup> As for the “reasonable expectation of profits” and “efforts of others” prongs,<sup>24</sup> the Commission pointed out that the purpose of the offering was to raise proceeds to create an “ecosystem” that would foster demand for the AirTokens and increase their value. Additionally, AirFox had informed investors that upon completion of the offering, it would attempt to obtain listing for the tokens on multiple digital token trading platforms in order to provide liquidity. It was AirFox and its agents, not the investors, who would take the steps necessary for the venture to succeed. Thus, all the essential entrepreneurial and managerial efforts would come from AirFox.

Finally, the Commission pointed to the numerous ways in which investment interest was aroused by AirFox through the adoption of marketing techniques designed to facilitate the sale of the tokens. These included the White Paper and other publications, and various social media and other communications sites directed primarily at those who had already demonstrated an interest in the purchase of digital assets, rather than at customers who might actually use the tokens to purchase airtime or data from prepaid wireless carriers, as AirFox had maintained, let alone any tangible goods or services. The SEC was convinced that the offering was structured to encourage speculative purchases by buyers who were primarily interested in obtaining a profit, and that it thus fit within the four corners of *Howey*.

## III. Discussion (including the *Zaslavskiy* and *Blockvest* cases)

The shot across the bow mentioned at the beginning of this article, the ingredients of which consisted of the Dao Report, SEC speeches and interview, and various media articles and stories, among perhaps other things, hit below the waterline in the *Paragon* and *AirFox* cases.<sup>25</sup>

This is well, given that with both of these entities it would seem that “there was no there there.” Having nothing of substance to offer their duped investors,<sup>26</sup> *Howey* was an appropriate vehicle for reining in the offering of assets of such questionable value and utility. The SEC has now served notice on any new start-up ICO issuer that it will probably have to register under the ‘33 Act and provide the requisite disclosure necessary for the protection of investors. And although an argument can be made that the Commission should extend the reach of the registration provisions to Bitcoin and Ether, these two digital currencies seem to have acquired sufficient (though perhaps debatable) cachet that their risk is minimal, notwithstanding the recent fall in the value of Bitcoin as of the time of this article from \$20,000 to under \$4,000. It is true that Bitcoin and Ether have both amassed such large computing power that they are probably as secure as virtual currencies ever can be,<sup>27</sup> but it should be remembered that hackers have been quite versatile in relieving digital asset owners of their wealth,<sup>28</sup> whether through defects in the blockchain or otherwise. The disclosure regime of the Securities Act would not necessarily halt the theft of assets, of course, but it could at least alert potential investors to the risk of such theft, as well as other downsides in investing in the exotic ICO marketplace. For the foreseeable future, such disclosure will likely be required of all new players in this marketplace.<sup>29</sup>

There is another problem. The SEC’s concern over virtual currencies extends to the prospect, and perhaps prevalence, of fraud in the ICO industry. The antifraud rules of the ‘33 and ‘34 Acts, Section 17(a) of the former, and section 10(b) of the latter, buttressed by Rule 10b-5, only apply, of course, to the offer, purchase, or sale of a *security*, and so any attempt to stamp out fraud in the ICO market depends, in the first instance, on a court’s willingness to find that the digital asset in question meets the *Howey* test. The results as of this writing are mixed.

As mentioned earlier,<sup>30</sup> two district judges on opposite coasts have recently decided cases involving virtual currencies and come to different conclusions.<sup>31</sup> In the *Zaslavskiy* decision,<sup>32</sup> the judge for the Eastern District of New York agreed with the U.S. Attorney that the two blockchain virtual currencies at issue, “REcoin” and “Diamond” or “DRC,” were securities under *Howey*.<sup>33</sup> The facts of the offering and the legal analysis were similar to those in *Paragon* and *AirFox*, but in *Zaslavskiy* the government also alleged violations of the antifraud rules. And the violations were not subtle. In marketing the REcoin and Diamond tokens, the defendant had asserted that they were secured by real estate and diamonds, respectively, although in fact he had never purchased any land or jewels to back them up.<sup>34</sup> Under these circumstances, the district judge did not hesitate in finding criminal violations of the antifraud provisions, a conclusion that would have been impossible had he not first found the coins to be a security.

By contrast, the judge in the *Blockvest* case<sup>35</sup> held that the SEC had not sufficiently demonstrated that the blockchain issuance of BLV digital tokens constituted the offer and sale of a security in violation of Section 5.<sup>36</sup> Critical to the court's decision appeared to be its findings that (1) rather than raising \$2.5 million from 32 investors, as the SEC argued, the issuer in fact raised that money from a single investor, and the deal with that investor eventually collapsed anyway;<sup>37</sup> (2) the 32 potential investors were in fact merely "testers" for the "Blockvest Exchange" who committed less than \$10,000 to the enterprise;<sup>38</sup> (3) the SEC failed to show that the 32 test investors had reviewed or read materials on the Blockvest website, White Paper, or media postings of the defendants when they clicked the "Buy" button on Blockvest's website;<sup>39</sup> (4) the 32 test investors were "sophisticated" investors known personally to the defendant;<sup>40</sup> (5) there was insufficient evidence to show that the test investors expected profits from the venture;<sup>41</sup> and (6) the mere fact that eight of the investors wrote "Blockvest" or "coins" on their checks in payment for the tokens was "not sufficient to demonstrate what promotional materials or economic inducements these purchasers were presented with prior to their investments."<sup>42</sup> As a result, at the preliminary injunction stage, the court held that the SEC had failed to show that securities were sold pursuant to the *Howey* test.<sup>43</sup>

The *Blockvest* court was also impressed by the fact that defendant Ringgold had acknowledged that "mistakes were made and state[d that] he has ceased all efforts to proceed with the ICO."<sup>44</sup> Aside from the red flag use of the passive voice,<sup>45</sup> Ringgold's pronouncement that he had abandoned the ICO smacks of one of the major exceptions to the mootness doctrine in Constitutional Law: "voluntary cessation of illegal activity," where the defendant is free to return to his old ways absent a definitive judgment that his conduct is unconstitutional, does not make a case or controversy moot.<sup>46</sup> This is particularly disturbing in this case, given that, according to the SEC, among other things, the offering materials for the BLV tokens (1) falsely claimed that they had been "registered" and "approved" by the SEC and used the SEC's seal on the Blockvest website as an imprimatur of approval; (2) falsely asserted that the ICO had been approved or endorsed by the Commodity Futures Trading Commission and the National Futures Association and used the CFTC and NFA logos and seals; and (3) falsely stated that the defendants were "partnered with" and "audited by" Deloitte Touche Tohmatsu Limited. Additionally, in order to convey the impression that they were offering a safe and legitimate investment, the defendants created a fictitious regulatory agency, the "Blockchain Exchange Commission" or "BEC," and gave the BEC its own fake government seal, logo, and mission statement, all of which were nearly identical to those of the SEC. The defendants also gave the BEC the same address as the SEC's headquarters.<sup>47</sup> The district judge shrugged off all these "weaknesses," notwithstanding the fact that some of the misrep-

resentations continued after the SEC filed its complaint.<sup>48</sup> Apparently, at least for the time being, the judge was happy to allow the defendants to remain free to return to their old ways. Whether this was wise remains to be seen.

## IV. Conclusion

The *Howey* test was designed to embody a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."<sup>49</sup> Moreover, "[i]n analyzing whether something is a security, 'form should be disregarded for substance."<sup>50</sup> And finally, "Congress intended the application of the ['33 and '34 Acts] to turn on the economic realities underlying a transaction, and not on the name appended thereto."<sup>51</sup> It should take no stretch of the imagination to see that application of the registration and antifraud provisions of the federal securities laws to the ICO industry and to the digital assets that are now flooding the market may well be necessary to protect the overeager investors in these risky instruments, and the courts should be no more hesitant to do so than the SEC. The Commission's recent shots across the bow of *Paragon* and *AirFox*, shored up by the decision in *Zaslavskiy*, are just the opening salvo in what promises to be a long war, and the fact that the shot fell short in *Blockvest* will hopefully represent nothing more than a brief pause in the campaign.

## Endnotes

1. See "SEC chief says agency won't change securities laws to cater to cryptocurrencies," CNBC interview, Wednesday, June 6, 2018, where Chairman Jay Clayton "made it clear in March that all ICOs constitute securities, and reiterated that Wednesday saying 'if it's a security, we're regulating it.'" (available at <https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-won-t-change-definition-of-a-security.html> (last visited November 30, 2018)).
2. 15 U.S.C. § 77e.
3. As of the date of the Clayton interview referenced in footnote 1, *supra*, Chairman Clayton apparently viewed only Bitcoin as not being a security, because of its function as a replacement for sovereign fiat currency. See "SEC Chairman Jay Clayton Says Bitcoin Not a Security, Most ICOs Likely Are" (available at <https://cointelegraph.com/news/sec-chairman-jay-clayton-says-bitcoin-not-a-security-most-icos-likely-are> (last visited November 30, 2018)). Today, however, it is apparently the Commission's view that both Bitcoin and Ether are commodities and therefore not subject to the *Howey* test for a security under investment contract analysis. See *SEC's Clayton needs to see key upgrades in cryptocurrency markets before approving a bitcoin ETF* (available at <https://www.cnbc.com/2018/11/27/sec-wants-key-upgrades-in-crypto-markets-before-approviing-bitcoin-etf.html> (last visited November 30, 2018)).
4. "Virtual currency" is defined as "a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status. . . ." The Financial Action Task Force, *FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks*, June 2014 (available at <http://www.fatf.gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>). Virtual currency

- should be contrasted with “fiat currency (a.k.a. ‘real currency,’ ‘real money,’ or ‘national currency’), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country.” *Id.*
5. Securities and Exchange Commission, Securities Exchange Act of 1934, Release No. 81207/July 25, 2017, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, at 18 (hereinafter “The DAO”). The DAO Report also warned that “any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.” *Id.* On November 8, 2018, the SEC issued a Cease and Desist Order against the online trading platform EtherDelta and the individual who created it, for failing to register EtherDelta as an exchange under Section 5 of the Exchange Act. *See* Securities Exchange Act of 1934, Release No. 84553/November 8, 2018, Administrative Proceeding File No. 3-18888, *In re Zachary Cohen*, Respondent.
  6. Blockchain technology allows persons to engage in a theoretically secure transaction online, such as the purchase of digital assets using other digital assets (Bitcoin for ether, for example) or using sovereign or fiat currency (Bitcoin for dollars, for example), through the employment of encrypted computer technology. The initial purchase transaction requires the use of unique cryptographic keys owned by the purchaser and seller (encoded in digital signatures), a timestamp, and relevant information about the transaction (that A, for example, has agreed to purchase Bitcoins from B, using Ether or dollars, and other relevant terms of the deal, usually embodied in a “smart contract” or computerized transaction protocol). This first transaction then takes the form of a digital “block.” In order to validate the transaction, numerous other users of the computer platform will solve a complex mathematical equation, presumably devised by the creator of the blockchain protocol, and each correct solution forms a new block in the chain. Once a majority of the users come to that same solution, the transaction is confirmed as genuine. Each correct solution constitutes independent agreement that the A to B transaction is a valid one. The users who form the verification chain are motivated to secure the network by solving the mathematical problem in question through a reward system which gives one of them a prize (a bitcoin, for example). *See generally*, “What Is Blockchain Technology?” (available at <https://www.coindesk.com/information/what-is-blockchain-technology>) and “How Does Blockchain Technology Work?” (available at <https://www.coindesk.com/information/how-does-blockchain-technology-work>). The security provided by blockchain is often illusory, however. *See, inter alia*, “The DAO,” *supra* note 5, at 1, 9-10 (hackers attacked the system, stealing one-third of the Ether virtual currency used to fund the sale of DAO tokens issued by the digital DAO Entity), and “Hacker lifts \$1 million in cryptocurrency using San Francisco man’s phone number, prosecutors say,” CNBC report, November 21, 2018 (man engaged in “SIM swapping” by taking over the phone number of another man, duping his wireless carrier, and using the information acquired to gain access to and drain cryptocurrency from the victim’s accounts at Coinbase and Gemini) (available at <https://www.cnn.com/2018/11/21/hacker-lifts-1-million-in-cryptocurrency-using-mans-phone-number.html> (last visited November 30, 2018)).
  7. An “ICO” is an “Initial Coin Offering.”
  8. Securities Act of 1933, Release No. 10574/November 16, 2018, Administrative Proceeding File No. 3-18897, *In the Matter of Paragon Coin, Inc., Respondent*, Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Penalties and a Cease-and-Desist Order (hereinafter “Paragon”). In the interest of conciseness, all future references to the facts and findings of the *Paragon* decision, except in the case of direct quotes, will not be separately footnoted but may be found in the above-referenced document available on the SEC’s website at SEC.gov.
  9. *Id.* at 7.
  10. 15 U.S.C. § 77b.
  11. 15 U.S.C. § 78c.
  12. *Securities & Exchange Comm’n v. W.J. Howey Co.*, 328 U.S. 293 (1946).
  13. *Paragon*, *supra* note 8, at 8. The language of *Howey* is somewhat different, but the elements are essentially the same.
  14. *See, e.g., U.S. v. Zaslavskiy, Memorandum & Order*, 17 CR 647 (RJD) 11-12 (E.D.N.Y. September 11, 2018): “‘cash is not the only form of contribution or investment that will create an investment contract. . . the ‘investment’ may take the form of ‘goods and services’ . . . or some other ‘exchange of value’” (Useton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991), cert. denied sub nom. *Alcox v. Useton*, 502 U.S. 893 (1991), quoting *Int’l Bhd. Of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 560 n. 12 (1979)). In *Zaslavskiy*, Eastern District Judge Raymond J. Dearie readily concluded that the defendant had offered and sold an investment contract in the form of two types of digital coins, REcoin and Diamond. Judge Dearie’s analysis essentially tracked that of the SEC in *Paragon* (and in the *AirFox* case to be discussed next), although the specific issue in *Zaslavskiy* was whether the defendant had violated the antifraud sections of the ‘33 and ‘34 Acts and the rules promulgated thereunder (he did). More recently, in a case decided by Judge Gonzalo P. Curiel of the Southern District of California, the judge denied a preliminary injunction to the SEC in a case involving an abandoned public offering of a digital asset, BLV tokens. Judge Curiel held that “[a]t this stage, without full discovery and [with the] disputed issues of material facts [by the plaintiff and defendant], the Court cannot make a determination whether the BLV token offered to the [32 “test”] investors was a ‘security.’ Thus, Plaintiff has not demonstrated that the BLV tokens purchased by the 32 test investors were ‘securities’ as defined by the securities laws.” *SEC v. Blockvest, LLC and Reginald Buddy Ringgold, III a/k/a Rasool Abdul Rahim El*, Case No.: 18CV2287-GPB(BLM), Order Denying Plaintiff’s Motion for Preliminary Injunction [Dkt. No. 30] 13-14 (S.D. Cal. November 27, 2018). The *Zaslavskiy* and *Blockvest* cases are discussed further in Part III, *infra*.
  15. This is really the third prong of *Howey*. The SEC in *Paragon* elided discussion of the “common enterprise” prong of the investment contract test, perhaps because it was clear to the Commission that the \$12,066,000 equivalent of virtual currency raised in the offering was pooled (or at least intended to be pooled, as *Paragon* never apparently launched its touted “ecosystem”) so as to meet the test of “horizontal commonality.”
  16. *Paragon*, *supra* note 8, at 8.
  17. The “profits” element of *Howey* may be met simply by showing that the purchasers expected to see an “increased value of the[ir] investment.” *SEC v. Edwards*, 540 U.S. 389, 394 (2004).
  18. *In re Carriereq, Inc., D/B/A AirFox*, Respondent, Securities Act of 1933, Release No. 10575, Administrative Proceeding File No. 3-18898, Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Penalties and a Cease-and-Desist Order (November 16, 2018) (hereinafter “*AirFox*”). In the interest of conciseness, all future references to the facts and findings of the *AirFox* decision, except in the case of direct quotes, will not be separately footnoted but may be found in the above-referenced document available on the SEC’s website at SEC.gov.
  19. *Id.* at 3.
  20. *Id.* at 5.
  21. *See supra* note 5.
  22. *AirFox*, *supra* note 18, at 6.
  23. *Id.* at 7.

24. Once again, as in *Paragon*, the SEC omitted discussion of the “common enterprise” prong of *Howey*, probably because the facts were clear that AirFox pooled the \$15 million equivalent in virtual currency to fund its unmaterialized projects.
25. Both ICO issuers were forced to cease and desist, register their securities under the ‘34 Act, and pay substantial penalties to the Commission, among other things.
26. Except for a patch of Blue Sky, perhaps?
27. The Bitcoin blockchain is secured at the hash rate of 3,500,000 TH/s, which is 3.5 million trillion hashes per second. This is the speed at which a computer can complete the mathematical calculation necessary to validate a particular transaction on the blockchain. Ether had been secured at the rate of 12.5 TH/s when it was only two years old. See “How Does Blockchain Technology Work?”, *supra* note 6, at 2-3.
28. See *id.*
29. SEC Chairman Jay Clayton views Bitcoin (and apparently Ether) as a commodity that is not subject to *Howey*. See *supra* notes 1, 3. This perhaps reflects his view that virtual currencies can be adequately regulated under existing rules rather than requiring the creation of a new rule or regulation governing them. However, the more decentralized transactions become, the more difficult it may be to meet the definition of a security. Blockchain technology is the paradigm of decentralization and proclaims one of its attractions to be the elimination of trusted intermediaries in the transaction verification chain. See, e.g., “What Is Blockchain Technology?”, *supra* note 6, at 3: “Authentication and authorization [of a specific transaction] supplied in this way [through blockchain technology] allow for interaction in the digital world without relying on (expensive) trust.” However, the lack of a centralized, trusted intermediary may end up defeating *Howey*. The more decentralization, the less likely it will be that the fourth prong of the *Howey* test, “the efforts of others,” will be satisfied.
30. See *supra* note 14.
31. Although it should be kept in mind that the decision in the Blockvest case was on a motion for a preliminary injunction.
32. 17 CR 647 (RJD), September 11, 2018.
33. *Id.* at 17.
34. *Id.* at 2, 17.
35. No. 18CV2287-GPB(BLM), Dkt. No. 30, November 27, 2018.
36. *Id.* at 15.
37. *Id.* at 10. This might defeat horizontal commonality under *Howey*, but not vertical commonality. The court, however, did not specify which test it was applying.
38. *Id.* at 10-11.
39. *Id.* at 12. Presumably the court here was driving at the reliance or transaction causation element of the test for Rule 10b-5 liability, although the district judge failed to clarify this. In any event, the issue at this point was not whether the plaintiff had proven the elements of 10b-5 liability, but simply whether it had offered or sold a security. That determination does not turn on the elements of antifraud liability, but rather on the elements of *Howey*.
40. *Id.* at 12. This goes at best to whether the offers and sales might have qualified for exemption from registration as a private placement, not whether the instrument in question was a security.
41. *Id.* at 13.
42. *Id.* at 14-15. This is true, but irrelevant, as it goes to the separate issue of reliance rather than whether what was offered or sold was a security. See *supra* note 39.
43. *Id.* at 13-15.
44. *Id.* at 15.
45. It is rather dreary to consider the many instances of persons acknowledging that mistakes “were made” as a way of avoiding personal responsibility for having made them.
46. See, e.g., *United States v. W.T. Grant Co.*, 345 U.S. 629, 633 (1953) (quoting *United States v. Aluminum Co. of America*, 148 F.2d 416, 448 (2d Cir. 1945)).
47. *Id.* at 4.
48. *Id.* at 16.
49. The Dao, *supra* note 5, at 11 (quoting *Howey*, 328 U.S. at 299 (emphasis added)).
50. *Id.* (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).
51. *United Housing Found. v. Forman*, 421 U.S. 837, 849 (1975).

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