

# SEC credits self-reporting and cooperation in not imposing penalty on ICO sponsor

Daniel Hawke

## Abstract

**Purpose** – To explain a February 20, 2019 US Securities and Exchange Commission (SEC) settled enforcement action against Gladius Network LLC for failing to register an initial coin offering (ICO) under the federal securities laws, in which Gladius was able to avoid a civil penalty by self-reporting the violation and cooperating with the SEC enforcement staff.

**Design/methodology/approach** – Explains Gladius' self-reporting, cooperation and remedial steps; why the SEC imposed no civil penalty on Gladius; and two similar cases the SEC instituted in July 2018 against companies that conducted unregistered ICOs, did not self-report, and were penalized. Provides analysis and conclusions.

**Findings** – The Gladius case offers important insight into how the SEC and its staff think about cooperation credit in resolving SEC enforcement actions and sends a clear message that self-reporting to the SEC can result in meaningful cooperation credit. In three recent cases, the Commission has made clear that once it put the industry on notice that ICOs could be securities that must be registered under the federal securities laws, a party risks enforcement action by failing to do so.

**Originality/value** – Expert analysis and guidance from an experienced securities lawyer who counsels clients on all manner of SEC enforcement, examination and regulatory policy matters.

**Keywords** Cooperation, US Securities and exchange commission (SEC), Initial coin offering (ICO), Securities Act of 1933, Section 5, Unregistered offering, Self-reporting

**Paper type** Technical paper

Daniel Hawke ([daniel.hawke@arnoldporter.com](mailto:daniel.hawke@arnoldporter.com)) is a partner at the Arnold & Porter Kaye Scholer LLP, Washington, District of Columbia, USA.

**O**n February 20, 2019, the SEC announced a settled enforcement action against Gladius Network LLC for failing to register its 2017 initial coin offering (ICO) under the federal securities laws<sup>[1]</sup>. Gladius, a company developing a peer-to-peer network to enable website content providers to fight distributed denial of service attacks, self-reported the violation, cooperated with the SEC enforcement staff and avoided a civil penalty.

As described in the Commission's order, the company conducted an ICO in late 2017 in which it publicly offered and sold "GLA Tokens" in exchange for Ether<sup>[2]</sup>, a digital asset, to raise the capital it required to build out its network. Gladius raised roughly \$12.7 million worth of Ether in its ICO. Gladius publicized through its website and social media the details of its offering and that its tokens would be available for purchase worldwide, including within the USA. Approximately 1700 investors purchased GLA Tokens, which were distributed in February 2018.

## Self-reporting, cooperation and remedial actions

In August 2018, Gladius self-reported its unregistered offering and sale of GLA Tokens to the SEC's Division of Enforcement. When it self-reported, Gladius "expressed an interest in

© Arnold & Porter Kaye Scholer, LLP.

taking prompt remedial steps” and “cooperated extensively with the staff, voluntarily providing documents and information to the Commission in a format that allowed the staff to conduct the investigation quickly and efficiently[3]”.

The SEC found that “Gladius did not register the offering pursuant to the federal securities laws, nor did it qualify for an exemption to the registration requirements[4]”. As a result, the Commission found that Gladius violated Sections 5(a) and 5(c) of the Securities Act of 1933[5]. Without admitting or denying the Commission’s findings, Gladius consented to an order in which it agreed to cease and desist from further violations of Section 5, and undertook to return funds to those investors who purchased tokens, to register its tokens as securities under the Securities Exchange Act of 1934, and to file periodic reports with the Commission.

### **No penalty on gladius**

Significantly, the Commission imposed no civil penalty on Gladius. The Commission explained that “the SEC did not impose a penalty because the company self-reported the conduct, agreed to compensate investors and will register the tokens as a class of securities[6]”. According to Robert Cohen, Chief of the SEC’s Cyber Unit, the case “shows the benefit of self-reporting and taking proactive steps to remediate unregistered offerings[7]”.

### **The DAO report of investigation**

The Commission noted in its press release that Gladius’s offering of GLA tokens occurred *after* the Commission had issued its DAO Report of Investigation under Section 21(a) of the Securities Exchange Act of 1934 in July 2017[8]. That report stemmed from an inquiry that the Commission’s Enforcement Division launched into whether a “virtual” organization known as “The DAO” and associated entities and individuals violated federal securities laws with unregistered offers and sales of DAO Tokens in exchange for “Ether,” a virtual currency. In its DAO Report, the Commission warned that ICOs could be securities offerings[9]. When it issued the DAO Report, the Commission stated that “[t]he Report confirms that issuers of distributed ledger or blockchain technology-based securities must register offers and sales of such securities unless a valid exemption applies[10]”.

According to the SEC, the purpose of the DAO Report, which was issued in lieu of filing an enforcement action in the DAO matter, was to “caution the industry and market participants” that the federal securities laws apply to blockchain and distributed ledger technology offerings “regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using US dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology[11]”. In apparent reference to the DAO Report, Mr Cohen commented in announcing the *Gladius* case: “The SEC has been clear that companies must comply with the securities laws when issuing digital tokens that are securities[12]”.

### **Penalties for companies that did not self-report**

The *Gladius* case follows two similar cases instituted by the SEC on November 16, 2018 against companies that conducted unregistered ICOs but, in those cases, the companies did not self-report and were penalized by the Commission. In cases against Paragon Coin and Airfox[13], the SEC charged both companies with violations of Section 5 of the Securities Act and imposed civil penalties of \$250,000[14]. In both cases, the companies commenced their token offerings in or around August 2017, just weeks after the Commission’s DAO Report. Paragon and Airfox raised \$12 and \$15 million, respectively, but did not register their offerings under the federal securities laws or qualify for an exemption from registration. In both cases, the Commission noted that it considered the remedial actions of each company and that the penalties would have been greater but for the “remedial acts undertaken by the Respondent and cooperation afforded the Commission staff[15]”.

## Analysis

The *Gladius* case sends a clear message that self-reporting to the SEC can result in meaningful cooperation credit. While *Gladius* did not avoid an enforcement action, it did avoid a civil penalty. In the *Paragon* and *Airfox* cases, while both companies received credit for taking remedial actions and cooperating with the staff, neither company self-reported and both companies paid civil penalties. When taken together with the DAO Report and the enforcement actions against *Paragon* and *Airfox*, the case against *Gladius* offers important insight into how the SEC and its staff think about cooperation credit in resolving SEC enforcement actions. The Commission clearly intended that its DAO Report be a warning to ICO sponsors that the failure to register an offering of tokens could result in enforcement action. Through all three post-DAO cases, the Commission made clear that once it put the industry on notice that ICOs could be securities that must be registered under the federal securities laws, a party would risk enforcement action by failing to do so. In *Gladius*, the company was able to avoid a civil penalty by self-reporting its failure to register its ICO, by offering the staff meaningful cooperation and by agreeing to undertake significant remedial actions. While the SEC has emphasized self-reporting, cooperation, and remediation in the past, the *Gladius* case is one of the strongest messages sent by the current SEC regime in connection with an enforcement action – and it remains to be seen whether similar settlements will follow.

## Notes

1. "Company Settles Unregistered ICO Charges After Self-Reporting to the SEC," Rel. No. 2019-15 (Feb. 20, 2019).
2. *In the Matter of Gladius Network LLC*, Sec. Act Rel. No 10608 (Feb. 20, 2019).
3. *In the Matter of Gladius Network LLC*, Sec. Act Rel. No 10608 (Feb. 20, 2019) at 6.
4. *In the Matter of Gladius Network LLC*, Sec. Act Rel. No 10608 (Feb. 20, 2019) at 2.
5. *In the Matter of Gladius Network LLC*, Sec. Act Rel. No 10608 (Feb. 20, 2019) at 6.
6. *Gladius* Press Release.
7. *Gladius* Press Release.
8. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Exchange Act Rel. 81207 (July 25, 2017) (DAO Report).
9. DAO Report at 11.
10. Press Release, "SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities," Rel. No. 2017-131 (July 25, 2017).
11. Press Release, "SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities," Rel. No. 2017-131 (July 25, 2017).
12. *Gladius* Press Release.
13. *In the Matter of Paragon Coin, Inc.*, Securities Act Rel. No. 10574 (November 16, 2018)(*Paragon* Order).
14. *In the Matter of Carrireq, Inc. D/B/A Airfox*, Securities Act Rel. No. 10575 (November 16, 2018) (*Airfox* Order).
15. *Paragon* Order at 9-10; *Airfox* Order at 8.

## Corresponding author

Daniel Hawke can be contacted at: [daniel.hawke@arnoldporter.com](mailto:daniel.hawke@arnoldporter.com)

---

For instructions on how to order reprints of this article, please visit our website:  
[www.emeraldgroupublishing.com/licensing/reprints.htm](http://www.emeraldgroupublishing.com/licensing/reprints.htm)  
Or contact us for further details: [permissions@emeraldinsight.com](mailto:permissions@emeraldinsight.com)