Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
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To Be or Not to Be – An Exchange: SEC Enforcement Action Against Unregistered Crypto Exchange

On November 8, 2018, the SEC instituted and simultaneously settled an important enforcement action against an unregistered cryptocurrency exchange, EtherDelta, a digital "token" trading platform.[1]

Background

According to the SEC, Zachary Coburn launched EtherDelta's website on July 12, 2016. Through December 15, 2017, EtherDelta executed over 3.6 million buy and sell orders in ERC20 tokens over the website.[2] The SEC order held that the ERC20 tokens included "securities," as defined by the Securities and Exchange Act of 1934 ("Exchange Act"). However, the order failed to specify which ERC20 tokens, in particular, were deemed to be securities by the SEC. In addition, approximately 92% (*i.e.*, 3.3 million) of the orders were entered after the SEC issued the DAO Report on July 25, 2017.[3] In the DAO Report, the SEC advised that a platform that offers trading of digital assets that are "securities" and operates as an "exchange," as defined by the federal securities laws, must register with the SEC as a national securities exchange or be exempt from registration.

What is an exchange?

Exchange Act Rule 3b-16(a) (the "Rule") provides a functional test to determine whether a platform, referenced in the DAO Report, meets the definition of "exchange" under the federal securities laws. The Rule states that an organization, association, or group of persons will meet the definition of an exchange if it satisfies the following conditions: (1) it brings together the orders for securities of multiple buyers and sellers; and (2) it uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

(1) Bringing together orders of securities of multiple buyers and sellers

The SEC found that EtherDelta operated as a marketplace for bringing together the orders of multiple buyers and sellers in tokens that included "securities," as defined by the federal securities laws. While the specific tokens at issue were not listed in the order, the SEC determined that the tokens had all the hallmarks of a security under the 1946 Supreme Court case of *Howey* – namely the investment of money with the reasonable expectation of profits, including through the increased value of their investments in secondary trading, based on the managerial efforts of others.[4]

(2) Non-discretionary methods for executing trades agreed to by buyers and sellers

EtherDelta brought together orders by receiving and storing orders in tokens in the EtherDelta's order book and displaying the top 500 orders (including token symbol, size, and price) as bids and offers on the EtherDelta website. EtherDelta thus provided the means for these orders to interact and execute through the combined use of the EtherDelta website,

order book, and pre-programmed trading protocols defined in the EtherDelta smart contract. These established non-discretionary methods allowed users to agree upon the terms of their trades in tokens on EtherDelta.

Coburn's fate

Ultimately, the SEC found that, because EtherDelta was operating as an "exchange," as defined in the Exchange Act, it should have registered with the SEC or qualified for an exemption. The SEC also determined that Coburn "should have known" that his actions would contribute to EtherDelta's violations. Because Coburn wrote and deployed EtherDelta's smart contract and exercised complete and sole control over its operations, the SEC found that he caused EtherDelta's violation of the Exchange Act. The action is yet another example of the Commission's stated priority of holding individuals accountable, even in the absence of finding fraud or scienter-based conduct.

Coburn, without admitting or denying the findings contained in the SEC's order, individually agreed to pay $300,000 in disgorgement plus $13,000 in prejudgment interest along with a $75,000 penalty. The SEC recognized Coburn's prompt remedial acts and cooperation during the investigation, which resulted in its decision not to impose a greater penalty. Going forward, Coburn agreed to testify in any related enforcement action.

What does this mean going forward?

Along with the SEC's recent actions against crypto hedge funds, broker-dealers and securities offerings, this additional action against a crypto exchange is likely more evidence of further crypto-enforcement actions to come.

In response, many crypto firms are seeking to legitimize their existing businesses to ensure compliance. For instance, firms in need of fund-raises are seeking to offer compliant ICOs (such as securities token offerings – STOs – under Regulation 506). Likewise, many crypto trading platforms are taking advantage of the alternative trading system ("ATS")[5] option under Regulation ATS, which generally exempts an ATS from registering as an exchange under the Exchange Act if it registers as a broker-dealer and files an initial operation report with the SEC on Form ATS prior to commencing operations.

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[1] *See* copy of Coburn Order here (https://www.sec.gov/litigation/admin/2018/34-84553.pdf). The SEC had previously brought and settled a similar case alleging failure to register as an exchange against cryptocurrency firm BTC Trading Corp. (see BTC Order here (https://www.sec.gov/litigation/admin/2014/33-9685.pdf)). The SEC likewise brought an action against Bitfunder (see Bitfunder Complaint here (https://www.sec.gov/litigation/complaints/2018/comp-pr2018-23.pdf)), which remains ongoing.

[2] ERC20 tokens refer to digital assets issued and distributed on the Ethereum blockchain using the ERC20 protocol, which is the standard coding protocol currently used by a significant majority of issuers in initial coin offerings ("ICOs"). If a programmer includes certain required functions in the token's smart contract, then the token is a ERC20 token.

[3] See copy of the DAO Report here (https://www.sec.gov/litigation/investreport/34-81207.pdf).

[4] *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[5] An ATS is "any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Exchange Act Rule 3b-16]; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of subscribers' trading on such [ATS]; or (ii) [d]iscipline subscribers other than by exclusion from trading."

Gregory D. DiMeglio   **Sara P. Crovitz**   **Nicole M. Kalajian**   **J. Patrick Green**

For more information, contact Gregory D. DiMeglio at 202.419.8401 or gdimeglio@stradley.com, Sara P. Crovitz at 202.507.6414 or scrovitz@stradley.com, Nicole M. Kalajian at 312.964.3507 or nkalajian@stradley.com or J. Patrick Green at 202.507.5151 or jgreen@stradley.com.