This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Hedge Fund Law Report
An Acuris company

Technology

U.S. District Court Rules That Digital Tokens in Initial Coin Offerings May Not Constitute Securities

Jan. 24, 2019

By Vincent Pitaro, *Hedge Fund Law Report*

On October 5, 2018, at the SEC's request, the U.S. District Court for the Southern District of California (Court) issued a temporary restraining order (TRO) stopping an allegedly fraudulent initial coin offering (ICO) by defendants Blockvest, LLC (Blockvest) and Reginald Buddy Ringgold, III. The SEC complaint (Complaint) alleged that, to give legitimacy to the ICO, the defendants created a bogus self-regulatory agency modeled on the SEC; falsely claimed that the offering was approved by the SEC and exempt from registration; and engaged in other misleading conduct. Following a November 16, 2018, hearing, the Court denied the SEC's motion for a preliminary injunction. This article analyzes the Court's order denying the motion (Order).

For more on SEC enforcement efforts in the digital currency space, see "SEC Enforcement Division Annual Report Emphasizes Continuing Focus on Retail Investors, Individual Accountability, Cyber Misconduct and Digital Assets" (Dec. 6, 2018); "Unregistered Crypto Fund Hit With Multiple Securities Laws Violations by SEC" (Oct. 18, 2018); and "SEC Cyber Unit Files Charges Against Allegedly Fraudulent ICO" (Jan. 11, 2018).

Defendants, Other Relevant Entities and Prior Proceedings

The SEC charged that defendant Blockvest had been selling digital tokens known as "BLVs" to raise funds for "various digital asset related financial products and services." Blockvest registered as a commodity trading advisor with the CFTC on July 24, 2018. It is not registered with the SEC in any capacity.

According to the Complaint, defendant Ringgold has never been registered with the SEC or CFTC in any capacity and has never been associated with a registered securities firm. He claims to be the founder of Blockvest and holds himself out as a founder and principal of several other related entities, none of which are named as a defendant in the action, including:

- Blockchain Exchange Commission, LLC, a purported regulatory organization;
- Blockchain Investment Group LLC;
- Blockchain Investment Group LLP;
- Master Investment Group, Inc.; and
- Rosegold Investments LLP (Rosegold).

None of the above entities, which share common officers and the same UPS store address with the defendants, is registered with the SEC or CFTC in any capacity.

In addition to those entities, the Order and Ringgold's opposition papers refer to Blockvest Investment Group LLC, an entity that owns 100% of Blockvest. Ringgold owns 51% of the company's membership interests. His mother and Michael Sheppard – who is described as the company's chief financial officer – own 20% each, and 9% are unissued. It is not clear whether this entity is the same as Blockchain Investment Group LLC, which is referenced in the Complaint.

The SEC asserted that the defendants made material misrepresentations and omissions in connection with the offering and sale of BLVs in Blockvest's white paper, in online materials or in other public statements. It charged that they were engaged in the sale of unregistered securities in violation of the Securities Act of 1933 (Securities Act) and violated the antifraud provisions of the Securities Act and the Securities Exchange Act of 1934 (Exchange Act).

On October 5, 2018, the Court issued the TRO, which:

- ordered the defendants to account for their assets;

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

- contained a broad asset freeze; and
- enjoined them from proceeding with the ICO and from violating the antifraud and registration provisions of the Securities Act and the antifraud provisions of the Exchange Act.

For additional information on these entities, the Blockvest ICO, the alleged fraud, the other allegations in the Complaint and the TRO, see "SEC Halts Allegedly Fraudulent ICO That Employed a Bogus Regulatory Agency and False Claims of SEC Approval" (Nov. 29, 2018).

Additional Facts Alleged by Defendants in Opposition to SEC Motion

In opposition to the SEC motion for a preliminary injunction, Ringgold asserted that:

- Blockvest's sole "investor" is Rosegold, which is run by Ringgold. Ringgold and Sheppard invested $175,000 and $20,000, respectively, in Rosegold. (This statement appears to be inconsistent with his acknowledgment in the same document that Blockvest Investment Group LLC owns 100% of Blockvest.)
- Blockvest had not become operational and had never sold any BLVs to the public.
- Blockvest issued BLVs to only 32 "partner testers," but those BLVs could not be released from the Blockvest exchange. BLVs were "utility" tokens intended for testing only.
- The testers put less than $10,000 in bitcoin and Ethereum digital currency onto the Blockvest exchange, about half of which was spent on third-party fees.
- Seventeen individuals invested money in, or lent money to, Rosegold. Nine of them signed declarations stating that they did not buy BLVs or rely on any of the defendants' alleged misrepresentations regarding Blockvest.

Ringgold also pledged not to proceed with the Blockvest ICO unless he gave 30 days' notice to SEC counsel.

In response, the SEC asserted that relevant documentation showed that BLV transactions exceeded $180,000, not the $10,000 claimed by defendants. In addition, Rosegold admitted raising about $150,000 from 17 individuals during pre-ICO solicitations, at least eight of whom wrote "coins" or "Blockvest" on their checks.

Legal Analysis

The SEC, as the moving party, had the burden of demonstrating that it was entitled to the preliminary injunction. According to the Court, to meet that burden, the SEC had to establish "(1) a prima facie case of previous violations of federal securities laws, and (2) a reasonable likelihood that the wrong will be repeated." (Citations omitted.)

For the reasons detailed below, the Court ruled that the SEC had not satisfied either requirement and denied its request for a preliminary injunction.

SEC Failed to Establish That BLVs Were Securities

The antifraud and registration provisions of the Securities Act and Exchange Act are tied to the offering and sale of "securities." Defendants' sole contention in opposition to the SEC's motion was that BLVs were not securities within the meaning of those laws.

The Court's analysis turned on the definition of "investment contract" first enunciated by the Supreme Court in SEC *v.* W.J. *Howey Co.*: "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."

See "Federal District Court in New York Rules That ICOs May Be Securities" (Oct. 4, 2018).

The SEC claimed that Blockvest raised $2.5 million from investors. It also asserted that Blockvest's white paper and website marketed the ICO as a securities offering in which the investors would pool money into a common business enterprise and be passive participants who would share in the profits of the venture.

The defendants countered that the 32 "testers" put less than $10,000 in the aggregate into Blockvest, that the BLVs were only designed for testing the platform and that no BLVs were ever issued to those testers. They also claimed that the $2.5 million investment referred to by the SEC, which would have come from a single investor, was never made.

The Court noted that, even though the defendants conceded that the Blockvest website accepted cryptocurrency for the purchase of BLVs, the SEC had offered no proof that any of the 32 "testers" had reviewed or relied on any of Blockvest's marketing materials

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
when purchasing BLVs on the Blockvest exchange. In addition, Ringgold testified that, even though the "buy now" button on Blockvest's website failed to indicate that the site was for testers and management only, a person who clicked on that button could not purchase BLVs because the site was not actually live.

The Court concluded that, based on the parties' "starkly different facts," there were unresolved issues of fact as to what marketing materials, if any, on which the 32 testers had relied. The SEC also provided no evidence that the 32 testers had expectations of profit from their purported purchases of BLVs, according to the Court. Therefore, the SEC failed to establish that BLVs were securities under the *Howey* test. During the future course of the litigation, however, the SEC may discover and present additional evidence that BLVs do, in fact, satisfy the *Howey* test.

Investments in Rosegold

The SEC also attempted to characterize the 17 individuals' investments in Rosegold as an unregistered sale of securities. Ringgold countered that those individuals were his friends and family or those of Sheppard and that they had invested based on their relationships with Ringgold or Sheppard, rather than on Blockvest's marketing materials.

The Court reasoned, "Merely writing 'Blockvest' or 'coins' on their checks is not sufficient to demonstrate what promotional materials or economic inducements these purchasers were presented with prior to their investments. . . . Accordingly, [the SEC] has not demonstrated that 'securities' were sold to the 17 individuals."

For more on ICOs and what constitutes a security, see "Compliance Corner Q3-2018: Regulatory Filings and Other Considerations That Hedge Fund Managers Should Note in the Coming Quarter" (Jul. 19, 2018); and "HFLR Cryptocurrency Webinar Examines Regulatory Developments, ICOs, Cryptocurrency Sweep, Custody and Other Compliance Issues" (May 3, 2018).

No Previous Violation of Securities Laws

Because the SEC had not shown that the defendants had been engaged in the offering or sale of "securities," the Court concluded that the SEC had failed to establish a prior violation of the securities laws by the defendants.

No Likelihood That Wrong Will Be Repeated

The Court also ruled that the SEC had not demonstrated a reasonable likelihood that the alleged wrong would be repeated. First, "it is disputed whether there have been past violations of the securities laws as it is disputed whether the 'sale' or 'offer' of the BLV token was a security," the Court reasoned. Implicit in this statement is that, if Blockvest had not been engaged in an offer or sale of securities, there was no "wrong" that could be repeated.

Second, the Court credited Ringgold's acknowledgement that "mistakes were made"; his assertion that he intended to comply with all applicable regulations; and his undertaking not to proceed with an ICO without guidance from compliance counsel and without giving 30 days' notice to the SEC. In addition, defendants did not oppose the preliminary injunction concerning compliance with securities laws.

Finally, to bolster its argument, the SEC claimed that, until October 11, 2018 (several days after issuance of the TRO), Ringgold continued to assert, falsely, that the Blockvest exchange was "registered with the SEC and NFA" and continued to make other alleged misrepresentations concerning Blockvest. The Court noted, however, that the SEC did not serve the Complaint on Ringgold until October 10, 2018, and that he had not yet retained counsel at that time. Moreover, there was no allegation that defendants had made any misrepresentations since retaining counsel.

New Development

On December 27, 2018, Corrigan & Morris LLP moved to withdraw as counsel for the defendants, citing unpaid fees and conflicts of interest arising out of defendants' refusal to cooperate and their insistence on filing certain claims and documents against advice of counsel.

The motion notes:

> Defendants have instructed counsel to file certain documents that such clients prepared without the benefit of counsel, and that, upon review, fall far short of the professional standards required by the Court of [counsel]. . . . [Counsel] refused to sign and file these papers with the Court and could not certify them as appropriate papers in compliance with their duties under FRCP Rule 11.

For CFTC regulation of virtual currencies, see "NFA Mandates New Disclosures on Certain Virtual Currency Activities" (Sep. 20, 2018); "What Fund Managers Investing in Virtual Currency Need to Know About NFA Reporting Requirements and the

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

CFTC's Proposed Interpretation of 'Actual Delivery'" (Mar. 1, 2018); and "Virtual Currencies Present Significant Risk and Opportunity, Demanding Focus From Regulators, According to CFTC Chair" (Feb. 8, 2018).

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL