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SEC Enforcement Matters

Court Reconsiders November 2018 Order and Issues Preliminary Injunction Against ICO

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By Vincent Pitaro, *Hedge Fund Law Report*

In October 2018, the SEC sought a preliminary injunction from the U.S. District Court for the Southern District of California (Court) against defendants Blockvest, LLC (Blockvest) and Reginald Buddy Ringgold, III, to stop an allegedly fraudulent initial coin offering (ICO). 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.

One month later, in November 2018, the Court ruled (November 2018 Order) that the SEC had not established entitlement to a preliminary injunction. In the latest chapter of this saga, on February 14, 2019, the Court reversed course and issued a preliminary injunction against the defendants. This article analyzes the Court's order (February 2019 Order) granting the SEC's motion for partial reconsideration.

For coverage of prior rulings by the Court in this action, see "U.S. District Court Rules That Digital Tokens in Initial Coin Offerings May Not Constitute Securities" (Jan. 24, 2019); and "SEC Halts Allegedly Fraudulent ICO That Employed a Bogus Regulatory Agency and False Claims of SEC Approval" (Nov. 29, 2018).

Relevant Facts and Prior Proceedings

According to the Complaint, defendant Blockvest had been selling digital tokens known as "BLVs" to raise funds for "various digital asset related financial products and services." Defendant Ringgold claims to be the founder of Blockvest and holds himself out as a founder and principal of a number of other related entities, although those related entities are not named as defendants in this action. He allegedly also raised funds through one of those related entities: non-party Rosegold Investments LLP (Rosegold).

The SEC claimed 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, on social media and in other public statements (collectively, Offering Materials). It alleged 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.

On October 5, 2018, the Court issued a temporary restraining order (TRO) that required the defendants to account for their assets; imposed a broad asset freeze; and enjoined them from proceeding with the ICO and from violating the antifraud and registration provisions of the securities laws.

Thereafter, the Court issued the November 2018 Order denying the SEC's request for a preliminary injunction. A central issue in that ruling was whether the defendants had engaged in an offering of "securities."

The SEC moved for reconsideration of the November 2018 Order. For the reasons discussed below, the Court granted the SEC's motion for reconsideration and preliminarily enjoined the defendants from violating Section 17(a) of the Securities Act, which makes it unlawful, in connection with the offer or sale of securities, to employ any device, scheme or artifice to defraud; to obtain money or property by means of misstatements or omissions of material fact; or to engage in fraudulent or deceptive business practices.

Legal Analysis

A motion for reconsideration under Rule 59(e) of the Federal Rules of Civil Procedure can be granted on the basis of newly discovered evidence, a clear error in the order being challenged or a change in controlling law.

On a motion for a preliminary injunction, the SEC is required to demonstrate: "(1) a prima facie case of previous violations of federal securities laws; and (2) a reasonable likelihood that the wrong will be repeated." A threshold question regarding defendants' alleged violation of the securities laws is whether their ICO involved securities.

As defined in the Securities Act, a security includes an "investment contract." In *SEC v. W.J. Howey Co.*, the U.S. Supreme Court held that an "investment contract" is "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).

SEC Established a Previous Violation of the Securities Laws

In the November 2018 Order, the Court held that the SEC had not established a prima facie violation of the securities laws because there were disputed factual issues as to whether the defendants had offered securities to the alleged investors. The Court had relied heavily on two of defendants' contentions:

1. They claimed to have issued BLVs only to 32 "partner testers," that those BLVs could not be released from the Blockvest exchange and that the BLVs were "utility" tokens intended for testing only.
2. Seventeen individuals had invested money in, or lent money to, Rosegold. Defendants claimed that they did so because of their family relationships or friendships with Ringgold, and not in reliance on any representation about Blockvest, BLVs or the ICO.

The defendants had asserted that neither of those solicitations had constituted offerings of securities. In its motion for reconsideration, the SEC contended that, in determining whether the defendants had offered securities to the 32 "testers" of BLVs and the 17 Rosegold investors, the Court had improperly required the SEC to show that those individuals expected to profit from the transactions. The Court rejected this contention, explaining that the *Howey* test is an objective one that turns on what is offered or promised to the purported investors. The Court denied reconsideration on this ground, reiterating that there were disputed issues of fact as to what was offered to the 32 BLV testers and the 17 Rosegold investors.

The SEC had also argued in its original moving papers that the Offering Materials constituted an unregistered offering of securities containing material misstatements in violation of Section 17(a) of the Securities Act. The Court acknowledged that it "did not directly address this alternative theory" in the November 2018 Order and determined that the SEC had, in fact, established a prima facie violation of Section 17(a) by the defendants.

Offering Materials for BLVs Involve a "Security"

The Court concluded that "the SEC has demonstrated that the promotion of the ICO of the BLV token was a 'security' and satisfies the [three-part] *Howey* test":

1. *Investment of Money*: The Offering Materials "invited or enticed potential investors to provide digital or other currency in exchange for BLV tokens."
2. *Common Enterprise*: They promised purchasers of BLVs "a pro-rated share of 50% of the profit generated quarterly as well as fees for processing transactions."
3. *Passive Investment*: The Offering Materials stated that BLV holders would be "passive" investors who would receive "passive income."

Defendants "Offered" Securities

The Securities Act defines "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The term was intended to be interpreted expansively and has a different and broader meaning in securities law than under contract law, according to the Court.

The Court rejected the defendants' contention that an offer requires a "manifestation of intent to be bound," reasoning that "[u]nder securities law and caselaw, the definition of 'offer' is broad and there is no requirement that performance must be possible or that the issuer must be able to legally bind a purchaser." An offer may occur even if the party making the offer cannot be bound by it. There is also no requirement for a completed sale or even acceptance of the offer.

Finally, the Court refused to consider defendants' argument that the SEC had not established the other elements of a violation of Section 17(a) of the Securities Act because they had raised them for the first time on the SEC's motion for reconsideration, rather than in opposition to the SEC's original motion for a preliminary injunction.

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).

SEC Established a Likelihood of Future Violations

The Court also reversed its prior determination that the SEC had not shown a reasonable likelihood that the defendants would violate the securities laws in the future. The November 2018 Order was premised on the totality of the circumstances, including:

- the SEC's failure to establish a prima facie violation of Section 17(a) of the Securities Act or other past violation of the securities laws;
- Ringgold's retention of counsel, after which he put the BLV ICO on hold; and
- Ringgold's acknowledgement that "mistakes were made" and his promise to give the SEC 30 days' notice before proceeding with the ICO.

The Court ruled that, in light of the following new facts and circumstances, the SEC had now established a reasonable likelihood of a future violation:

- The SEC had, in fact, made out a prima facie claim of violation of Section 17(a), which created an inference that defendants would violate the securities laws again.
- The motion to withdraw filed by defendants' counsel indicated that defendants had improperly tried to file documents that their counsel refused to sign or certify in accordance with Rule 11 of the Federal Rules of Civil Procedure.
- Defendants' failure to retain new counsel raised "concerns whether [d]efendants will resume their prior alleged fraudulent conduct."
- Under all the circumstances, defendants' creation of a fictitious regulatory agency using a seal, logo and mission statement nearly identical to that of the SEC was harder to characterize as a mere "mistake."

Additional Developments

Simultaneously with the February 2019 Order, the Court also granted the motion of defendants' counsel to withdraw from the case. The Court gave Blockvest until March 15 to obtain substitute counsel or risk default proceedings against it. Ringgold may proceed pro se.

The SEC also recently notified the Court of a complaint filed against Ringgold in the Court by Tommy and Christine Garrison, who claim that Ringgold, Rosegold and another Ringgold entity defrauded them and their family members out of more than $800,000, including by way of sales of various ICO tokens and investments in Rosegold, which was allegedly marketed to them as a private investment fund.

For additional insights regarding the 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 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).