

**TOP 10 “DOS” AND “DON’TS” IF THE SEC CALLS ABOUT YOUR TOKEN OFFERING;
WHAT TO EXPECT
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NOVEMBER 2, 2018**

In 2017, a record amount of money, approximately \$6.1 billion, was raised through the public sale of tokens, and through July 31, 2018, approximately \$6.2 billion was raised.¹ As of July 31, 2018, there are 1,722 publicly traded tokens with a market capitalization of approximately \$277 billion.² In late December 2017, after approximately 1,600 tokens were publicly trading, Jay Clayton, the Chairman of the Securities and Exchange Commission (“SEC”), issued a personal statement opining that “[b]y and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws.”³ The public token sales occurring in 2017 obviously took a contrary position and issuers did not believe the registration requirements of the federal securities laws applied to such public token sales.⁴ Virtually all tokens (with the exception of BitCoin and Ether), are potential targets for an SEC investigation, assuming that the SEC has a jurisdictional basis to exert its enforcement powers.

So, what should you expect if the staff of the SEC Division of Enforcement calls?

1. **DO:** If you do receive a call from the SEC staff and you actually answer the phone, you should advise the staff that the company is represented by counsel and who will contact the staff. The SEC staff will not be mad if you do that. The SEC staff expects clients to refer the call to counsel. You may believe that you are the best person to talk to the SEC because you are experienced in making difficult presentations, usually in front of venture capital funds who are tough sells, and who else can competently explain your project and why the tokens are not securities. But, talking to an SEC enforcement attorney can result in very different consequences. A bad presentation to a VC may result in no investment by that VC in the company; a bad presentation to the SEC can result in an enforcement action derived from statements made during an unsupervised or ill-prepared call.
2. **DON’T:** Freak out or conversely, downplay it. The fact that the SEC has called is not good news but over-reacting is not helpful. Neither is ignoring it. You must take this outreach by the SEC very, very seriously. Once the company is on the radar screen for the SEC enforcement staff, it is better to be respectful, and, as much as possible, reasonably cooperative, no matter how much you may not want to be. During an investigation, the SEC staff must be considered as a powerful adversary. At the same time, however, it has considerable latitude both with respect to recommending enforcement actions and also to making your life miserable with demands for documents and testimony.
3. **DO:** Allow your counsel to find out the nature of the inquiry (of course, if the company has done a public token sale and there are U.S. purchasers, one can safely assume the topic of the

¹ Source: <https://www.icodata.io/> on July 31, 2018.

² Source: <https://www.CoinMarketCap.com>.

³ Source: <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

⁴ As a general matter, many issuers in 2017 utilized a two-step approach, first using a private pre-sale of rights to acquire future tokens and relying upon an exemption (usually Rule 506(b) or Rule 506(c) of Regulation D under the Securities Act of 1933) from the registration requirements of the federal securities laws and then conducting a public token sale.

inquiry). If the SEC staff has indicated that a formal order of investigation has been issued, your counsel should request a copy. The formal order provides the SEC staff with authority to issue subpoenas in an investigation. It is a document drafted from a template and will only provide the most general information about the investigation, including most importantly what potential claims the SEC staff is investigating (at least at the outset).⁵

4. **DON'T:** Forget to promptly send a document preservation memorandum or email to all parties likely to have responsive documents. Your counsel will provide you a template for that memorandum or email.

5. **DO:** Expect that this will not be the only call from the SEC staff. Once you have come to the attention of the SEC staff for some reason (*e.g.*, a staff member read about your public token sale, a member of the public has complained to the SEC about the sale of the token or the price at which the token is trading, a foreign regulatory body has referred the case to the SEC etc.), the staff is unlikely to stop its inquiry until it has received relevant documents and possibly taken testimony.

6. **DON'T:** Forget that SEC investigations (whether informal or formal) will cost a lot of money and management time because the SEC will demand lots of documents, emails, messages and ultimately testimony. The fact that document collection and production can be a costly, time-intensive process that can distract management and employees from the business will not excuse a failure to provide the requested information. This argument is not likely to sway the SEC staff. Timing on production of documents will be quick although the SEC staff will provide extensions if the staff feels you and your counsel are taking the production schedules seriously.

7. **DO:** Protect the attorney-client privilege and work-product protections for documents, messages etc. Expect the SEC to challenge any conceivable waiver of the attorney-client privilege. For example, the SEC staff may question the application of the privilege to a VC board member sharing attorney-client privileged communications about the company with his or her general partners at the venture capital fund.

8. **DON'T:** Expect the SEC to agree that your token is not a security under the Howey test (*i.e.*, an investment contract exists if there is an investment of money, in a common enterprise, with an expectation of profits from the efforts of a promoter or third party). The SEC staff has yet to take that position with respect to any tokens other than Bitcoin and Ether. The SEC staff has its own interpretation of the Howey prongs and among other things, does not believe “common enterprise” must be satisfied under the Howey test despite significant case law to the contrary.

9. **DO:** Expect the subpoena reach of the SEC to be broad. Purchasers of the tokens may in fact be subpoenaed by the SEC staff. Issuing subpoenas may make it necessary to determine which stakeholders need to know about an investigation, including management, the audit committee, the board of directors, independent auditors, and, possibly the public. While not a public company in the sense that we view, for example, Facebook, you need to be prepared for public disclosure within the crypto community because the tokens may be held by tens of thousands of holders and if information begins to leak out about an SEC investigation, there could be adverse consequences to the token’s valuation and the network.

⁵ The formal order of investigation may be authorized the Director of the Division of Enforcement pursuant to delegated authority from the Commission. The SEC staff does not have to make a presentation to the Commission for approval to obtain a formal order of investigation.

10. **DON'T:** Assume it will be easy to get your token or token offering approved by the SEC. The SEC has yet to qualify, register or otherwise formally approve any token offering. Assuming that a token is a security, in the absence of further guidance by the SEC, it will not be a quick, easy or short process with the SEC for a token to trade publicly.