

SEC FORM 10

Overview & Filing Timeline

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CURRENT ENVIRONMENT

With the SEC's settlements with CarrierEQ (aka Airfox) and Paragon in November of 2018, it is apparent an Initial Coin Offerings ("ICO") could be subject to SEC compliance or enforcement. While neither Airfox nor Paragon settled with the SEC under the supposition of guilt, the presumption by many in the industry is that many tokens sold in the previous few years as part of an ICO were sold and have been trading as "unregistered securities," violating the Securities Act of 1933 and Exchange Act of 1934.

More specifically, many companies using an Initial Coin Offering as a funding mechanism failed to:

- File a registration statement containing information about itself, the securities it is offering, and the offering itself (Securities Act of 1933) or qualify the offering for an appropriate exemption from registration.¹
- Have an effective registration statement or meet certain thresholds to report information regularly about business operations, financial condition, and management (Exchange Act of 1934).¹

Luckily for ICO Token Issuers, the SEC seems willing to forego enforcement action in certain circumstances and settle with a issuers...for a price.

Particularly in the case of AirFox and Paragon, settlement terms included the following²:

- Paying a \$250,000 fine
- Publicly offering a reimbursement claim to ICO participants (also known as a "rescission offer")
- File a General Registration Statement on Form 10 with the SEC within 90 days (and maintain status for at least 1 year)

The terms of the settlements of Airfox and Paragon will leave management teams with a difficult set of options to choose from. The Form 10 filing for Airfox shows the company to have received a "Going Concern" audit opinion. This means the auditor has doubt over the company's ability to continue to do business in the future. When looking at the audited financial statements, you see that Airfox had to include the rescission offer on their books as a current liability. This liability is for the entire ICO amount raised, as at time of audit it was uncertain how many investors will take advantage of the ability to be reimbursed. This has left the company in a position of potential insolvency, and leaves the auditor with no other choice but to issue a going concern opinion.⁶

While the overall settlement terms have been perceived as harsh by some and mild by others, both camps seem to underestimate the settlement term related to the Filing of a Form 10, essentially "going public" without an IPO.

This filing requirement brings up a set of questions that all ICO issuers should be aware of.

FILING A FORM 10

What is a Form 10?

The SEC Form 10 is a “General Form” for registering securities. Filing a Form 10 enables the securities to have the potential for trading. Unlike an S-1, a Form 10 filing does not register previously restricted securities as unrestricted. Issuers must also have securities approved by Financial Industry Regulatory Authority (FINRA) and rules of the secondary trading exchange platform.⁴

Why is the SEC choosing the Form 10 as a vehicle towards compliance?

The Form 10 paves a way for a “Direct Listing” of trading securities, using a different vehicle than other well-known registration tools (i.e. traditional IPO, Reg A/D exemptions). A distinct difference between a Form 10 filing and other filing mechanisms, is that a Form 10 does not propagate the issuance of new shares to the public. Since tokens were distributed before a “traditional” offering for many token issuers, the Form 10 is the most direct path to compliance using existing securities frameworks. With the changes in the Securities Act Rule 144 in February of 2009, a Form 10 registration has become an avenue for previously non-reporting entities. In fact, Item 10 on the Form 10 itself calls to entities whom specifically issued sales of unregistered securities.³

Who has to file a Form 10?

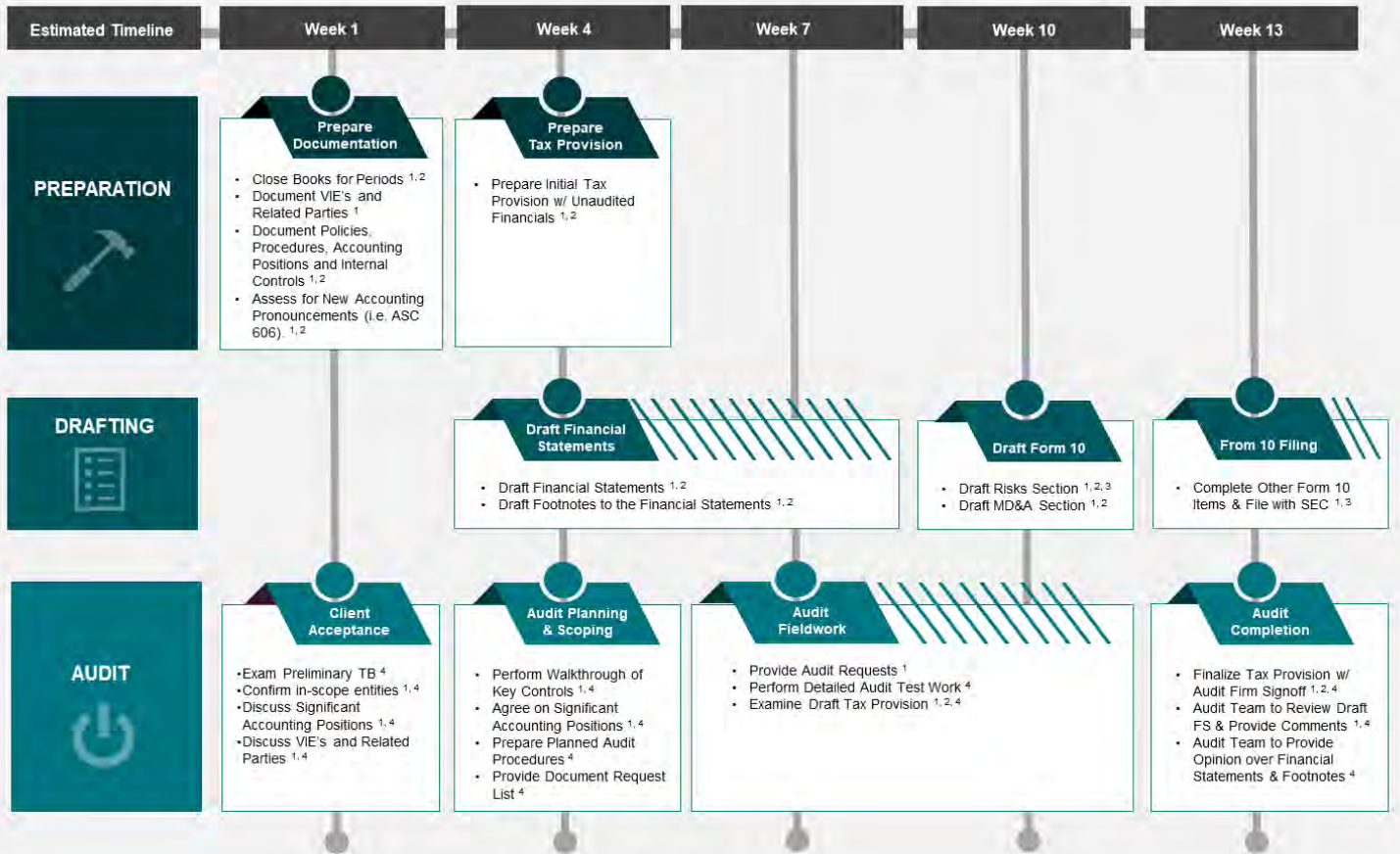
Issuers are required to file a Form 10 when the issuer has greater than \$10,000,000 in total assets and 750+ shareholders.⁴

What are the compliance requirements of a Form 10?

Initial filing requires completion of 15 key items (as outlined by the Form 10), including disclosing (1) Business Information, (2) Financial Information, (5) Director and Executive Officer details, (7) Related Parties, (10) Previous Sales of Unregistered Securities & a set of audited (13/15) Financial Statements.³

Upon filing the Form 10, the issuer is subject to providing an audited annual financial statement filing (10-K), audited quarterly filings (10-Q)⁴, 8-K filings for relevant events (such as Entry/Termination of Material Agreement, Bankruptcy, etc.)⁷, and Proxy Statements (i.e. BOD member proposals and other key areas of corporate governance).

FORM 10 AUDIT & FILING TIMELINE



Contributing Parties | (1) Management | (2) Consultants | (3) Legal Counsel | (4) Auditors

AUDIT CHALLENGES FOR TOKEN ISSUERS

There are many challenges for token issuers when getting and staying compliant with the public registration requirements. One of the most difficult tasks is preparing, drafting, and having audited financial statements, and providing them on a quarterly and annual basis thereafter. In the case of Paragon and Airfox, this requirement was fulfilled (albeit with a subsequently SEC-granted 30 day extension).

In addition to the timing constraints, there are many common challenges token issuers face when preparing for a financial statement audit and drafting financial statements, such as:

- Lack of appropriate documentation to support evidence tested during the audit period (uniquely for token issuers, keeping old private keys and exchange credentials are crucial). Other considerations are included within a whitepaper on auditing digital assets.
- Under or undocumented accounting policies, processes, and accounting stances related to key areas that affect financial statements and disclosures.
- Custom-built or inadequate systems that do not provide the appropriate level of data needed for audit purposes.
- Inadequate funding, especially considering the price movement in ETH (and other currencies) in the markets in the past year. This may be amplified if the SEC allows the rescission and returning of funds to ICO participants.
- Under-resourced internal accounting teams may lack experience and bench strength to take the company through a financial statement audit.

While the requirements and potential timeline of filing a Form 10 (and ongoing compliance) are daunting, the right mix of crypto-savvy management team members, 3rd-Party consultants, legal counsel, auditors can successfully navigate the challenges effectively.

If your team is already in talks with the SEC regarding a potential settlement, there are steps to be taken now to ensure the process of achieving compliance is as smooth as possible. This includes aligning your consulting, legal, and auditing resources early on to ensure each function is comfortable and ready to complete the requirements in the appropriate timeline. We will focus on an audit timeline for the purposes of this article, but legal counsel and other items should be considered concurrently.

AUDIT CADENCE & EXPECTATIONS

Before the Settlement Date

Importantly, Paragon and Airfox's compliance requirement deadlines were set 90 days after the settlement date. Initial contact occurred months in advance. Preparing a fully auditable accounting environment and performing the audit in the same 90 day timeframe can be daunting, so preparing as much documentation possible prior to the settlement is advisable. Management may want to consider bringing in outside consultants as necessary to close the books, document policies, document procedures and controls, and document relevant accounting policies and positions.

If dealing with the SEC, presumably legal counsel has been leveraged during the process. However, even if not directly contacted by the SEC, counsel should be advised during the Form 10 filing process. Before the settlement date, management should also screen, hire, scope and plan with an external audit firm to initialize the audit once the books have been prepared and/or the settlement has been finalized.

After the Settlement Date

Management (with the help of consultants) should begin drafting the financial statements, and Form 10 filing statement. Concurrently, auditors will finalize the planning stages of audit, have walkthroughs with management, and begin fieldwork. Management and the auditors will work in tandem drafting the Financial Statements, Tax Provision and providing comments. As the financial statements are completed, the auditor will provide an opinion over the financial statements and review the Form 10.

Timeline

If the process is methodically planned, finalizing the financial statements and filing the Form 10 within the 90-day deadline achievable. For further details see timeline infographic on page 3.

Cost

Pricing, especially when auditing token issuers and digital assets, varies wildly depending on a multitude of factors. These include audit preparation of the issuer, crypto wallet structures (and number) used, potential custodial accounts (on behalf of customers), reporting integrity (due to many homegrown company-created platforms), and overall volume and complexity of transactions. Engaging early in the process is key to keeping costs down.

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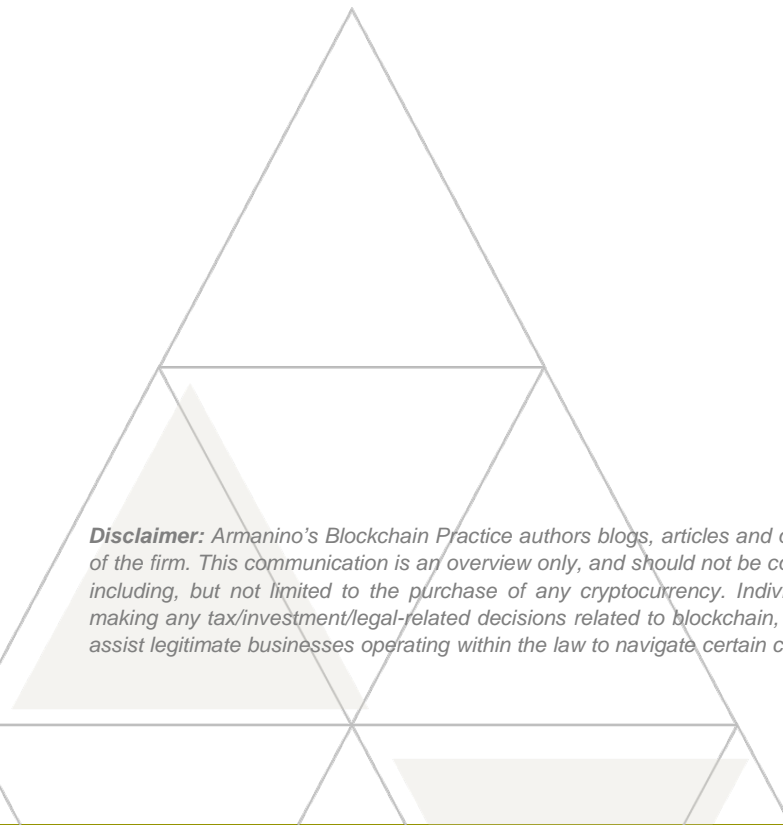
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For additional info on SEC Form 10, contact:

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