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SECURITIES OFFERINGS

The Wild West of ICOs: What Investors Need to Know

BY JENNIFER E. KREIN AND CARLY A. KESSLER

Over the last two years, initial coin offerings (''ICOs'') have skyrocketed. During 2017, funds raised through ICOs exceeded $4 billion, around 40 times the $100 million raised in 2016. The third quarter of 2017 alone had 105 ICOs raising over $1.32 billion. ICOs are incredibly attractive because they are an alternative way to raise capital outside of traditional markets, without the need to sell stock or pitch venture capitalists, essentially functioning as a cross between an IPO and a crowdfunding campaign. However, while IPOs and crowdfunding are regulated to protect investors, ICOs are swirling in an evolving grey area. This creates risk for investors who may be vulnerable to scammers, and uncertainty for entities raising funds through ICOs as to whether they need to follow securities laws. The result is a wild west of virtual investments without a clear sheriff in town.

Jennifer E. Krein is a financial markets litigation specialist at Robins Kaplan LLP focusing on securities fraud and misrepresentation, market manipulation, and structured finance. She is based in the firm's Minneapolis office and can be reached at JKrein@RobinsKaplan.com.

Carly A. Kessler is an associate in Robins Kaplan LLP's New York office practicing primarily in business litigation, and can be reached at CKessler@RobinsKaplan.com.

Cryptocurrencies & ICOs

Cryptocurrencies like Bitcoin and Ether function as decentralized currencies that represent digital funds. Users transact directly with each other, and transactions are verified by other users on a Blockchain, which operates as a distributed ledger. The appeal of a decentralized network is that governance and economic value is dispersed among the network's stakeholders, as opposed to being controlled by centralized authorities or entities. For ICOs, cryptocurrencies are used in fundraising events, where participants pay an issuer digital funds in exchange for a unique coin or token that represents an eventual share of assets, rights to profits, and voting rights similar to traditional securities, or, simply the right to use particular products or services.

In a similar vein to offering documents of IPOs, ICOs frequently release a whitepaper describing the project, the purpose, and the terms of the ICO. However, the information found in a whitepaper is much more general in nature, and is not subject to the stringent requirements of various securities laws. Those interested in ICOs can read through a number of whitepapers before deciding whether to participate in a particular ICO.

Once an ICO is chosen, participants transfer digital funds to the issuer's address, online wallet, or other digital account. Upon the completion of the ICO, the issuer distributes its coins or tokens to the participant's individual address on the Blockchain. While cryptocurrencies and Blockchain function as decentralized systems, they are not immune to centralized governmental rules and regulations.

The SEC's Application of the Howey Test to ICOs

To be offered and sold in the U.S., all securities must be registered with the Securities & Exchange Commission (''SEC''), or must qualify for an exemption from the registration requirements. Both the Securities Act of 1933 and the Securities Exchange Act of 1934 provide definitions of what constitutes a ''security,'' with courts interpreting the term broadly to allow for a variety of different investment vehicles. The crux of whether an issuance qualifies as a security depends on the underlying characteristics of what is being offered. In the case of ICOs, this principles-based approach doesn't necessarily provide a bright line, so the key is to figure out the characteristics that will cause an ICO to involve a security.

In July of 2017, the SEC provided some clarity on this issue in a non-enforcement report following an ''attack'' that diverted around a third of the funds raised in an ICO. In 2016, Slock.it created The DAO, a venture fund and Decentralized Autonomous Organization based on Ether, and raised around $150 million in an ICO. The purpose of the fundraising was to create assets through the sale of DAO tokens, which would fund various projects. Depending on the success of different projects, participants would share in the earnings as a return on their investment. Shortly after the close of the ICO, and before project funding began, a hacker capitalized on a defect in The DAO's code, and rapidly steered around $60 million worth of Ether from The DAO to the hacker's Blockchain address.

The saving grace was a portion of The DAO's code that prevented the hacker from moving the diverted funds for 27 days. This gave Slock.it and its co-founders the opportunity to endorse a ''Hard Fork'' to The DAO's Blockchain, changing the protocol to transfer all the funds raised, including the stolen funds, to a recovery address. This transfer essentially made it as though the ''attack'' never occurred, and the participants that adopted the new protocol avoided any loss of their investment. Following the SEC's investigation, the agency analyzed whether the DAO Tokens were ''securities'' for purposes of U.S. securities laws, utilizing Section 2(a)(1) of the Securities Act, Section 3(a)(10) of the Securities Exchange Act, and the widely accepted *Howey* test for investment contracts.

In *Howey*, the Supreme Court of the United States held that a security is found if it is ''1. an investment of money 2. in a common enterprise 3. with a reasonable expectation of profits 4. to be derived from the entrepreneurial or managerial efforts of others'' *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The ''investment of money has long been recognized to encompass forms of consideration beyond cash, including goods and services, or other exchanges of value.'' *Isleton v. Comm. Lovelace Motor Freight, Inc.*, 940 F. 2d 564, 574 (10th Cir. 1991). Because investors in The DAO used Ether to make their investments in exchange for DAO Tokens, the SEC found that there was an investment of ''money.''

The agency also determined that elements two and three were met because DAO Token holders pooled their funds and collectively voted on which projects should be funded in a common enterprise, and, had a reasonable expectation of profits since The DAO was a for-profit entity created to fund projects in exchange for a return on investment, with token holders sharing in the profits from various contracts.

The final prong centered on an analysis of whether the ''efforts of others'' outside of the token holders, were ''undeniably significant ones,'' and such essential managerial efforts that ''failure or success of the enterprise'' would be affected *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F. 2d 476, 482 (9th Cir. 1973). As a part of The DAO's protocols, Curators were chosen to vet contractors, determine which proposals would be presented for a vote, determine the order and frequency of those proposals, and, whether they could drastically reduce the default quorum required for a successful vote. While DAO Token holders had voting rights and could put forth proposals, the Curators were given extensive and subjective control over the proposal and voting process, an essential part of the success or failure of The DAO.

Given the pseudonymity and dispersion of the investors, it was difficult for them to ''band together, effect change, or exercise meaningful control.'' These circumstances paired with the fact that DAO Token holders depended on Slock.it, its founders, and the Curators to provide managerial efforts to monitor operations, protocols, and protect investor funds, created a situation that satisfied the ''efforts of others'' element.

Meeting all four prongs of the *Howey* test, the SEC determined that the DAO Tokens were securities under federal securities laws. The agency's position affirms the application of the *Howey* test to new market technologies.

Increased Regulator Scrutiny

Financial regulators and watchdogs across the globe are increasingly placing ICOs under careful scrutiny. In the U.S., the SEC and CFTC are at the helm of the charge. Following the July report on The DAO, on September 25, 2017, the SEC announced the creation of an internal Cyber Unit that will focus on cyber-related misconduct, including exploring violations involving distributed leger technology and ICOs.

Recent comments by SEC Chairman Jay Clayton echo the agency's dedication to the ICO space, but warn that although most ICOs have the ''sufficient number of hallmarks'' of securities, that online platforms listing and trading virtual coins or tokens in ICOs are vulnerable to manipulation and other ''fraudulent practices by ICO insiders, management and better-informed traders.'' On October 17, 2017, the CFTC announced that digital tokens used in ICOs could be considered commodities. This follows a 2015 determination that Bitcoin and other virtual currencies are encompassed in the definition of, and are properly defined as commodities *In re Coinflip, Inc. d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29 (September 17, 2015).

Like the SEC's approach, the CFTC stated that the analysis of whether a token is a commodity will be decided on a case-by-case basis, to see if oversight of an ICO is warranted. Other governments are also addressing the sharp rise and danger of ICOs. The European

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Securities and Markets Authority (''ESMA'') recently stated that ICOs are very risky and speculative investments with extreme price volatility, and, are susceptible to fraud and money laundering. The ESMA also warned that investors could lose all of their invested capital, and, depending on the structure, ICOs could fall outside of the scope and protection of EU laws and regulations. Even Russian authorities have a plan to regulate ICOs, but have promised to not let regulations kill innovation.

Some countries have gone as far as a complete ban on all ICOs. China outlawed them in September of 2017 as ''unauthorized and illegal'' financing activities that involve financial crimes like the ''illegal distribution of financial tokens, the illegal issuance of securities, illegal fundraising, financial fraud,'' and, pyramid schemes. Shortly after China's announcement, South Korea followed suit.

U.S. Scams & Current Litigation

The potential risk and cost of issuing coins or tokens in an ICO, which are later deemed to be securities, is incredibly high. The repercussions can include federal and state enforcement actions resulting in monetary penalties, criminal sentences, and, private plaintiff litigation. So far, three types of actions regarding ICOs have commenced. An enforcement action and a criminal case were filed following an ICO scam, class action lawsuits keep piling up, and, the SEC's new Cyber Unit filed its first enforcement action for an ICO.

On September 29, 2017, the SEC charged Maksim Zaslavskiy and two of his companies with defrauding investors and selling unregistered securities in a pair of ICOs supposedly backed by investments in real estate (REcoin Group Foundation), and diamonds (DRC World) *SEC v. REcoin Group Foundation, LLC DRC World, Inc., a/k/a/ Diamond Reserve Club, and Maksim Zaslavskiy*, September 29, 2017. The ICOs were marketed to investors to generate returns based on the increased value of the underlying assets, the appreciation in value and demand of the tokens as the companies grew. Zaslavskiy also misled investors by telling them that a ''team of lawyers, professionals, brokers and accountants'' were investing the ICO proceeds in these ventures.

The Complaint alleges that in fact, there were no underlying assets, and, the purported ''team of professionals'' was never consulted or hired. Following the SEC action, the DOJ filed a criminal case against Zaslavskiy on October 27, 2017, charging him with securities fraud conspiracy in connection with ''engaging in illegal unregistered securities offerings, fraudulent conduct, and, misstatements designed to deceive investors,'' as a part of the two ICOs *U.S. v. Zaslavskiy*, October 27, 2017, E.D.N.Y. 17M934.

The second set of actions, which began as managerial disputes, have turned into class action lawsuits in California and Florida. In July of 2017, Tezos conducted an ICO selling over 607 million ''Tezzies'' for about $232 million, which is now valued around $600 million. The California state court action was filed on October 25, 2017 alleging that Arthur and Kathleen Brietman, founders of Dynamic Leger Solutions, and the owners of the Tezos code, failed to follow securities laws by not registering the ''Tezzies'' with the SEC, and, lied to investors both regarding how the investor's money would be used, and the timing of when the project would be operational *Andrew Baker v. Dynamic Leger Solutions Inc. et. al.*, CGC-17-562144.

Causes of action include the unauthorized sale of securities and fraud under federal securities laws, in addition to false advertising, unfair competition, and, alter ego liability under California law. The second class action was filed in Florida federal court on November 13, 2017, and similarly alleges the unauthorized sale of securities and fraud in violation of the Securities Act and Florida law, rescission of contract, alter ego liability, and, deceptive and unfair trade practices *Gaviria v. Dynamic Ledge Solutions, Inc.*, 6:17-CV-01959-ORL-40-KRS, M.D. Fla. Since November, other class action lawsuits involving ICOs have been filed.

The third set of actions involve an ICO scam that raised $15 million worth of cryptocurrencies called PlexCoins, from August 2017 to the present. Solicitation materials promised investors returns ranging from 200% to 1,354% in 29 days, touted a non-existent global team of financial and legal professionals, hid the identity of the executives because of previous legal issues, and, stated that the principal place of business was in Singapore rather than Quebec.

Because of the scam, the Financial Markets Administrative Tribunal of Quebec issued ex parte orders banning PlexCorps, PlexCoin, and its creators from all investment activities, advertising, and, solicitation involving Quebec residents. The orders came in July of 2017, ahead of the August launch. The SEC's Cyber Unit then followed by filing its first ICO enforcement action on December 1, 2017 for the same scam against the recidivist Canadian law violators. Primary allegations include the illegal unregistered offer and sale of securities, securities fraud, aiding and abetting, and, misappropriating investor funds.

A Word of Caution for Investors

The sentiment and marketing surrounding the current surge in ICOs is eerily reminiscent of other booms and busts. Once the old adage ''we're all making money because we're all making money'' crops up, serious caution should follow. There's a lot to be said when even the Wolf of Wall Street villain Jordan Belfort, who spent 22 months in prison for financial crimes touts that ICOs are ''the biggest scam ever. . . it's far worse than anything I was ever doing.''

If an ICO involves unregistered securities not subject to an exemption, this opens the door to fraud and fuels deceit from unscrupulous issuers looking to take advantage of unknowing investors. Although securities laws may provide some protections, given that ICOs are still in regulatory limbo, investors need to be vigilant. For the time being, those looking to participate in the new markets should choose ICOs that are already working within existing regulatory frameworks, since they increase legal certainty, decrease risk, and, strengthen investor protections.

One option is purchasing coins or tokens in an ICO as an accredited investor in a private placement under Regulation D. In the alternative, some issuers targeting accredited investors in the U.S. have recently started using the Simple Agreement for Future Tokens (''SAFT'') format, which provides information on how the tokens will eventually be used, and, has investor protections in place in case a project does not come to fruition. It has yet to be seen whether SAFT filings will satisfy the SEC. At the very least, these agreements indicate a willingness of issuers to seek improved regulatory guidelines, and could be an interim middle ground until regulations and case law catch up with technology.

Those not meeting the threshold requirements of an accredited investor can look at ICOs that are structured under Regulation A+, general Crowdfunding, or Regulation S. Additional proactive efforts for participants include ensuring that ownership of the offering organization is identifiable, developers are transparent with their plans and can be easily contacted, there is either an operational platform, or a working product or service, and, ICO funds are stored in an escrow wallet with at least one key ''held by a neutral third party.'' Warning signals involve guaranteed investment returns, gimmicky promises, a lack of details in marketing materials or whitepapers, and, hard sales pitches.

The decentralized and international nature of the market, along with how closely some ICOs resemble securities offerings can create uncertainty. The primary takeaway for ICO participants is to be cognizant of the complexities, and, the potential limitations of legal protections for ICOs.

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