Crypto Asset Enforcement Actions: TKO for ICOs? or Course Correction for a New Asset Class?
Panel Description

• Federal regulators, including the SEC, CFTC, OCC, and FinCEN, continue to shape the regulatory landscape for crypto currencies, crypto token issuers, money service businesses, and other entities that facilitate crypto transactions. While many of the earliest enforcement actions were resolved by consent, increasingly defendants are choosing to litigate more of these cases. New to the fray are investors’ class counsel seeking rescission for investors who have lost billions to fraudsters.

• This program examines recent federal developments at the agency level and in the courts with comprehensive reviews of the latest enforcement actions, class action litigation, and regulatory guidance for issuers, investors, money transmitters, and other participants in the crypto markets. Based on the latest developments, panelists will distill lessons for prospective issuers and investors, and assess the state of the market for crypto assets in light of the legal realities.
Speakers & Overview

I. Speakers

• **Brian Castro**, U.S. House of Representatives, Financial Services Committee; Vice-Chair Financial Institutions Litigation Subcommittee and Securities Litigation & Arbitration Subcommittee
• **Robert M. Crea**, CFA, CAIA, K&L Gates LLP
• **Marlon Q. Paz**, Seward & Kissel LLP

II. Appendix

• Additional Materials
Deconstructing Decentralization

Robert M. Crea, JD, CFA, CAIA
Of Counsel, San Francisco
DECENTRALIZATION

- Core Concept of Blockchain Technology
- Applicability to:
  - Utility Tokens
  - Virtual Currencies / Payment Systems
- What does it mean to “control” a digital asset protocol?
- When does it make sense to apply the disclosure regime of the federal securities laws to Digital Assets?
THE HOWEY TEST

Pursuant to the Howey test a transaction is an “investment contract” if all of these features exist:

- (1) an investment of money
- (2) in a common enterprise
- (3) with a reasonable expectation of profits
- (4) to be derived from the entrepreneurial or managerial efforts of others.

SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)
THE DAO

Look how much I have.

Can I hold it?

cryptocomics.io
THE DAO

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

B. DAO Tokens Are Securities

1. *Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology*

Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes “an investment contract.” *See 15 U.S.C. §§ 77b-77c.* An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *See SEC v. Edwards,* 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.,* 328 U.S. 293, 301 (1946); *see also United Housing Found., Inc. v. Forman,* 421 U.S. 837, 852-53 (1975) (The “touchstone” of an investment
4. Derived from the Managerial Efforts of Others

a. The Efforts of Slock.it, Slock.it’s Co-Founders, and The DAO’s Curators Were Essential to the Enterprise

Investors’ profits were to be derived from the managerial efforts of others—specifically, Slock.it and its co-founders, and The DAO’s Curators. The central issue is “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973). The DAO’s investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO’s Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO’s investors.
U.S. Securities / Commodity Law Issues for Cryptocurrencies
U.S. COMMODITIES REGULATION

- Bitfinex / Coinflip enforcement actions (CFTC 2016)
  - Virtual currency is a commodity
  - CFTC has regulatory jurisdiction over exchanges and trading venues other than spot market transactions
- CFTC vs. CabbageTech dba Coin Drop Markets (EDNY 2018)
  - Virtual currency is a commodity
  - CFTC has jurisdiction over fraud and manipulation in underlying spot markets for virtual currencies even if not related to a future or derivative.
  - Other regulators may also have jurisdiction
- Retail commodity transaction – actual delivery under CEA s.2(c)(2)(D)
  - Platform offering “commodity” on margin to persons that are not eligible contract participants or eligible commercial entities must “deliver” it to buyer on spot (within 28 days) or register as a futures commission merchant
  - CFTC interpretation – buyer must have free control
  - CFTC asks whether Congress should shorten delivery time for cryptocurrency spot
CRYPTOCURRENCIES AS COMMODITIES / SECURITIES?
FORMER CFTC GARY GENSLER

- April 23, 2018 – Former CFTC Chairman Gary Gensler said in a *speech* that Ether and Ripple might be securities:

> “But what about ether and ripple? . . . These all seem to have attributes of that Howey Test. . . . I think there’s a strong case, but it’s not whether I think so. I think there’s a worthy public debate about these issues.”

> “[For the SEC to come to a ruling on these issues,] I think that this is a multi-year process. . . . I think nine months at the least, maybe two to five years at the longest.”
EVOLVING DECENTRALIZATION?

- June 14, 2018 – SEC Director of Corporation Finance William Hinman delivered a speech, expressing views on Bitcoin, Ether and how the SEC might interpret digital assets in light of the Howey Test.
SEC DIRECTOR HINMAN’S SPEECH

As to Bitcoin

“[W]hen I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. **The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception.** Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value.” (emphasis added)
SEC DIRECTOR HINMAN’S SPEECH

As to Ether

“[P]utting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.” (emphasis added)
SEC DIRECTOR HINMAN’S SPEECH

- K&L’s analysis on Director Hinman’s speech: *Metamorphosis: Digital Assets and the U.S. Securities Laws.*
<table>
<thead>
<tr>
<th>Hinman Factor</th>
<th>Implications Under <em>Howey</em></th>
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<tr>
<td>1. Prominent and Central Developer: Is there a</td>
<td>A person or group playing a prominent role in the creation, sale, development, maintenance,</td>
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<tr>
<td>person or group that has sponsored or promoted the</td>
<td>and promotion of a digital asset network weighs in favor of a positive finding under the</td>
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<td>creation and sale of the digital asset, the efforts</td>
<td>fourth prong of <em>Howey</em>.</td>
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<td>of whom play a significant role in the development</td>
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<td>and maintenance of the asset and its potential</td>
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<td>increase in value?</td>
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## SEC DIRECTOR HINMAN’S SPEECH

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<th>Implications Under Howey</th>
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<tr>
<td><strong>2. Developer Incentive and Influence:</strong> Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?</td>
<td>Ongoing retention by a developer of digital assets, especially if publicly known, could mean a developer is incentivized to influence the digital asset network or that other purchasers might reasonably conclude that the developer would have an influential impact on the value of the digital asset. Such perceptions could contribute to a positive finding under the fourth prong of Howey. On this issue, we would note that retention of a stake or interest might not be limited to actual ownership of digital assets but could also be construed as the ability to exercise influence or control over the governance of a network.</td>
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## Hinman Factor vs. Implications Under Howey

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<th>Implications Under Howey</th>
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<td><strong>3. Excess Fundraising</strong>: Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?</td>
<td>Raising money beyond what is necessary to build a digital asset network can indicate a need for the promoter to have proceeds from which it can continue to undertake efforts to increase a network’s value. Such circumstances indicate that the network might in fact be a common enterprise subject to ongoing central authority, which weighs in favor of positive findings under the second and fourth prongs of Howey.</td>
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SEC DIRECTOR HINMAN’S SPEECH

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<td><strong>4. Investment Value:</strong> Are purchasers “investing,” that is, are they seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?</td>
<td>Many ICOs were specifically marketed as investments and promised substantial returns. Similarly, many ICOs were structured to provide value through scarcity and the digital assets were sold to early purchasers with discounts. These facts weigh significantly in favor of a positive finding under the third prong of Howey.</td>
</tr>
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### SEC DIRECTOR HINMAN’S SPEECH

#### Hinman Factor

**5. Are SEC Protections Necessary?**
Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?

#### Implications Under Howey

These prudential, policy-based questions are independent of a *Howey* analysis and may be the trickiest to answer when contemplating a digital asset network. We could imagine a scenario where an investor could make an investment decision based on knowing the development plans of a prominent digital asset network curator.
### Hinman Factor

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<th>6. Other Persons in Control: Do persons or entities other than the promoter exercise governance rights or meaningful influence?</th>
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### Implications Under *Howey*

One might be able to exercise control over a digital asset network without necessarily owning a significant portion of digital assets on that network. In such case, a positive finding under the fourth element of *Howey* is more likely.
WHAT IS CONTROL?

- In the context of a Digital Asset Protocol, “control” could take a number for forms, including, without limitation, through:
  - Concentrated ownership of digital assets issued with respect to a protocol;
  - The ability to issue or affect the market supply or market prices of Digital Assets with respect to a Digital Assets Protocol;
  - Concentrated hashpower with respect to a Digital Assets Protocol;
  - Influencing the number of network nodes on the Digital Assets Protocol;
  - Exercising an influential role of Curation with respect to a Digital Assets Protocol.

- Control also could be effective through a group of ostensibly unaffiliated software developers who act in concert.

- The structure of the Digital Asset Protocol and the Digital Assets issued pursuant to that protocol matter.
CFTC REVISITS ETHER

RELEASE Number
7855-18

December 11, 2018

CFTC Seeks Public Comments on Crypto-asset Mechanics and Markets

Washington, DC — The Commodity Futures Trading Commission (CFTC) is seeking public comment and feedback in order to better inform the Commission’s understanding of the technology, mechanics, and markets for virtual currencies beyond Bitcoin, namely Ether and its use on the Ethereum Network.

In a Request for Information (RFI) that will be published in the Federal Register, the CFTC is asking for public feedback on a range of questions related to the underlying technology, opportunities, risks, mechanics, use cases, and markets, related to Ether and the Ethereum Network. All comments must be received within 60 days of publication in the Federal Register. The RFI also seeks to understand similarities and distinctions between Ether and Bitcoin, as well as Ether-specific opportunities, challenges, and risks.

The CFTC expects the comments and information received will benefit LabCFTC, the CFTC’s FinTech initiative, and help to inform the Commission’s understanding of these emerging technologies.
ARE CRYPTOCURRENCIES SECURITIES?
IN RE KIK INTERACTIVE

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
100 F Street NE
Washington, DC 20549

DIVISION OF ENFORCEMENT

November 16, 2018

Via E-mail (pgibbs@cooley.com / kenneth.lench@kirkland.com)

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Cooley LLC
3175 Hanover Street
Palo Alto, CA 94304-1130

Ken Lench, Esq.
Kirkland & Ellis LLP
655 Fifteenth Street NW
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Re: In re Kik Interactive (HO-13388)

This letter confirms the telephone conversation of November 16, 2018. In that conversation, we advised you that the staff of the Securities and Exchange Commission has made a preliminary determination to recommend that the Commission file an enforcement action against your clients, Kik Interactive Inc. and the Kin Ecosystem Foundation. This proposed action would allege violations of Sections 5(a) and 5(c) of the Securities Act. The recommendation may involve a civil injunctive action and may seek remedies that include a preliminary and permanent injunction, disgorgement, prejudgment interest, and civil money penalties.
CRYPTO ASSET ENFORCEMENT ACTIONS: TKO FOR ICOs?
OR COURSE CORRECTION FOR A NEW ASSET CLASS?

ABA BUSINESS LAW SECTION – 2019 SPRING MEETING

Marlon Q. Paz | March 2019 | Vancouver, British Columbia, Canada
TOPICS

- Opportunities to redefine clearance, settlement and custody of securities
- Federal Enforcement Landscape
- Considerations for Broker-Dealers
- Considerations for Investment Advisers
- Considerations for Platforms Trading Digital Assets
- Key Takeaways and Considerations
Opportunities to redefine clearance, settlement and custody of securities

Blockchain
**How Blockchain Works**

1. A wants to send money to B.
2. The transaction is represented online as a 'block'.
3. The block is broadcast to every party in the network.
4. Those in the network approve the transaction is valid.
5. The money moves from A to B.
6. The block then can be added to the chain, which provides a transparent record of transactions.

Source: GAO: GAO-17-061

- A's Public Key
- A's Private Key
- B's Public Key
- B’s Private Key
FEDERAL ENFORCEMENT LANDSCAPE
SECURITIES LAW
“Yes, it would be wonderful if the regulators, you know, got into the 20th century, much less the 21st and we would be able to avoid some issues. I have to deal with the cards that have been dealt me and with that I’ll thank you for your time.”

Judge Raymond Dearie
ENFORCEMENT BY THE SEC

- Initial Coin Offerings (ICOs) have been used by startups and other parties to issue cryptographic tokens on a blockchain network to raise capital.

- In September 2017, the U.S. Securities and Exchange Commission (SEC) made two key announcements in September of 2017.
  - Cyber unit to target violations involving distributed ledger technology and ICOs as part of a new effort to fight cybercrime.
  - Retail strategy task force that will develop proactive, targeted initiatives to identify misconduct impacting retail investors, including to pursue "misconduct perpetrated using the dark web," where bitcoin and other cryptocurrencies are used to pay for illicit goods.
“I have yet to see an ICO that doesn’t have a sufficient number of hallmarks of a security . . . there is also a distinct lack of information about many online platforms that list and trade virtual coins or tokens offered and sold in ICOs.”

SEC Chairman Clayton | November 9, 2017
FIRST SEC CYBER UNIT CASE

• Dec. 2017 - SEC filed charges against a recidivist Quebec securities law violator, Dominic Lacroix, and his company, PlexCorps.
• Lacroix and PlexCorps marketed and sold securities called PlexCoin on the internet to investors in the U.S. and elsewhere, claiming that investments in PlexCoin would yield a 1,354 percent profit in less than 29 days.
• “The ICO for the PlexCoin Tokens was an illegal offering of securities because there was no registration statement filed or in effect during its offer and sale, and no applicable exemption from registration.”
MUNCHEE TOKENS

- Munched, Inc. halted its ICO after being contacted by the SEC, and agreed to an order in which the SEC found that its conduct constituted unregistered securities offers and sales.

- Munchee was seeking $15 million in capital to improve an existing iPhone app centered on restaurant meal reviews and create an “ecosystem” in which Munchee and others would buy and sell goods and services using the tokens. The company communicated through its website, a white paper, and other means that it would use the proceeds to create the ecosystem, including eventually paying users in tokens for writing food reviews and selling both advertising to restaurants and “in-app” purchases to app users in exchange for tokens.
ARE ICOs SECURITIES?

To determine how traditional securities regulation applies to ICOs, the SEC will undoubtedly apply the four-pronged Howey Test, derived from the 1946 Supreme Court decision in *SEC vs. W.J. Howey Co.*, which states that a security is an investment contract in which a person 1) invests their money; 2) in a common enterprise; 3) with an expectation of profits; 4) based on the efforts of the promoter or a third party. In order to be considered a security, an offering must meet all four prongs.
On July 25, 2017, the SEC provided guidance on its views of whether ICOs are securities when it released a Section 21(a) Report of Investigation on its findings regarding the token sale by The DAO.

In applying the *Howey* test, the SEC focused on whether the efforts of others were “the undeniably significant ones ... that affect the failure or success of the enterprise.”
On October 3, 2018, the SEC filed a Complaint against Blockvest, LLC and Reginald Buddy Ringgold, III a/k/a Rasool Abdul Rahim El alleging violations of the Federal Securities Laws in connection with the offer and sale of unregistered securities.

Blockvest is a Wyoming limited liability company that was set up to exchange cryptocurrencies but has never become operational.

Judge Curiel stated that Blockvest’s promotion of digital tokens met the definition of a security established under Howey:

“The court concludes that the contents of defendants’ website, the white paper and social media posts concerning the ICO of the BLV tokens to the public at large constitute an 'offer' of 'securities' under the Securities Act.”
CONSIDERATIONS FOR BROKER-DEALERS
If tokens are deemed securities, intermediaries such as token exchanges and promoters would likely need to comply with broker-dealer registration requirements.

Section 15(a)(1) of the Exchange Act makes it unlawful for a person to “effect a transaction in securities” or “attempt to induce the purchase or sale of, any security” unless they are registered as a broker or dealer.
“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.”

Stephanie Avakian, Co-Director of the SEC’s Enforcement Division stated in the press release concerning TokenLot,
IN THE MATTER OF TOKENLOT

- SEC’s first case charging an unregistered broker-dealer for selling digital securities
- TokenLot, LLC, a self-described “ICO Superstore,” and its owners settled charges with the SEC.
- 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.
FINRA v. Timothy Tilton Ayre

- 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 is the first FINRA case 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.
CONSIDERATIONS FOR INVESTMENT ADVISERS
ICO OPERATING AS AN UNREGISTERED INVESTMENT ADVISER?

- Consider that a sponsor of a token offering may be deemed an investment adviser under the Investment Advisers Act of 1940 and subject to registration with the SEC or with one or more states as such. In addition, the company may be deemed an investment company subject to the requirements of the Investment Company Act of 1940.

- Section 203A of the Investment Advisors Act generally makes it unlawful for any “investment advisor, unless registered, to use any means of interstate commerce in its advisory business.”
  - Section 202(a)(11) defines “investment advisers” as persons who receive compensation for providing advice about securities as part of a regular business.

- Investment advice regarding certain ICOs.
“Hedge funds seeking to ride the digital asset wave continue to proliferate,” said C. Dabney O’Riordan, Co-Chief of the Asset Management Unit. “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 its first-ever enforcement action finding a violation of the registration provisions of the Investment Company Act of 1940 by a fund manager based on its investments in digital assets

Crypto Asset Management (CAM) offered a fund, the Crypto Asset Fund, LLC (Fund), that operated as an unregistered investment company while falsely marketing it as the “first regulated crypto asset fund in the United States.”

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.
CONSIDERATIONS FOR PLATFORMS TRADING DIGITAL ASSETS
The SEC staff has noted that online trading platforms have become a popular way investors can buy and sell digital assets, including coins and tokens offered and sold in so-called Initial Coin Offerings.

“If a platform offers trading of digital assets that are securities and operates as an ‘exchange,’ as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration.”

TokenLot also marks the first enforcement action against a token-trading platform.
STATE REGULATION AND ENFORCEMENT ISSUES

Richard I. Alvarez
Overview

• States are aggressively pursuing issuers/promoters/intermediaries involved in coin and token offerings
• State activity focused on regulating ICOs and combating alleged fraudulent activity
• State regulation of ICOs follows SEC Howey-based approach
• Initial state enforcement proceedings targeting sales of unregistered securities and alleged fraudulent offerings
• State regulation is growing; national standard elusive
State Regulation of ICOs and Security Token Offerings

• State regulators have joined the SEC to aggressively pursue regulation of ICOs and security token offerings, including prosecution of fraudulent coin offerings.

NASAA – ‘Operation Cryptosweep’ launched in early 2018:
• A joint, coordinated enforcement effort by US state and Canadian securities regulators to identify fraudulent cryptocurrency-related investment products

• To date, has resulted in over 200 active investigations into cryptocurrency-related investment products and ICOs, including more than 50 enforcement actions

• Massachusetts and Texas have been the most aggressive in pursuing enforcement actions against fraudulent ICOs; Colorado and North Dakota have recently increased enforcement efforts

• State focus has been on the potentially fraudulent nature of ICOs, highlighted by the fact that many ICOs are made over the internet, making such offerings ‘...untraceable, uninsured and unregulated.’

• States are also concerned about crypto trading on unregulated digital platforms that lack the protections of regulated financial markets
Sales of Cryptocurrency and Security Tokens

- Generally, ICOs are considered by states to be offers and sales of securities
- Offerings of securities need to be registered or exempt from registration both federally and in each particular state
- States will consider most, if not all, coin offerings to be subject to state regulation
  - Private placements under Regulation D offer the most common/functionally useful state exemption
- ICOs offered on the internet complicate state compliance efforts
- Most states have shown willingness to move against fraudulent/unregistered coin offerings
- NASAA has shown no interest in creating a national standard, making state law compliance a challenging hodge-podge of potentially contradictory regulation
- CO, MA & TX most aggressive in pursuing actions against ICO promoters and fraudulent coin offerings
- WY is the first state to propose cryptocurrency regulations meant to support the growth of ICOs and blockchain within their state
State Enforcement Actions

• MA & TX have been most aggressive in pursuing actions against unregistered/fraudulent ICOs
• Caviar: first enforcement action by MA Securities Division
• USI-Tech: emergency cease and desist order by TX State Securities Board for illegal/fraudulent investments in cryptocurrencies
• BitConnect: enforcement actions brought by NC & TX for failing to comply with state securities registration and dealer registration provisions
New York Regulation of Market Participants

• New Virtual Currencies regulations adopted by NY require a ‘BitLicense’ when engaged in any of the following activities:
  • Virtual currency transmission
  • Storing, holding, or maintaining custody or control of virtual currency on behalf of others
  • Buying and selling virtual currency as a customer business
  • Performing exchange services as a customer business
  • Controlling, administering, or issuing a virtual currency.

• Appears to be focused on market participants acting as currency exchanges/offering wallet-type services
Appendix
In the past year, the U.S. Securities Exchange Commission (“SEC”) and Chairman Jay Clayton have repeatedly cautioned the cryptocurrency and initial coin offering (“ICO”) industries about the securities law implications for digital assets. On February 6, 2018, in testimony before the Senate Banking Committee, Chairman Clayton notably asserted that “[e]very ICO I’ve seen is ‘a security.’” [1]

Such guidance and statements have led many industry participants to ask whether Ether—the second most prominent cryptocurrency after Bitcoin—might be a security in light of the Ethereum Foundation’s initial fundraising and promotional efforts in creating Ether, as well as their ongoing curation activities. [2] The question has been of great importance to many participants in the cryptocurrency and ICO markets in the last several months.

On June 14, 2018, William Hinman, the SEC’s Director of the Division of Corporation Finance, delivered a speech entitled Digital Asset Transactions: When Howey Met Gary (Plastic) (the “Hinman Speech”), in which he stated that, putting aside the fundraising that accompanied the creation of Ether, “current offers and sales of Ether are not securities transactions.” (emphasis added). This statement was based on a novel theory of evolving decentralization that may very well have significant ramifications for cryptocurrency and ICO markets. The Hinman Speech also provides guidance for how the Division of Corporation Finance might evaluate whether a given digital asset constitutes a security.

This post discusses the context and implications for Director Hinman’s conclusions surrounding Ether. It also analyzes the specific factors he suggests weighing in determining whether a given digital asset is a security.

The Consequences of Deeming Ether a Security

Were Ether to be deemed a security, the consequences would be profound and immediate for many industry participants. For example, issuers and resellers of Ether arguably could be subject to enforcement actions under the Securities Act of 1933 (as amended, the “Securities Act”), which makes it illegal to sell or offer to sell securities unless a registration statement is filed with the SEC or the offering or sale falls under an available exemption from the registration requirements of the Securities Act. [3] Furthermore, cryptocurrency exchanges that host trading in Ether would need to register as a national securities exchanges or alternative trading systems (“ATS”). [4] Since no cryptocurrency exchange is yet registered, trading activities in Ether could be significantly hindered or cease altogether. Such an interruption would likely affect ICO fundraising, as Ether is a prominent currency of denomination for many ICOs. Private fund managers trading in Ether could be subject to registration as investment advisers under the Investment Advisers Act of 1940 or analogous state regulatory regimes.
Additionally, the SEC has the power to investigate violations of the law and to make criminal referrals to the U.S. Department of Justice. The SEC’s enforcement powers reach to “any person,” including natural persons, in violation of the law. Additionally, private rights of action sounding under federal and state laws also could be brought.

SEC and CFTC Jurisdictional Questions

Whether Ether constitutes a security also implicates which regulatory agencies would have jurisdiction over investor protection and cryptocurrency exchanges. On February 6, 2018, each of SEC Chairman Clayton and Chairman J. Christopher Giancarlo of the U.S. Commodity Futures Trading Commission (“CFTC”) testified before the U.S. Senate Banking committee on the subject of cross-agency coordination with respect to virtual currencies. During that testimony, Chairman Clayton acknowledged that only the SEC could exercise jurisdiction over a cryptocurrency exchange that is hosting securities trading. Chairman Giancarlo acknowledged that, even if a cryptocurrency exchange hosted trading in virtual currencies deemed to be commodities, the CFTC’s regulatory jurisdiction does not extend to spot commodity trading although it does have authority to police fraud and manipulation in spot markets. It thus remains unclear what agency, if any, would be the principal regulator for exchanges hosting trading in virtual currencies that are spot commodities.

As background, the CFTC asserted jurisdiction over virtual currencies in 2015, prior to the broad distribution of Ether. In a preliminary order issued on March 7, 2018, a federal district court supported the CFTC’s assertion of jurisdiction, but that order applied to virtual currencies generally and not to Ether specifically.

The question of which agency has jurisdictional authority over cryptocurrency and ICO exchanges is one that also impacts investor protection. On March 7, 2018, the SEC’s Divisions of Enforcement and Trading and Markets released a Statement on Potentially Unlawful Online Platforms for Trading Digital Assets cautioning investors that many such exchanges are not registered as a national securities exchange or as an ATS. The statement specifically called into question the trading protocols, the integrity of such exchanges, pricing transparency, and fairness to users. While the statement specifically targeted exchanges of ICOs, the concerns expressed also could apply to many exchanges for traditional cryptocurrencies.

Following this statement, many observers speculated as to whether the SEC might exercise jurisdiction over traditional cryptocurrency exchanges—almost all of which trade Ether—on a finding that Ether is a security. Former CFTC Chairman Gary Gensler, who served under President Barack Obama, weighed into the question of whether Ether might be a security on April 24, 2018, at the “Business of Blockchain” conference sponsored by the MIT Technology Review. Mr. Gensler acknowledged the commonly held view that Bitcoin likely is not a security because it came into existence through autonomous mining efforts rather than being sold into existence as an “incentive in validating a distributed platform” characteristic of many ICOs. Regarding Ether, however, former Chairman Gensler opined that “there’s a strong case” that it is a security based on the initial sale and the central role of the Ethereum Foundation as a developer of the Ethereum network. Noting that his remarks represented only his own views as a private citizen, Mr. Gensler also said that he thought it would be a “multi-year process” for the SEC to come to a ruling on whether Ether might be a security. No doubt to the relief of many, the Hinman Speech, although not a ruling, came much sooner.

SEC Director William Hinman—Ether Is Not Presently A Security

The Hinman Speech may provide insight into how the SEC views virtual currencies (i.e., not just ICOs) under the securities laws. Director Hinman posited “can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security” and answered with a “qualified ‘yes.’” Most prominently, the Hinman Speech concludes that even though Ether might have been a security when the Ethereum Foundation initially sold Ether in 2014, Ether no longer is a security and has morphed into something else as the Ethereum network has become decentralized over time.

Director Hinman also provided some guidance about what decentralization process may be sufficient to remove a token from being considered a security under the Howey test:
If the network on which the token or coin is to function is sufficiently decentralized—where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts—the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise’s success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

Director Hinman did not elaborate on what specific facts or case law he weighed in concluding that the Ethereum network has become decentralized or how the process of decentralization somehow transmogrified Ether from being a security into something else. He reasoned “that the analysis of whether something is a security is not static and does not strictly inhere to the instrument” citing as examples assets that could be packaged and sold in an investment strategy, contract, fund, or trust. To some extent, this conclusion appears to have been a prudential one on the basis that “applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.”

Director Hinman’s remarks on decentralization have several important implications:

- **What is Ether if not a Security?**—If the SEC staff does not view Ether as a security, then it would appear that Ether may in fact be a virtual currency subject to the CFTC’s anti-fraud jurisdiction as a spot commodity.

- **Jurisdiction over Cryptocurrency Exchanges**—The SEC staff would appear not to be looking to use Ether as a basis for asserting broad jurisdiction over existing cryptocurrency and ICO exchanges. Given the CFTC’s lack of jurisdiction over commodity spot markets, questions thus remain as to what agency, if any, will address the SEC’s publicly stated concerns on the quality, transparency, and fairness of existing exchanges. If no federal agency asserts jurisdiction, will jurisdiction be left to the individual states?

- **Implications for**—The theory that decentralization of a digital asset network over time might alter the digital assets’ original securities characterization also might prove beneficial to some producers of virtual currencies and ICOs that have been working through the tricky issues of how to remediate offerings that may have violated securities laws.

- **Maybe the SAFT Isn’t Dead Yet**—Director Hinman’s theory of decentralization as a means to morph a security into a non-security also might restore some credibility to the “simple agreement for future tokens” or “SAFT” as a technique to insulate tokens from being deemed securities. As background, the SAFT has been a commonly used instrument over the past year to fundraise for the development of digital asset platforms. The theory behind the SAFT is that the SAFT itself would be deemed to be a security issued pursuant to Rule 506(c) of Regulation D of the Securities Act but that the digital assets would be issued only once the platform is functional, such that the digital assets themselves would be deemed a “utility” and not a security. By not being securities, such digital assets arguably could trade on secondary market platforms free from the restrictions of the securities laws. [13] The Cardozo Blockchain Initiative, a group of academics and legal practitioners organized under the auspices of Cardozo Law School, publicly criticized the SAFT approach in November 2017 in a paper entitled *Not So Fast—Risks Related to the Use of “SAFT” for Token Sales*. The SAFT also appears to have come under regulatory criticism following the SEC’s December 2017 enforcement action in *In re Munchee Inc*., which involved the sale of tokens pursuant to a pre-sale instrument akin to the SAFT. [14] Following news accounts of a broad dissemination of subpoenas earlier this year by the SEC to token sponsors and their advisers, a number of prominent crypto news editorials further challenged the SAFT approach. [15] If the process of decentralization can effectively change a security into something else, then the SEC staff may be open to viewing the digital assets issued subsequent to the SAFT as distinct from the securities posture of the SAFT.

**Potential No-Action Relief**

The Hinman Speech acknowledges that the question of whether a particular digital asset involves the sale of a security is a “fact-sensitive legal analysis” and, importantly, indicates that the SEC staff “stand[s] prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use." This statement is accompanied by a footnote wherein Director Hinman acknowledges that his speech should not be regarded as an opinion “on the legality or appropriateness of a SAFT … it is clear I believe a token once offered in a security offering can, depending on the circumstances, later be offered in a non-securities transaction.”
The SEC’s Division of Corporation Finance is one of several SEC divisions that reviews and considers no-action relief. Although the Division of Corporation Finance has yet to provide no-action relief in the cryptocurrency or ICO space, we are hopeful that Director Hinman’s statement indicates that additional guidance, particularly with respect to the SAFT, may be forthcoming. Given Director Hinman’s expressed willingness to provide no-action guidance, future token sponsors would be well-advised to consider obtaining no-action relief in areas where there is uncertainty over the application of federal securities laws.

Additionally, no-action relief may be a consideration for issuers who offered unregistered securities and are now seeking guidance on the difficult decision of whether to offer remediation. Those issuers may be able to demonstrate, based on the status of their platforms, that their virtual currencies should no longer be considered securities. We would caution, though, that such no-action relief would not necessarily preclude the possibility of private rights of action.

**Influential Factors in Determining Whether Digital Assets Implicate Securities Laws**

The Hinman Speech indicates that a key determination for whether a digital asset is a security depends on whether a third party drives the expectation of a return—in other words, the third and fourth prongs of the *Howey* test. Courts often break the *Howey* test (as expounded over the years) into four elements to determine whether (i) there exists an investment of money, (ii) there exists a common enterprise, (iii) there is a reasonable expectation of profits, and (iv) the profits come from the entrepreneurial or managerial efforts of third parties. [16]

Regarding the third and fourth prongs of *Howey*, Director Hinman provides a list of illustrative, non-exhaustive factors that indicate how the Division of Corporation Finance might consider the issue. We address each in turn:
<table>
<thead>
<tr>
<th>Hinman Factor</th>
<th>Implications Under Howey</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Prominent and Central Developer:</strong> Is there a person or group that has</td>
<td>A person or group playing a prominent role in the creation, sale, development,</td>
</tr>
<tr>
<td>sponsored or promoted the creation and sale of the digital asset, the efforts</td>
<td>maintenance, and promotion of a digital asset network weighs in favor of a positive</td>
</tr>
<tr>
<td>of whom play a significant role in the development and maintenance of the</td>
<td>finding under the fourth prong of Howey.</td>
</tr>
<tr>
<td>asset and its potential increase in value?</td>
<td></td>
</tr>
<tr>
<td><strong>2. Developer Incentive and Influence:</strong> Has this person or group retained</td>
<td>Ongoing retention by a developer of digital assets, especially if publicly known, could</td>
</tr>
<tr>
<td>a stake or other interest in the digital asset such that it would be</td>
<td>mean a developer is incentivized to influence the digital asset network or that other</td>
</tr>
<tr>
<td>motivated to expend efforts to cause an increase in value in the digital asset?</td>
<td>purchasers might reasonably conclude that the developer would have an influential</td>
</tr>
<tr>
<td>Would purchasers reasonably believe such efforts will be undertaken and may</td>
<td>impact on the value of the digital asset. Such perceptions could contribute to a</td>
</tr>
<tr>
<td>result in a return on their investment in the digital asset?</td>
<td>positive finding under the fourth prong of Howey.</td>
</tr>
<tr>
<td><strong>3. Excess Fundraising:</strong> Has the promoter raised an amount of funds in</td>
<td>Raising money beyond what is necessary to build a digital asset network can indicate a</td>
</tr>
<tr>
<td>excess of what may be needed to establish a functional network, and, if so,</td>
<td>need for the promoter to have proceeds from which it can continue to undertake efforts</td>
</tr>
<tr>
<td>has it indicated how those funds may be used to support the value of the</td>
<td>to increase a network’s value. Such circumstances indicate that the network might in</td>
</tr>
<tr>
<td>tokens or to increase the value of the enterprise? Does the promoter continue</td>
<td>fact be a common enterprise subject to ongoing central authority, which weighs in favor</td>
</tr>
<tr>
<td>to expend funds from proceeds or operations to enhance the functionality and/or</td>
<td>of positive findings under the second and fourth prongs of Howey.</td>
</tr>
<tr>
<td>value of the system within which the tokens operate?</td>
<td></td>
</tr>
<tr>
<td><strong>4. Investment Value:</strong> Are purchasers “investing,” that is, are they</td>
<td>Many ICOs were specifically marketed as investments and promised substantial returns.</td>
</tr>
<tr>
<td>seeking a return? In that regard, is the instrument marketed and sold to the</td>
<td>Similarly, many ICOs were structured to provide value through scarcity and the digital</td>
</tr>
<tr>
<td>general public instead of to potential users of the network for a price that</td>
<td>assets were sold to early purchasers with discounts. These facts weigh significantly in</td>
</tr>
<tr>
<td>reasonably correlates with the market value of the good or service in the</td>
<td>favor of a positive finding under the third prong of Howey.</td>
</tr>
<tr>
<td>network?</td>
<td></td>
</tr>
<tr>
<td><strong>5. Are SEC Protections Necessary?:</strong> Does application of the Securities Act</td>
<td>These prudential, policy-based questions are independent of a Howey analysis and may be</td>
</tr>
<tr>
<td>protections make sense? Is there a person or entity others are relying on that</td>
<td>the trickiest to answer when contemplating a digital asset network. We could imagine a</td>
</tr>
<tr>
<td>plays a key role in the profit-making of the enterprise such that disclosure</td>
<td>scenario where an investor could make an investment decision based on knowing the</td>
</tr>
<tr>
<td>of their activities and plans would be important to investors? Do informational</td>
<td>development plans of a prominent digital asset network curator.</td>
</tr>
<tr>
<td>asymmetries exist between the promoters and potential purchasers/investors in</td>
<td></td>
</tr>
<tr>
<td>the digital asset?</td>
<td></td>
</tr>
<tr>
<td><strong>6. Other Persons in Control:</strong> Do persons or entities other than the</td>
<td>One might be able to exercise control over a digital asset network without necessarily</td>
</tr>
<tr>
<td>promoter exercise governance rights or meaningful influence?</td>
<td>owning a significant portion</td>
</tr>
</tbody>
</table>

of digital assets on that network. In such case, a positive finding under the fourth element of Howey is more likely.

Further, on the question of whether a digital asset might be deemed a consumptive utility or a security, Director Hinman provided the following factors that the SEC staff might consider. We address each in turn:
<table>
<thead>
<tr>
<th>Hinman Factor</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Utility or Investment?</strong> Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?</td>
<td>An emphasis on speculation weighs heavily in favor of a positive finding of the third prong of Howey. Chairman Clayton previously has asserted that an emphasis on potential secondary market trading is “especially troubling,” noting that the sale of tokens based on the potential for purchasers to profit by reselling tokens on a secondary market “are key hallmarks of a security and a securities offering.” [17]</td>
</tr>
<tr>
<td><strong>2. Price Setting:</strong> Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?</td>
<td>Where a promoter maintains the ability to influence the secondary market price, the greater the risk becomes of a positive finding under either the third or fourth prong of Howey.</td>
</tr>
<tr>
<td><strong>3. Consumptive or Speculative Intent?</strong> Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive intent, as opposed to their investment intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?</td>
<td>This factor touches on several issues, including the potential for speculation, terms of sale and token structure. As to terms of sale, we would note that the SEC might find the existence of a security notwithstanding investor representations to the contrary of consumptive intent, particularly if there are other circumstances surrounding the token structure and manner of offering that weigh in favor of positive findings under the third and fourth prongs of Howey.</td>
</tr>
<tr>
<td><strong>4. Token Design and Use:</strong> Are the tokens distributed in ways to meet users’ needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser’s expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?</td>
<td>Similar to factor #3, tokens tied to incremental use cases or with built-in degrading features are less likely to be used for speculation. Such tokens would less likely support a positive finding under the third prong of Howey.</td>
</tr>
<tr>
<td><strong>5. Availability to the Public:</strong> Is the asset marketed and distributed to potential users or the general public?</td>
<td>A broad and indiscriminate distribution to the public, as opposed to a targeted distribution to potential digital asset network users, suggests that purchasers may be speculators, thus weighing in favor of a positive finding under the third prong of Howey.</td>
</tr>
<tr>
<td><strong>6. Asset Distribution:</strong> Are the assets dispersed</td>
<td>The more broadly distributed digital assets are on a network, the</td>
</tr>
</tbody>
</table>
across a diverse user base or concentrated in the hands of a few that can exert influence over the application?

less likely the digital asset network would appear to be subject to central control of a digital asset network or authority. We would caution, however, against conflating ownership of digital assets with control of a digital asset network. Depending on the governance structure of a given digital asset network, one might be able to control a network with little to no ownership of the digital assets issued with respect to the network.

Digital assets sold with respect to a network in its early stages of development may more likely be deemed securities for several reasons. The network looks more like an investment in a common enterprise (i.e., the second prong of Howey) captive to the management and curation of third parties to make the network fully functional (i.e., fourth prong of Howey).

7. Network Maturity: Is the application fully functioning or in early stages of development?

Conclusion

The Hinman Speech provides welcome common-sense advice for prospective participants in digital token offerings. However this advice also raises many questions about the regulatory posture of virtual currencies and ICOs, particularly with respect to decentralization, that may require industry participants to seek further interpretive guidance or no-action relief. While Director Hinman caveated that his speech represented his personal views and not those of the SEC, we believe they provide a barometer of the views of the SEC staff. In an environment of frequent and unsettling change, the character of digital assets may itself see future unexpected metamorphoses. Federal district courts are now evaluating through class action litigation some of the same issues discussed in the Hinman Speech and may come to different conclusions. In the meantime, the Hinman Speech provides helpful guidance that sponsors of new digital asset networks and ICOs should consider in consultation with securities counsel.

* The authors acknowledge the assistance of Kimmi H. Pham, a summer associate of K&L Gates.

Endnotes

1 Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission Before the S. Comm. on Banking, Housing and Urban Affairs, 115th Cong. (Feb. 6, 2018) (testimony of Jay Clayton, Chairman, SEC).


6 15 U.S.C. §§ 77h-1(g), 77t(d).

7 See SEC Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC (Feb. 6, 2018); Written Testimony of Chairman J. Christopher Giancarlo before the Senate Banking Committee (Feb. 6, 2018) (the "Giancarlo Statement").

8 See Giancarlo Statement ("In 2015, the CFTC determined that virtual currencies, such as Bitcoin, met the definition of ‘commodity’ under the [Commodity Exchange Act]. Nevertheless, the CFTC does NOT have regulatory jurisdiction under the CEA over markets or platforms conducting cash or ‘spot’ transactions in virtual currencies or other commodities or over participants on such platforms."). A spot commodity is a commodity available for delivery within 28 days, as opposed to a contract for delivery at a future date.


11 The full text of former Chairman Gensler’s comments can be found here.

12 To clarify some of the confusion we have seen in the press, Director Hinman concluded that current offers and sales of Ether are not securities transactions. Director Hinman did not broadly conclude that offers and sales of ICO tokens created and sold pursuant to smart contracts on the Ethereum platform are not securities transactions.


16 See SEC v. Edwards, 540 U.S. 389, 393 (2004); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); see also United Housing Found., Inc. v. Forman, 421 U.S. 837, 852-53 (1975) (The “touchstone” of an investment contract “is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”)

17 Id.
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Crypto Asset Enforcement Actions: TKO for ICOs? or Course Correction for a New Asset Class?

Presenter Biographies

**Brian Castro** is an attorney and entrepreneur in Washington, DC. He advises financial services providers and technology companies on compliance with federal and state laws and regulations governing corporate organization, IPOs and private securities offerings, crypto-assets, crowdfunding, contracts, and financial transactions. His clients also include registered investment advisers, broker dealers, and funding portals. Previously Mr. Castro served as the Obama Administration’s National Ombudsman. In that role he worked with 30+ federal agencies, startups, and other small and middle market businesses to eliminate unnecessary red tape and promote access to capital. His experience includes co-founding a crowdfunding platform and working in the U.S. Senate on a range of economic issues, including the JOBS Act of 2012, which legalized crowdfunding and expanded access to capital raised under Regulation A+ and Regulation D. He serves on the ABA Blockchain and Negotiable Instruments Rule Book Task Force and the ABA Business Law Section Council. Mr. Castro earned a B.S. from Cornell University and a J.D. from the Duke University School of Law.

**Robert M. Crea** counsels investment advisers, private fund managers and broker-dealers on a variety of fund formation, regulatory and compliance, and securities law matters. He regularly works with clients to structure and document U.S. and offshore private investment funds and assists clients with a variety of state and federal regulatory and compliance issues. He represents pension plans and other institutional investors in connection with their investments in hedge funds, private equity, venture capital and real estate funds.

Mr. Crea also counsels on regulatory matters affecting cryptocurrencies and blockchain technology. In addition, he advises emerging companies regarding formation and financing and mergers and acquisitions. Mr. Crea is a CFA charterholder and CAIA charterholder and a member of each of the CFA Institute and CAIA Association.

**Marlon Paz**, a partner at Seward & Kissel LLP, regularly advises broker-dealers and other financial services firms in matters relating to securities regulation, SEC and FINRA enforcement, internal investigations and examinations, compliance and white collar crime. Marlon also serves on the faculty of Georgetown University Law Center and UC Berkeley School of Law.
Marlon served in senior positions during his six-year tenure at the SEC, where he played a key role in developing the SEC’s positions on many important regulatory and enforcement matters. He also has extensive experience with global anti-corruption issues, including the Foreign Corrupt Practices Act, anti-money laundering matters, and U.S. economic sanctions laws.

**Richard Alvarez** is principal of the Law Office of Richard I. Alvarez His practice focuses primarily on state securities, or “blue sky,” laws, as well as on federal and state registration and compliance matters for broker-dealers and investment advisers. For over three decades, Richard has advised corporate issuers, registered and unregistered funds, including hedge funds and private equity funds, investment banks, broker-dealers and investment advisers, among others, on a wide range of complex state regulatory issues. His experience includes securing state securities law approvals for public and private securities offerings, US and cross-border change-in-control transactions, issuances under employee benefit programs and secondary trading activities. He has also advised firms seeking to become FINRA members, advised existing broker-dealers on state and federal regulatory matters, and advisers on compliance with initial and on-going SEC investment advisor requirements.

Prior to establishing his firm in 2001, Richard was of counsel to the international law firm of Orrick, Herrington & Sutcliffe LLP, heading up its Blue Sky Department and supporting that firm’s Market Regulation Group. Prior to that time, Richard worked for the international law firms of Dewey Ballantine and Milbank Tweed Hadley & McCloy.