

Dangers of the ICO – Investing in Crypto **A talk with Professor John Morley**

I. ICOs and Cryptocurrency

- A. Cryptocurrency and initial coin offering (ICO) markets have grown rapidly in the past few years, spanning the globe and include a range of participants. ICOs have been seen as an effective way for entrepreneurs to fundraise.
- B. Key terms
 - 1. Cryptocurrency: virtual coins or tokens that are created and disseminated using blockchain technology.
 - 2. Blockchain: electronic distributed ledger that is maintained by various participants in a computer network.
 - 3. ICO: fundraising event using blockchain technology in which a token or coin is offered in return for fiat current or cryptocurrency.
- C. How does a typical ICO proceed
 - 1. ICO sponsors typically release a white paper available online describing the project, including the terms of the ICOs. The white paper includes information that would permit an investor to make an investment decision, its status, key members of the sponsoring organization, and the key terms of the ICO.
 - 2. A participant in the ICO is typically required to transfer cryptocurrency to the designated ICO sponsor. The ICO token is distributed to the participant's designated online wallet. A token entitles the holder to certain rights. ICO tokens typically do not represent an ownership interest in the sponsoring organization.
- D. Cryptocurrency on the securities spectrum
 - 1. Virtual currencies like bitcoin and ether are not securities. They may act as a substitute for legal or fiat currency. They are not issued by a particular sponsor or company. The SEC considers bitcoin to be a commodity or a digital asset.
 - 2. Utility tokens vary in structure. They represent some future access to a company's product or service and do not confer ownership rights.
 - a. Most of the utility tokens offered to date may actually qualify as a security under the securities laws.
 - 3. Security tokens are backed by an external asset and grant ownership rights to the purchaser.

II. ICOs and Securities Laws

- A. An issuance of securities would require compliance with the federal rules, including registering with the SEC or would otherwise have to qualify for an exemption.

B. SEC v. W.J. Howey Co.¹

1. W.J. Howey Co. offered real estate contracts for the development of orange groves. Under the arrangement, buyers would buy the land and lease it back to the company, which would operate the citrus farm on the land.
2. The Supreme Court ruled that the sale-leaseback agreement was an investment contract constituting the sale of a security. The Court created a 4 prong test for determining whether a transaction involves a sale of a security:
 - a. There is an investment of money
 - b. In a common enterprise
 - c. From which an expectation of profits from the investment arise
 - d. Garnered from the efforts of a third party and largely outside the investor's control.

C. The DAO Report

1. In 2017, "The DAO" (Decentralized Autonomous Organization) launched an ICO in which it issued over 1.15 billion DAO tokens in exchange for about 12 million ether.
 - a. The ICO was marketed to investors in various ways, including on a website where the tokens could be purchased.
 - b. During the offering period, the co-founders marketed and widely publicized the ICO as being similar to buying shares in a company and getting dividends and that participants would receive some voting and ownership rights. They also promised that the DAO would be traded on the secondary market.
 - c. Purchasers were not limited to accredited investors.
 - d. Essentially, the DAO would function like a venture capital fund in that the DAO would have "curators" who would identify investment opportunities.
2. The SEC determined that the DAO had violated securities regulations for its unregistered offering of securities.² It did not pursue enforcement actions but issued the DAO report outlining its determinations.
 - a. Applying the *Howey* standard, the SEC determined that the DAO had engaged in a sale of securities because: the purchasers' ether payments in exchange for tokens was an investment of money; purchasers were investing in a common enterprise; purchasers had a reasonable expectation of profits; and any profits earned were derived from the efforts of the "curators" or the DAO.

¹ 328 U.S. 293 (1946): <https://www.law.cornell.edu/supremecourt/text/328/293>

² Release No. 81207 / July 25, 2017. Report of Investigation Pursuant to Section 21(a) of the

² Release No. 81207 / July 25, 2017. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO: <https://www.sec.gov/litigation/investreport/34-81207.pdf>

- b. The SEC stated that tokens, coin, and other digital assets issued on blockchain may be securities under the securities law and must be registered or otherwise qualify for an exemption from registration.
- D. The SEC looks at function over form.
1. Under Section 2(a)(1) of the Securities Act, a security includes “an investment contract.”³ As *Howey* laid out, an investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.
 2. Section 5(a) and (c) of the Securities Act requires offers and sales of securities to be registered with the SEC unless it qualifies for an exemption from registration.
 3. Registration requirements are in place to protect investors and provide them with material information to make informed investment decisions.
- E. Typically, the SEC has initiated enforcement actions on the most egregious bad actors. E.g. PlexCorps:
1. PlexCorps raised \$15 million from tens of thousands of investors on the issuance of PlexCoins. In its white paper, it promised profits of over 1000% in less than a month and that the proceeds would be used to develop other products. It also obfuscated who was on its management team, alleging that it consisted of “experts” from around the world with its principal base of business in Singapore but that their identities had to be kept hidden for concerns over privacy and poaching by competitors. Dominic Lacroix, PlexCorp founder, is alleged to have misappropriated the funds and used them for his home improvement and lavish spending. The team was comprised only of Lacroix and his employees and was based on Quebec. Lacroix was a known securities violator in Canada.
 2. The SEC filed a complaint against PlexCorps for securities fraud and the unlawful sale of securities.⁴ The Court granted a preliminary injunction and asset freeze.
- F. Regulatory challenges
1. Since no ICO has been registered with the SEC, there is substantially less investor protection in ICOs than in traditional securities. Potentially greater opportunities for fraud.
 2. ICO markets span borders and transactions can occur quickly which amplify risks to investors.
 3. Law enforcement may face challenges in tracing money or obtaining info from overseas entities.

³ 15 U.S.C. § 77b

⁴ SEC v. PlexCorps et al., 17-cv-7007: <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-219.pdf>