Federal Judge Rules SEC Failed To Establish ICO Tokens Are Securities

I. Overview

On November 27, 2018, Judge Gonzalo P. Curiel of the United States District Court for the Southern District of California dealt a temporary setback to the Securities and Exchange Commission (the "SEC") in its efforts to secure a preliminary injunction against a planned initial coin offering ("ICO") by Blockvest, LLC ("Blockvest"). In an 18-page order, the district court denied the SEC's motion on grounds that the agency had failed to establish that the ICO tokens in question are subject to the federal securities laws.[1]

II. Background

The SEC alleged that Blockvest had offered and sold unregistered securities in the form of digital tokens called "BLVs." Blockvest allegedly offered the BLVs in a fundraising event in exchange for forms of widely accepted virtual currency, such as Bitcoin and Ether. According to the SEC's initial complaint, Blockvest—along with its principal, Reginald Buddy Ringgold III—had developed a phased plan to sell the BLVs, including a pre-sale as well as a $100 million ICO launch scheduled for December 1, 2018.[2] At the time of the complaint's filing, Blockvest allegedly had raised $2.5 million through the sale of pre-ICO BLVs and had received funds from at least 32 investors in exchange for future BLVs.[3]

The SEC argued that a preliminary injunction was necessary because Blockvest was not complying with the antifraud provisions of the securities laws. Accordingly, the SEC deemed the Blockvest ICO to be an "offering of securities" and alleged that the company had run afoul of the applicable registration and disclosure requirements.[4] The SEC also alleged that Blockvest and Ringgold had made several material misrepresentations and omissions, thereby violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10-5(b) thereunder and Sections 5(a) and 17(a) of the Securities Act of 1933. For example, the SEC alleged that Blockvest had engaged in a range of intentionally misleading conduct, such as falsely representing that Blockvest had "obtained regulatory 'approval,' most notably misleading potential investors that Blockvest and its ICO are 'approved' by the [Commission]."[5]

Blockvest asserted a markedly different account of the events surrounding its planned ICO. The company contended that the BLVs were a "utility commodity token, not a security."[6] Relying on the Supreme Court's seminal opinion in *SEC v. W.J. Howey Co.*,[7] Blockvest argued that the three elements of the *Howey* test were absent; namely, there was no "investment of money," no "common enterprise," and no "profits to come solely

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[1] Order Denying Plaintiff's Motion for Preliminary Injunction *Securities and Exchange Commission v. Blockvest, LLC,* et al, No. 18CV2287-GPC, 2018 WL 4955837 (S.D. Cal. Oct. 5, 2018).

[2] Complaint at ¶ 1, 5 *Blockvest,* 2018 WL 4955837 (No. 18CV2287-GPC).

[3] Plaintiff's Reply in Support of Order to Show Cause re: Preliminary Injunction at 2 *Blockvest,* 2018 WL 4955837 (No. 18CV2287-GPC).

[4] Complaint at ¶135 *Blockvest,* 2018 WL 4955837 (No. 18CV2287-GPC).

[5] *Id*. at ¶ 66.

[6] Defendants' Opposition to Application by Plaintiffs for Preliminary Injunction at 11 *Blockvest,* 2018 WL 4955837 (No. 18CV2287-GPC).

[7] 328 U.S. 293, 298-299 (1946).

from the efforts of others."[8] According to Blockvest, the BLVs were "akin to a credit against fees to be expended on trades on the crypto currency exchange."[9] Blockvest also contended that the alleged $2.5 million proceeds of token pre-sales derived from a merely contemplated transaction with a particular investor and that "the exchange itself, which is a work in progress, and was not open to the public, [had only] conduct[ed] some limited tests by 32 affiliated persons."[10] Under Blockvest's framing, the test investors purportedly had no intention to profit from their purchases of BLVs, because they were primarily "internal people" and "helped [Blockvest] with different functions needed to test the platform."[11]

In his order, Judge Curiel held that the SEC had failed to demonstrate that the BLVs were in fact securities subject to the federal securities laws. In his analysis, he pointed out that "[t]he grant of a preliminary injunction is the exercise of a very far reaching power never to be indulged except in a case clearly warranting it."[12] Applying the *Howey* test, the district court concluded that the SEC had not demonstrated that the BLVs satisfied any of the three prongs required to be a security. Regarding the first and second prongs, the SEC had not shown that BLVs were an "investment of money" in a "common enterprise" because there was a factual dispute regarding whether and to what extent the 32 investors had relied on Blockvest's promotional materials and oral representations.[13] Regarding the third prong, the SEC failed to demonstrate that the investors had an "expectation of profits," given that there was factual dispute regarding whether the test investors actually believed they would make money from the BLVs.[14]

Judge Curiel found persuasive Blockvest's description of the BLVs as being "utility commodity tokens" exchanged for testing purposes among affiliated persons. Notably, Judge Curiel adopted the SEC's favored approach of using the *Howey* test to determine whether an ICO token is a security. Nevertheless, he held that the SEC's efforts to apply the test to Blockvest's BLVs were insufficient given the substantial factual uncertainty.[15] Consequently, Judge Curiel denied the Commission's request for a preliminary injunction on grounds that there exist legitimate factual and legal disputes surrounding the events in question.[16]

III. Conclusion

Cryptocurrency offerings and ICOs remain priority areas for the SEC. This early decision demonstrates that these areas are highly dependent on the facts and circumstances. While Judge Curiel's decision represents a temporary setback in the SEC's litigation against Blockvest, his reliance on the analytical framework of the *Howey* test may be viewed as a victory for the agency. We expect that the SEC will continue to bring enforcement actions against ICOs on the basis of similar theories.

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[8] Defendants' Opposition to Application by Plaintiffs for Preliminary Injunction at 11-12 *Blockvest*, 2018 WL 4955837 (No. 18CV2287-GPC).

[9] *Id*. at 12.

[10] *Id*. at 9.

[11] Order Denying Plaintiff's Motion for Preliminary Injunction at 12 *Blockvest*, 2018 WL 4955837 (No. 18CV2287-GPC).

[12] *Id*. at 7.

[13] *Id*. at 13.

[14] *Id*. at 13-14.

[15] *Id.* at 11-14.

[16] *Id*. (citing *Dymo Indus., Inc. v. TaperPrinter, Inc.*, 326 F.2d 141, 143 (9th Cir. 1964)).

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to contact Bradley J. Bondi (202.862.8910, bbondi@cahill.com), David R. Owen (212.701.3955, dowen@cahill.com), C. Wallace DeWitt (202.862.8932, cwdewitt@cahill.com), Charles A. Gilman (212.701.3403, cgilman@cahill.com), Helene R. Banks (212.701.3439, hbanks@cahill.com), Geoffrey E. Liebmann (212.701.3313, gliebmann@cahill.com) or Brian Thayer (212.701.3840, bthayer@cahill.com).