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U.S. District Judge Rejects Argument that Sale of "Stand-In" Tokens Was Not a Sale of Unregistered Securities

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On January 8, 2021, Judge Richard Seeborg of the United States District Court for the Northern District of California issued an Order denying a motion to dismiss in *S.E.C. v. NAC Foundation, LLC*, *et al*. The U.S. Securities & Exchange Commission (SEC) had previously filed a civil complaint against blockchain development company NAC Foundation, LLC (NAC) and NAC's CEO, Marcus Rowland, alleging that NAC's and Rowland's sale of "stand-in" digital tokens constituted a fraudulent and unregistered sale of digital securities. The Department of Justice (DOJ) brought a parallel criminal proceeding, alleging violations of federal wire fraud and money laundering statutes. DOJ also filed a separate criminal case against former high-profile lobbyist Jack Abramoff in connection with his role in the promotion of NAC's digital assets.

The SEC alleged that NAC and Rowland sought to introduce and sell "AML Bitcoin," a new digital asset. However, "because certain aspects of the 'privately regulated public blockchain' upon which AML Bitcoin would operate were still under development," participants in the initial coin offering (ICO) for AML Bitcoin would not be issued actual AML Bitcoin tokens, but instead would receive "stand-in 'ABTC tokens,'" which could be exchanged for AML Bitcoin once AML Bitcoin's blockchain was completed. The defendants claimed that AML Bitcoin could be traded "on participating exchanges and trading websites," but that participation in the ICO did not result in an "investment contract" under U.S. securities laws. The ICO ran from October 2017 to February 2018, and the defendants raised approximately $5.6 million, primarily from retail investors. While the ABTC tokens were available for online trading, the defendants made no effort to register the ABTC tokens – or AML Bitcoin – as a security with the SEC. After the SEC filed its complaint, the defendants filed a motion to dismiss, arguing that the SEC had failed to establish that the ABTC tokens were "securities" under the federal securities laws.

Judge Seeborg looked to the Supreme Court's decision in *S.E.C. v. W.J. Howey Co.* and held that the ABTC tokens were qualifying securities. Specifically, Judge Seeborg looked to the Ninth Circuit's three-part *Howey* test, which requires "(1) an investment of money (2) in a common enterprise (3) with an expectation of profits produced by the efforts of others."

With respect to the "common enterprise" element, Judge Seeborg noted that "a common enterprise exists where the investment scheme involves either 'horizontal commonality' or 'strict vertical commonality.'" He further noted that "'vertical commonality may be established by showing that the fortunes of the investors are linked with those of the promoters.'" Based on that standard, Judge Seeborg found that it was "quite plausible – and indeed, probable" that strict vertical commonality existed between the defendants and the ICO participants. This was because "the 'fortunes' of the ICO participants – as measured by either the trading value of their ABTC tokens *or* the future trading value of AML Bitcoin – were 'linked' to the 'fortunes' of defendants – as measured by the trading value of their ABTC tokens, the future trading value of AML Bitcoin, *or* the general success of their enterprise."

Judge Seeborg analogized another factually similar case, *S.E.C. v. Telegram Group, Inc.*, where the court held that the SEC had made a "substantial showing of strict vertical commonality" when the ICO participants' potential profits directly depended upon the defendants' success in developing an underlying blockchain system and whose defendants also retained ICO tokens. However, unlike the NAC defendants, the *Telegram* defendants had pledged to relinquish control of the tokens they retained during the ICO. As such, Judge Seeborg held that the NAC defendants' financial fortunes were even more strongly tied to the ICO participants because they had made no such pledge to relinquish their tokens.

With respect to the "expectation of profits," Judge Seeborg held that the SEC had alleged sufficient facts to show both that the ICO participants had an expectation of profit and that the profits were a product of the efforts of a person other than the investor. Specifically, ICO participants expected "that both the ABTC tokens and AML Bitcoins would be tradeable on stock market-like exchanges," and that both the ABTC tokens and AML Bitcoins "could 'appreciate in value through speculative trading.'" The Judge noted that, apart from being redeemed for AML Bitcoin at some future point, ABTC tokens were "solely objects for trading." Moreover, any objectively reasonable ICO investor in the ABTC tokens "likely viewed his or her prospective trading success as a function of the defendants' efforts" because "the demand for ABTC or AML Bitcoin . . . would rely almost exclusively on market perception of defendants' work product." In other words, the "ICO participants 'recognized that an investment in [ABTC tokens] was a bet that [defendants] could successfully encourage the mass adoption of [AML Bitcoin], thereby enabling a high potential return' on either the 'resale of the [ABTC tokens]' or the future sale of AML Bitcoin, for which ABTC tokens could be redeemed."

The *NAC* case is the latest of several recent securities fraud cases filed by the SEC involving digital assets. And Judge Seeborg's decision is another example of function over form in a securities fraud case involving digital assets. That is, no matter how many disclaimers and warnings you put in your marketing materials, if the ICO passes the *Howey* test, you will need to register with the SEC – or operate under an exemption – in order to sell the asset.

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