Initial Coin Offerings: Consumer Implications & Considerations

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# Table of Contents

Abstract ............................................................................................................................................. 3  

Background ......................................................................................................................................... 1  
   What is an Initial Coin Offering? ...................................................................................................... 1  
   History of ICOs .................................................................................................................................. 3  
   IPO v. ICO: What is the difference .................................................................................................... 5  

Risks of Investing in an ICO ................................................................................................................ 7  
   Exploits, Hacks, and Social Engineering ............................................................................................ 7  
   ICO Fraud ........................................................................................................................................ 8  
   Lack of value .................................................................................................................................... 10  
   Volatility ......................................................................................................................................... 12  

ICO Regulations ................................................................................................................................... 14  
   Securities v. Commodities ................................................................................................................ 14  
   Regulatory Requirements .................................................................................................................. 15  
      Cryptocurrencies .......................................................................................................................... 15  
      Utility Token .................................................................................................................................. 16  
      Securities Token ............................................................................................................................ 17  
   Regulator Response .......................................................................................................................... 19  

What to Consider as a prospective Investor ....................................................................................... 21  
   What is the value of this token? ......................................................................................................... 21  
   Who am I buying this token from? .................................................................................................... 21  
   Can I afford to lose my investment? .................................................................................................. 21  
   What is the structure of this ICO and is it legal? ............................................................................... 21  
   Are there alternative investments better suited for my needs? ......................................................... 22  

Appendices ......................................................................................................................................... 23  
   Appendix A: Guidance from the Federal Trade Commission (FTC)............................................... 23  
   Appendix B: Guidance from the Securities and Exchange Commission (SEC).............................. 24  
   Appendix C: Securities and Exchange Commission (SEC) ICO Investor Alert ................................ 27  
   Appendix D: Securities and Exchange Commission (SEC) Statement on ICOs .............................. 33
ABSTRACT

In recent years initial coin offerings (ICOs) have become an increasingly popular mechanism for raising capital for cryptocurrency and blockchain-based projects. This influx of capital into new, untested financial products represents an opportunity for non-traditional investors, but may also pose significant risk of financial harm to novice investors. This paper provides background information on the origins and proliferation of ICOs, explains the risks involved with investing in ICOs, and details a number of considerations potential investors ought to contemplate before committing their resources to a new ICO-funded project. An assessment of this market indicates that investors should be extremely cautious when considering investing in an ICO and should, at the very least, possess a fundamental understanding of what cryptocurrency is and how it derives its value, as well as what risks are inherent to cryptocurrencies and what external factors exacerbate this risk.
BACKGROUND

What is an Initial Coin Offering?

An initial coin offering (ICO) is a fundraising mechanism a company can use to fund the development or release of a new cryptocurrency or cryptocurrency-backed project. An ICO provides non-institutional investors the ability to buy new cryptocurrencies, known as tokens, when startup ventures, first release them to the public to raise capital. An ICO is often compared to an initial public offering (IPO), where a company or project seeks funds from investors to kick-start a business in exchange for a share or ownership stake in the company. In a traditional IPO, the share’s value is based on the company’s valuation or “market capitalization” (i.e., the market value of the firm’s equity). The tokens issued in an IPO, however, do not necessarily derive their value from the issuing company’s valuation. Because ICO token sales are not (yet) beholden to all the same rigorous regulations as the shares issued in IPOs, these tokens can derive value from many factors, ranging from intrinsic utility to scarcity and “faith” (not unlike fiat currencies) to the wisdom or foolishness of the crowd. In the U.S., most of the tokens sold in legal ICOs derive their value from a specific use case of the token, such as a way to purchase data storage, or the expected value of the issuing company’s future projects. Given the abstract and complex nature of cryptocurrency tokens, it’s difficult to accurately measure the utility or determine the value of any individual token, particularly if it is not directly derived from a company or project’s valuation.

The first ICO occurred in 20131, and the prevalence of this token-backed “crowdfunding” mechanism has proliferated in the cryptocurrency and blockchain technology space, raising five times as much capital in 2017 than that raised through traditional venture capital2 in the same time frame.

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An ICO offering takes two primary forms:\(^3\):

1. **Capped ICOS:** In a capped ICO, the token-issuing venture sets a limit on the sale of new tokens in order to raise a predetermined amount of capital. The company will establish a price point for tokens and sell the tokens on a first come, first serve basis, or with a limit per individual buyer. Token sales cease once the ICO achieves the predetermined funding goal. If the campaign does not reach its goal, the venture returns the funds raised through the ICO. ICOs with low caps may exclude individual investors from participating in the primary market, which some consider an unfair and exclusionary practice. Capped ICOs are generally considered “safer” than uncapped. A predetermined project budget can serve as an indicator that the project exists for purposes beyond simply raising money.

2. **Uncapped ICOS:** In an uncapped ICO, there is no predetermined token price or limit on the quantity of tokens the venture may offer for sale. The ICO platform sells tokens to the highest bidder in order to maximize the amount of capital raised for the venture. ICOs conclude, either, when a company raises what it deems to be enough capital, after a pre-determined amount of time, or after the sale of a pre-determined number of tokens. Uncapped ICOs receive criticism arguing that they are a cash grab. In an uncapped ICO the amount of capital required to for the project is not considered, rather the venture uses an ICO to raise as much money as possible. Many argue that providing a new venture too much funding reduces incentives to work on the project and can decrease likelihood for success\(^4\).

There are numerous variations on these basic types of offerings, such as auctions, reverse auctions, sales to only accredited investors, and many more.\(^5\) The cryptocurrency venture’s whitepaper contains the specific details of the project, such as the structure of the ICO (i.e., whether the token price or quantity are fixed), the factors expected to influence the token’s volatility, the extent of the cryptocurrency’s decentralization (i.e. whether it relies on mining, client, developer, exchange, node, or owner subsystem decentralization\(^6\)), and so on. Investors should employ the utmost scrutiny


when considering ICOs that are structured to raise as much capital as possible. ICO whitepapers that fail to specify how much capital is necessary to successfully launch the project may indicate a money grab, where founders intend to exploit the capital raised in the name of a project without regard for whether or not the project succeeds. ICOs that indicate specific, reasonable funding goals, which are clearly tied to specified project goals, will likely face less price volatility and are less likely to be scams.\(^7\) There is risk in purchasing any asset; however, investors should be highly cautious and conduct their due diligence when buying an unproven asset like a cryptocurrency sold via poorly regulated mechanisms that may attract bad actors\(^8\).

**History of ICOs**

The first ICO occurred in 2013 when Mastercoin raised approximately $5 million\(^9\) to facilitate the creation of its new cryptocurrency. Mastercoin’s innovation was that, rather than forming a new blockchain, it was built on top of the Bitcoin blockchain, enabling the creation of a new coin, while utilizing the security and mining community surrounding Bitcoin\(^10\). Ethereum and Waves replicated the success of Mastercoin by raising $18 million\(^11\) in 2014 and $16 million\(^12\) in 2016. Since then the prevalence of ICOs has exploded, with over 250 ICOs, generating $5 billion in 2017 alone\(^13\). The popularity of ICOs began to slow in late 2017 as the number of new ICOs dipped to 40 in December, down from a high of 100 in October\(^14\). Despite the decline, market saturation has made it increasingly difficult for projects to hit their fundraising targets. In June 2017, when investor interest in ICOs was high but the total number of ICOs was relatively low, 93 percent of projects were funded compared to 23 percent in November 2017 when more ICOs began to crowd the market\(^15\).

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9. The project was paid for with 4,700 bitcoins, which hold a cash equivalent of $5 million.
The ICO model rivals the conventional venture capital model in raising capital for new cryptocurrency projects. In the venture capital model, institutional investors, such as hedge funds, and venture capital firms, raise capital to invest both directly into a cryptocurrency or a cryptocurrency-based company. In 2017, private equity from venture capital represented just over $830 million investment\(^{18}\) into various cryptocurrencies, which is less than a fifth of the investment capital acquired through ICOs. Venture capitalists generally receive high returns through extensive due diligence and research to assess potential risks and rewards before investing, thereby avoiding scams and infeasible projects. In the ICO model, investors are younger, less educated, and less wealthy\(^{19}\) than their investment banker counterparts, which may lead to an increase in the capital raised by fraudulent or poorly planned projects.

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The profit potential of ICOs has drawn numerous investors to this risky market. One of the more successful ICOs, Ethereum, was initially offered in 2014 at 2000 Ether for one bitcoin, or the equivalent $0.25 worth bitcoin at that time\(^2^0\). At its peak price on January 14\(^{th}\), 2018, one Ether could be sold for $1,390\(^2^1\), representing a 4,800 percent return over four years. Promises of high returns and the excitement in the media and throughout the internet surrounding blockchain and cryptocurrencies have contributed to this recent influx of capital into ICOs from non-institutional investors.

**IPO v. ICO: What is the difference**

An IPO and an ICO are similar in that they both seek to raise capital for a project or company. Apart from that they are very different investments regarding regulatory oversight, value, and structure\(^2^2\):

<table>
<thead>
<tr>
<th>Regulatory Oversight</th>
<th>Initial Public Offering (IPO)</th>
<th>Initial Coin Offering (ICO)</th>
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<tbody>
<tr>
<td></td>
<td>In an IPO, a company is legally required to submit a legal document called a prospectus before issuing shares for public sale. Investors expect this document to contain a certain level of transparency and to provide essential information about the company, such as potential risks, financial information, and the details of the IPO. The Securities and Exchange Commission (SEC) must also approve an IPO based on past performance, financial statement audits, and minimum earnings. These requirements serve to prevent fraud as well as small, likely to fail companies from scamming investors out of their money.</td>
<td>The regulatory framework surrounding ICOs is poorly defined and poorly enforced compared to the framework for IPOs. ICOs typically include a whitepaper that outlines the project and the structure of the ICO, but there is no clear regulatory requirement for what information such whitepapers must contain. Unlike IPOs, the majority of ICOs have no financial track record and only offer a whitepaper, or at best a working prototype of the project, as the basis for the venture’s potential value. The lack of a “track record” makes ICOs exceptionally risky, since all information about the project is inherently speculative and based on an idea rather than evidence.</td>
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**Initial Public Offering (IPO)**

Stocks purchased through an IPO represent tangible ownership of part of the company. Certain types of stock allow investors to vote in shareholders meetings on the future of the company and its leadership team. Investors are also entitled to a specific stake of the company’s profits in the form of dividends.

**Structure**

The SEC approval process for an IPO takes 90-180 days and requires significant legal and capital investment for a firm to set up. A typical IPO involves the sale of underwritten securities by investment banks to accredited investors. To qualify as an accredited investor one must have either a sufficiently high income (>$200,000 per year), sufficient assets (>$5,000,000), or is a professional in the field in which they are investing.

These requirements create investment barriers for the average individual under a banner of preventing unqualified investors from losing money on poor investments. Individual investors who do not meet these requirements must wait until the IPO is over, and then buy the security on the private market after the price may have risen.

**Initial Coin Offering (ICO)**

In an ICO, there is usually no promise of ownership. The ICO is merely the purchase of tokens, which may or may not appreciate in the future once the project goes live. The stated value of a token depends on the individual project the token is linked to and the expectations surrounding whether the token will either gain value as a currency or has (or will have) some specific utility in the present (or future).

Ventures can set up ICOs quickly and can sell tokens to anyone. Open access is usually touted as the most prominent advantage of an ICO over an IPO. It allows for a more substantial number of potential investors and is more "egalitarian". Because ICOs have no participation threshold requirements, inexperienced non-professional investors who lack sufficient investing knowledge may prop up many ICO-funded ventures that would otherwise not draw funding from accredited investors.

This model has gained much criticism from the Securities and Exchange Commission (SEC), as it allows non-accredited investors to participate in the sale of cryptocurrency tokens that behave like securities, which may be in violation of U.S. securities law. The SEC has argued that such tokens constitute the illegal sale of an unregistered security and has taken enforcement action in the past. To circumvent this “roadblock,” many ICO-backed ventures will not sell cryptocurrency tokens in the United States.
RISKS OF INVESTING IN AN ICO

Exploits, Hacks, and Social Engineering

The ICO market lacks a significant regulatory structure, operates via systems of pseudo-anonymous transactions between both token holders and token issuers, and due to the nature of blockchain, has irreversible token transfers, making it a prime target for phishing scams and hacking\(^23\). As of December 2017, investors into ICOs have lost 10 percent of all proceeds due to some form of hacking\(^24\).

Hacking in the ICO marketplace occurs primarily through “phishing” attacks, where hackers impersonate genuine ICO-backed ventures, substituting their Bitcoin or Ethereum wallet addresses for those of the valid ICOs so that token purchases are paid to the hackers instead of the hosts of the ICO.

One such example is the hack of Bee Token, an ICO-funded venture that intended to create a decentralized short-term rental service similar to AirBnB. Hackers sent a fake\(^25\) email to subscribers on the Bee Token mailing list telling them to invest immediately to capitalize on a bonus deal Bee Token was supposedly running because of a deal with Microsoft that was also fake. Investors collectively lost more than $833,000 due to this scam\(^26\).

The most well-known case of an ICO exploit occurred with a new token that intended to create a better, more organized method for the creation of “smart contracts” known as the Decentralized Autonomous Organization (DAO) on the Ethereum blockchain. In April 2016, the DAO successfully raised $150 million during its ICO. Months later, in June 2017, a hacker managed to exploit a known bug within the DAO source code, allowing him to drain $50 million worth of Ethereum from the DAO. There have been several proposals for how to recover the lost Ether, such as rolling back the transaction or locking the funds in the destination wallet, but so far, the Ethereum community has not come to

\(^23\) Note: Hacking is used here as a broad term to cover all exploits, social engineering, and other methods to transfer take wealth from one individual and give it to another without their knowledge or consent.


consensus on any potential remedy for those who lost funds in the exploit. The DAO requires consensus among 51 percent of its community to make any changes to its protocol, which means investors affected by the exploit may be out of luck.\(^27\)

Investors should be wary of emails or bulletins from ICOs that cannot be corroborated through a 3rd party source. Scammers can create fake websites and emails that look identical to authentic sites and communications, and once investors send cryptocurrency tokens to scammers, there is little recourse for getting it back. Exploits or hacks are much more difficult to prevent, as they are often result from faulty code or imperfect protocols, which unskilled investors cannot verify themselves. With newer, untested projects and ventures, investors should learn about the types of security procedures the project employs, and make sure that they are comfortable with the potential risk of losing their investment through a hack or exploit.

ICO Fraud

There is a growing number of fraudulent ICOs taking the form of “exit scams,” that is, ICOs that advertise a new blockchain project, raise money for it, and then disappear, taking the money despite never making a good faith effort to complete the project. While the tokens purchased in the ICO may exist, they are effectively worthless because the project from which they would have derived value will never come to fruition.

It is difficult to provide an accurate or complete estimate of the magnitude of ICO fraud, given that the majority of ICO-funded projects have yet to materialize, mature, or conclude. Furthermore, while abandoned or failed projects attempted in good faith are not fraudulent, they are common in the ICO space and result in investor losses. With limited regulatory red tape and low ICO set-up costs, ICO-funded ventures have little incentive to empirically determine the potential value and feasibility of their projects. This lack of stewardship, coupled with rampant ICO fraud, means that ICO investments are generally riskier than IPO-funded ventures and may result in a loss of investor funds at a higher rate than IPOs.

\(^{27}\) https://www.coindesk.com/understanding-dao-hack-journalists/
An investigative report published by *The Wall Street Journal* on May 17, 2018, identified suspicious or questionable practices in 271 Initial Coin Offerings (ICOs). This represents one-fifth of the 1,450 total offerings that the paper investigated in which investors have put a total of $1 billion.

These red flags included ICOs with teams composed of people with fake names and with photos pulled from stock photo websites or from other sources, 111 white papers that copied sections word-for-word from other projects, 121 projects that didn’t name any employees or staff members, and 24 offerings that promised reward without risk—a practice the SEC forbids. *The Wall Street Journal* reported that investors have lost up to $273 million from the projects examined.

There are also several examples of blatant scams that have defrauded investors of millions of dollars.

Confido, a project based on the Ethereum blockchain successfully raised ~$375,000 during its ICO. Confido advertised its venture as a decentralized escrow service for various financial transactions. After a successful ICO in November 2017, the CEO of Confido, Joost Van Doorn, posted a vague statement on the project’s subreddit, stating that the company was facing legal trouble and was sorry for any losses investors faced. After posting that announcement, Confido removed the subreddit, website, project team LinkedIn profiles, and other traces of the company from the Internet and vanished with the investors’ capital.

In the highest value exit scam, Benebit, a project that aimed to “revolutionize the world of cash back and loyalty programs” successfully raised $2.7 - $4 million in early January 2018. After an investor realized that the employee headshots posted on the company’s website were in fact from staff photos from a boy’s school in the UK, Benebit shut down its website and deleted the

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LinkedIn profiles of the company’s alleged team members and disappeared with the investors’ capital.

ICO scammers can create seemingly legitimate projects without difficulty using services like Fiverr, a company that enables anonymous individuals to offer freelance work over the Internet. One user with the screen-name “Cryptoprenur” offers “professionally designed white papers ... for your ICO or block-chain ... project.” 32 for as little as $140. Scammers can steal pictures of fake team members from various online sources, as observed in the Benebit scam, and several services 33 offer fake LinkedIn followers who can create the appearance of a legitimate team member, even if that member does not exist. In all, scammers can expend less than a $1,000 to build a convincing, illegitimate ICO project that has the potential to defraud millions of dollars from would-be investors—a sobering insight that ought to discourage imprudent ICO investing.

Investors should consider and verify the legitimacy of a project before investing. With a little funding and deceptive ingenuity, scammers can create polished websites, convincing social media accounts, and ostensibly professional whitepapers for nonexistent ventures. One obvious giveaway that a supposed ICO venture may be a scam is when the true identity and credibility of project’s team members cannot be verified through a reputable source. Before purchasing tokens in an ICO, investors should search for interviews, news articles, or other reliable ways to confirm that the team is genuine and is staking its reputation (and potentially its private resources) on a project.

Lack of value

Scams, hacks, and fraud are not the only concern investors ought to consider before purchasing tokens in an ICO. Even when honest, legitimate, or well-intentioned founders launch ICOs and evade becoming the targets of scams or hacks, there are serious concerns for investors about the potential real returns of an ICO investment. New tokens offered through an ICO have no trading history, little to no inherent value, and can gain traction despite the will of their creator.

The most well-known example of a cryptocurrency with almost no implicit value is Dogecoin, a token based on a popular Internet meme involving a picture of a Shiba Inu dog and grammatically incorrect statements interpreting the dog’s inner monologue. Jackson Palmer, the creator of Dogecoin, has stated in an article he wrote for Vice’s Motherboard that “Dogecoin started as a parody of the multitude of alternative cryptocurrencies.” The token’s icon is a stylized image picture of the “doge” meme’s Shira Inu with a D over it. Dogecoin peaked at a market cap of almost $2 billion in January 2018. Subsequently, the token has lost over 75 percent of its value and holds a market cap of $430,000 as of March 2018, representing over $1.57 billion in losses to investors.

In another example, a coin known as “The Useless Ethereum Token” (UET) held an ICO in July 2017 raising over $340,000 worth of Ethereum. The UET’s icon is a stylized hand holding up its middle finger, and its website describes the company as the “First 100% Honest Ethereum ICO” and states “The UET ICO transparently offers investors no value, so there will be no expectation of gains.”

ICOs for essentially worthless tokens are usually not so obvious. Investors ought to be sure the tokens they are purchasing have intrinsic value stemming from the projects they are linked to. Having an active “user” or “owner” community and generating buzz on numerous platforms does not confer value on a token. A truly valuable token will have some utility other than growing in value. That utility can range from acting as a method of payment to the promise of future goods or services. In any case, the price an investor pays for a token should not exceed the inherent value of a token. The high returns resulting from many ICOs are often a by-product of the hype surrounding an ICO, rather than a reflection of any real long-term or inherent project value. Reading an ICO whitepaper and understanding how the company’s tokens derive their value is essential before choosing to invest. Investors should only invest if they believe the project has long term-merit and a reasonable chance at success.

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Volatility:

Another issue investors face when investing in ICOs, and cryptocurrencies in general, is the sheer volatility of token prices.

From the peak total market cap of $823 billion on January 7, 2018 the market capitalization for cryptocurrencies dropped to a low of $396 billion only one month later on February 11th, representing a 51 percent loss for the average cryptocurrency investor. The potential for rapid losses and gains makes cryptocurrencies some of the most volatile, and thus risky, investments available.

Price volatility is inherent to any investment, but cryptocurrencies have proven to be especially volatile. For example, bitcoin’s one-month price volatility measured as standard deviation from the monthly mean, averaged 211 between April 2013 and February 2018, according to CoinMarketCap data. The S&P 500, an index of the U.S. top 500 companies, averages 9.5 standard deviation from

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the monthly mean over the same period\textsuperscript{40}. ICOs in particular face extreme volatility due to their low market caps, trading volumes, and lack of trading history. ICO investors should expect rapid fluctuations in price, which makes ICOs a poor investment choice for those seeking stable returns.

There is also evidence of price manipulation in various cryptocurrency markets. In these cases, a single, or small group of investors intentionally buy or sell coins to artificially raise prices before selling their investments for a profit. In a paper\textsuperscript{41} published in January 2018, researchers identified a series of suspicious trades on the Mt. Gox trading platform, where a single trader was able to raise the price of bitcoin from $150 to $1000 over a 3-month period in late 2013 allowing that trader to make millions in profits. Price manipulation, in the form of a “pump-and-dump” scheme\textsuperscript{42}, relies on the volatility of the market and ability for individual investors to convince others of a token’s growth potential. Pump-and-dump schemes may give the impression that a token’s price is rising, causing investors to buy more tokens compounding the price increase. After the original buyer dumps his or her tokens while the price is high, the price will then crash, leaving the remaining investors to absorb potentially millions of dollars in losses. These types of schemes are illegal and prosecuted in the traditional stock market; however, due to the anonymous nature of cryptocurrency, the likelihood of identifying and prosecuting market manipulators or recovering funds lost from this fraudulent practice is highly unlikely.

Investors should be wary of the extremely high levels of cryptocurrency volatility. While volatility can mean rapid gains, it also presents an equal possibility for loss. Investors should not invest money into cryptocurrencies that they cannot afford to lose, as there is no guarantee of positive returns. Furthermore, they should be suspicious of price gains that appear to have no underlying cause, as this may be indicative of a pump-and-dump scheme.

\textsuperscript{42} A form of securities fraud where an investor artificially inflates the price of an asset in order to sell the cheaply purchased asset once the price has increased.
ICO Regulations

Several regulatory agencies have already begun to crack down on ICOs, with further planned regulation precipitating massive losses in cryptocurrency value\textsuperscript{43}. The regulatory structure surrounding ICOs and cryptocurrencies is poorly defined and is expected to change drastically in the coming months and years. As it stands, there are, two primary agencies that regulate ICOs in the United States, the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC). Before an investor buys into an ICO, it is essential that he or she understand the protections or lack thereof that are in place.

The determination for which organization is in charge of enforcement actions and new regulations hinges on whether the token is considered a security, commodity, or simply a store of value or medium of exchange.

Securities v. Commodities

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<th>Security</th>
<th>Commodity</th>
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<tr>
<td>Definition</td>
<td>“A contract, transaction, or scheme, whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”</td>
<td>“A good that is sold freely to the public. It can be agriculture, fuel, or metals. It is traded in bulk in the commodity or spot market.”</td>
</tr>
<tr>
<td>Regulator</td>
<td>The U.S. Securities and Exchange Commission (SEC)</td>
<td>The U.S. Commodities Futures Trading Commission (CFTC)</td>
</tr>
</tbody>
</table>

Security  | Commodity
---|---
**Regulatory Structure**  |  Commodities broadly include anything tradable with inherent value (e.g., lumber, gold, metals, etc.).
Whether the SEC considers an ICO token a security depends on the following three-part test:
1) Do funders buy the token due to anticipated profits or due to its underlying value?  | The CFTC holds the authority to “regulate the trading of commodity futures in the U.S.” and seeks to prevent fraud as well as remove obstructions to interstate commerce.
2) Does the token’s value rely on a specific person or organization project to derive its value or does the underlying technology of the token provide its value?  | The sale of commodities faces little restriction. However, the CFTC is empowered to prevent fraud and other schemes that may abuse commodity contracts unfairly for personal gain.
3) Do funders invest money into the token?  | The SEC will likely classify a token that passes all three parts of the test as a security and consider it subject to the relevant fraud prevention regulations.

**Regulatory Requirements**

Ignoring fraudulent tokens, most new tokens sold through ICOs fall under three basic categories: cryptocurrencies, utility tokens, and security tokens. The token’s use will determine whether the token is a security or a commodity, as well as which regulatory rules may apply to the new token. Investors should understand the type of token they are buying and the regulatory requirements that the ICO should be following. Investors should treat ICOs that fail to adhere to regulatory requirements with utmost scrutiny.

**Cryptocurrencies**

A cryptocurrency token or coin is the most well-known version of contemporary digital currencies. The primary purpose of these types of coins, like Bitcoin\(^{44}\) or Ripple\(^{45}\), is to serve as a transfer of value between individuals or entities. Similar to fiat currency or other units of account with no intrinsic value, these cryptocurrencies derive their value from supply, demand, price discovery, and even faith. (Although, some argue that cryptocurrencies can have intrinsic value if they serve purposes beyond simply representing a unit of account.)

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When buying cryptocurrencies such as Bitcoin, investors should understand that the intended use case of the tokens is as a transfer of money between individuals or entities. With the rise of services that allow the exchange of fiat currency for Bitcoin through ATMs\(^46\) and a growing number of businesses that will accept Bitcoin as payment for goods and services\(^47\), there has been a corresponding rise in the value of these types of cryptocurrencies. However, this short-run volatility should not drive cryptocurrency investment decisions.

The state of regulation for cryptocurrencies is varied. The CFTC has classified Bitcoin as a commodity and has stated that it will work to prevent fraud, manipulation, and abusive practices related to its sale. CFTC Chairman Christopher Giancarlo has reported however that these cash markets, for now, do remain largely unregulated and has warned investors of the high volatility, and trading practices of participants in these markets\(^48\).

**Utility Token**

A utility token symbolizes a future use of a company’s goods or services. Utility tokens do not represent the value of some other commodity or service but are the commodity themselves. The creation of a utility token allows for projects to raise funds from private individuals (in a manner similar to “crowdfunding”) in exchange for the future promise of a project. A utility token can best be described as a currency with a specific use case, usually as a means of buying or selling a particular good and service.

An example of this type of utility token is FileCoin\(^49\). The purpose of FileCoin is to allow for data storage space on unused hard-drives in exchange for the token. The creation of this marketplace, and the continual addition of new FileCoins through miners to be sold to those who wish to use the service enables the exchange of data services using FileCoin as a symbolic intermediary representing the value of the data storage.

FileCoin raised over $257 million in its two ICOs in early August 2017. The value of FileCoin and other utility tokens are inherent. When purchasing tokens

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\(^48\) CFTC. (2016, June 2). CFTC Orders Bitcoin Exchange Bitfinex to Pay $75,000 for Offering Illegal Off-Exchange Financed Retail Commodity Transactions and Failing to Register as a Futures Commission Merchant. Retrieved from CFTC: https://www.cftc.gov/PressRoom/PressReleases/pr7380-16

such as FileCoin, and other utility tokens, investors should evaluate them on their underlying utility versus an expectation of future profits from selling the token at a later date. When used in this way, utility coins, like FileCoin, fail criteria one and two of the securities definition and thus are unlikely to face regulation from the SEC.

Utility tokens may still be subject to enforcement action from either the CFTC or the Federal Trade Commission (FTC) to prevent outright fraud and market manipulation.

In June 2016 the CFTC ordered a Hong Kong-based Bitcoin Exchange, Bitfinex, to pay $75,000 in fines for “Offering illegal off-exchange financed retail commodity transactions and failing to register as a futures commission merchant.” The CFTC argues that Bitfinex allowed users to borrow funds from other users to trade Bitcoins on leveraged, margined or financed basis. An investigation from the CFTC found that Bitfinex failed to deposit bitcoins into the appropriate wallets and thus was engaged in fraudulent activity. The CFTC has shown that it is willing to bring enforcement actions in the cryptocurrency market when clear fraud occurs.

**Securities Token**

A security token symbolizes the ownership of an asset external to the token itself. A security token has value because it promises a share of profits or returns due to the purchase of the token itself. Theoretically, security tokens could replace the sale of common stock as a means of owning a company. As suggested by their name security tokens are regulated as securities and are required to register with the SEC and provide a host of financial disclosures to the public beyond what is standard in a typical whitepaper.

As it stands security tokens are illegal in the United States without being first registered with the SEC. As of July 2017, there has not been a single registered ICO with the SEC meaning there are not any legal security tokens currently on the market. Any token which claims to provide partial ownership or a cut of

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future profits after purchase is a security token and is illegal under U.S. securities law.

The SEC also requires securities to be sold by a licensed seller or registered brokerage firms. Prospective investors can find the status of an individual as a licensed seller or firm through the public SEC database: Investor.gov. Sales of securities by unlicensed sellers may be in violation of the Securities Exchange Act and are more likely to be fraudulent.

There have been some attempts to register the sale of tokens with the SEC such as tZERO, a subsidiary of Overstock.com, which is attempting to create a SEC compliant marketplace for future security tokens. tZERO market its tokens as utility tokens, but seeks to open the market for future, SEC compliant, securities tokens. As of March 1st, 2018, the SEC has launched a probe into tZERO along with various other tokens which it considers to be securities with enforcement expected to follow. It is unclear whether the SEC will be willing to allow the sale of security tokens in the future.

Many companies have claimed to be issuing utility tokens while in reality they function as security tokens. On July 25th, 2017, the SEC released a report on the DAO exploit, in which they concluded that the DAO should be classified as a security, arguing that it constituted an investment contract. In the report, the SEC claims that investors in the DAO invested money and had a reasonable expectation of profits derived from managerial efforts of others. The SEC alleged that the DAO had violated the exchange act by not registering the sale of its securities with the SEC and failing to meet several disclosure requirements. While the SEC has chosen not to pursue enforcement action, it is

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clear that the SEC considers the sale of cryptocurrencies to fall within its purview and will take action accordingly in the future.

**Regulator Response**

Both the SEC and the CFTC have displayed interest in preventing the rampant fraud and hacking that exist within the crypto-currency market and have both released statements cautioning investors and promising future enforcement actions.

SEC Chairman Jay Clayton on December 11th, 2017 released a statement on cryptocurrencies and ICOs cautioning investors that no ICO has registered with the SEC. Clayton advised investors to be incredibly cautious in their potential investments into ICOs and to “apply good common sense” when considering new opportunities.

The CFTC released a customer advisory urging customers to understand the inherently risky nature of cryptocurrency markets due to the price volatility, cyber risks, and other unfair business practices. The CFTC further warns about the frequent fraud that occurs in the cryptocurrency space. The CFTC provides a useful online research checklist and database to assist investors with their background research on various projects to ensure that they follow regulatory procedures and are unlikely to be a scam.

In January 2018 the SEC and CFTC released a joint statement from their heads of enforcement divisions stating their commitment to prosecute violations of securities and commodities laws. It is clear that regulators of cryptocurrencies and ICOs have taken notice of the issues that these assets face and will be stepping up enforcement in the future.

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In February 2018 the SEC launched a crypto-currency probe, issuing dozens of subpoenas and information requests to various crypto-currency companies\textsuperscript{62}. The SEC thus far has refused to comment on the probe, but it is clear that SEC enforcement on tokens and ICOs which it considers to be offering securities will be stepping up in the months to come.

Other government agencies have also indicated that they intend to begin bringing enforcement actions against ICOs and cryptocurrencies in general which they deem in violation of various government regulations.

The Financial Crimes Enforcement Network (FinCEN) in March 2018 published a letter\textsuperscript{63}, which stated they are planning to classify cryptocurrency developers and exchanges as “money transmitters.” FinCEN is a subsidiary of the U.S. Treasury and works to enforce regulations preventing finance for terrorism and money laundering.

The Consumer Finance Protection Bureau (CFPB), the Federal Trade Commission (FTC) have both issued advisories\textsuperscript{64} \textsuperscript{65} urging potential investors in ICOs and cryptocurrency to be extremely wary about the volatility and risks involved. While there have been no direct enforcement actions from either regulator as of the publication of this paper, they are monitoring the issue closely.

U.S. regulators have taken note of the violations of U.S. trade and security law that many ICOs and cryptocurrencies perpetrate. Many ICOs have begun to try to block U.S. citizens from being involved to circumvent SEC regulations regarding the sale of securities to non-accredited investors, but with the ease at which investors circumvent these safeguards,\textsuperscript{66} the SEC has chosen to proceed with enforcement action. U.S. investors should expect increased scrutiny from regulators in the future including many enforcement actions.

against fraudulent ICOs or ICOs, which have failed to follow the guidelines outlined by U.S. securities law.

**WHAT TO CONSIDER AS A PROSPECTIVE INVESTOR**

What does this all mean to a prospective investor who still wants exposure to ICOs and the cryptocurrency space? A prospective investor should consider the following five questions before investing in any particular ICO:

**What is the value of this token?**

Tokens can represent a variety of things ranging from ownership of a company to nothing but faith. Prospective investors must consider whether or not they truly believe in the value of the token itself or if they are being caught up in the hype and are trying to make quick profits. While investors may earn profits in the short run, in the long run, valueless tokens will result in overall losses.

**Who am I buying this token from?**

The ICO market is rife with scams. Investors need to know who is running the project that they are buying tokens from and ensure that the team behind the project are real people by either using reputable third-party sources or meeting them in person. If an ICO feels fishy, or if the team seems more focused on raising money than creating a valuable product or service then investors should treat it with scrutiny.

**Can I afford to lose my investment?**

ICOs and cryptocurrency in general face extremely volatile prices. When combined with the risk of hacks, scams and other factors there is a substantial chance that an investment may disappear or lose a significant amount of its value. Before investing in an ICO ensure that investors must understand the possibility that their investment may not be recovered and ensure that they are comfortable with that possibility.

**What is the structure of this ICO and is it legal?**

ICOs take a wide variety of structures, and many may not be legal under U.S. law. Investors should understand the type of ICOs that they are buying into and understand how that ICO falls within the U.S. regulatory framework. If an ICO
promises profits or relies on the efforts of a specific person or organization, it is likely a security. Investors should ask whether a project has registered with the SEC if their token’s case seem to fall under the securities definition. When in doubt the SEC can be reached directly by phone, email, or online for any questions investors or businesses may have. Coinbase has also released a spreadsheet and legal analysis to help investors determine whether a particular ICO is a security or not.

Are there alternative investments better suited for my needs?

While stocks and bonds may not be as glamorous or potentially lucrative as ICOs, they are as a whole much safer and more stable. They face more regulatory requirements and often have mechanisms in place to recover money that investors have lost through fraudulent activities. Before investing money into a highly volatile and risky ICO or cryptocurrency, investors should consider all of their options. Including the traditional stock market. Non-accredited investors should consult a financial advisor before making any significant investments.

Appendices A-D offer additional guidance from government agencies regarding ICO classification and investing.
Appendix A: Guidance from the Federal Trade Commission (FTC)

Know the risks before you invest in cryptocurrencies

February 16, 2018
by Elizabeth Kwok
Division of Financial Practices, FTC

It’s not just bitcoin. There are now hundreds of cryptocurrencies, which are a type of digital currency, on the market. They’ve been publicized as a fast and inexpensive way to pay online, but many are now also being marketed as investment opportunities. But before you decide to purchase cryptocurrency as an investment, here are a few things to know:

• **Cryptocurrencies aren’t backed by a government or central bank.** Unlike most traditional currencies, such as the dollar or yen, the value of a cryptocurrency is not tied to promises by a government or a central bank.

• **If you store your cryptocurrency online, you don’t have the same protections as a bank account.** Holdings in online “wallets” are not insured by the government like U.S. bank deposits are.

• **A cryptocurrency’s value can change constantly and dramatically.** An investment that may be worth thousands of dollars on Tuesday could be worth only hundreds on Wednesday. If the value goes down, there’s no guarantee that it will rise again.

• **Nothing about cryptocurrencies makes them a foolproof investment.** Just like with any investment opportunity, there are no guarantees.

• **No one can guarantee you’ll make money off your investment.** Anyone who promises you a guaranteed return or profit is likely scamming you. Just because the cryptocurrency is well-known or has celebrities endorsing it doesn’t mean it’s a good investment.

• **Not all cryptocurrencies or the companies behind them are the same.** Before you decide to invest in a cryptocurrency, look into the claims the company is making. Do an internet search with the name of the company and the cryptocurrency with words like review, scam, or complaint. Look through several pages of search results.

Appendix B: Guidance from the Securities and Exchange Commission (SEC)

Initial Coin Offerings (ICOs)
Companies and individuals are increasingly considering initial coin offerings (ICOs) as a way to raise capital or participate in investment opportunities. While these digital assets and the technology behind them may present a new and efficient means for carrying out financial transactions, they also bring increased risk of fraud and manipulation because the markets for these assets are less regulated than traditional capital markets. That’s why we are providing this information about the three “Rs” of ICOs: Risks, Rewards and Responsibilities.

5 Things You Need to Know about ICOs

- ICOs can be securities offerings.
  - ICOs, based on specific facts, may be securities offerings, and fall under the SEC’s jurisdiction of enforcing federal securities laws.
- They may need to be registered.
  - ICOs that are securities most likely need to be registered with the SEC or fall under an exemption to registration.
- Tokens sold in ICOs can be called many things.
  - ICOs, or more specifically tokens, can be called a variety of names, but merely calling a token a “utility” token or structuring it to provide some utility does not prevent the token from being a security.
- ICOs may pose substantial risks.
  - While some ICOs may be attempts at honest investment opportunities, many may be frauds, separating you from your hard-earned money with promises of guaranteed returns and future fortunes. They may also present substantial risks for loss or manipulation, including through hacking, with little recourse for victims after-the-fact.
- Ask questions before investing.
  - If you choose to invest in these products, please ask questions and demand clear answers.

What investors need to know
So, what do you need to know about ICOs before investing? Start with some basic research on Investor.gov and take note of the following:

- Products can be sold and traded internationally.
  - Recognize that these products are often sold on markets that span national borders and that significant trading may occur on systems and platforms outside the United States. Your invested funds may
quickly travel overseas without your knowledge. Although the SEC actively enforces securities laws, risks can be amplified, including the risk that market regulators may not be able to effectively pursue bad actors or recover funds.

- Research your financial professional.
  - Understand the opportunity that is being presented, and do your homework on the individual who is doing the presenting. Is the offering legal and is the person offering this product licensed to do so? Make sure you visit investor.gov for more resources before you invest. Arm yourself with knowledge from this Investor Bulletin.

- If an investment sounds too good to be true, be cautious.
  - As with any other type of potential investment, if a promoter guarantees returns, if an opportunity sounds too good to be true, or if you are pressured to act quickly, please exercise extreme caution and be aware of the risk that your investment may be lost.

- Understand how the product is traded.
  - Many platforms for trading digital assets refer to themselves as "exchanges," which can give the misimpression to investors that they are regulated or meet the regulatory standards of a national securities exchange.

What market professionals need to know

As SEC Chairman Jay Clayton has stated, tokens and offerings that feature and market the potential for profits based on the entrepreneurial or managerial efforts of others contain the hallmarks of a security under U.S. law.

- Use caution before promoting offers and selling coins.
  - Market participants should use caution when promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions. Similarly, those who operate systems and platforms that effect or facilitate transactions in these products should be aware that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act of 1934.

- The SEC protects Investors, and expects you to.
  - Gatekeepers and others, including securities lawyers, accountants and consultants, should be guided by the principal motivation for the SEC’s registration, offering process and disclosure requirements: Investor protection and, in particular, the protection of Main Street investors.

- SEC Report of Investigation on Coin or Token Offerings.
  - Market professionals, including securities lawyers, accountants and consultants, are encouraged to read closely
the 21(a) investigative report the SEC released in 2017, concluding that a particular token was a security.

- Know when an exchange needs to be registered.
  - If a platform offers trading of digital assets that are securities and operates as an "exchange," as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration.
Appendix C: Securities and Exchange Commission (SEC) ICO Investor Alert

Investor Bulletin: Initial Coin Offerings (ICOs)

07/25/2017

Developers, businesses, and individuals increasingly are using initial coin offerings, also called ICOs or token sales, to raise capital. These activities may provide fair and lawful investment opportunities. However, new technologies and financial products, such as those associated with ICOs, can be used improperly to entice investors with the promise of high returns in a new investment space. The SEC’s Office of Investor Education and Advocacy is issuing this Investor Bulletin to make investors aware of potential risks of participating in ICOs.

Background - Initial Coin Offerings

Virtual coins or tokens are created and disseminated using distributed ledger or blockchain technology. Recently promoters have been selling virtual coins or tokens in ICOs. Purchasers may use fiat currency (e.g., U.S. dollars) or virtual currencies to buy these virtual coins or tokens. Promoters may tell purchasers that the capital raised from the sales will be used to fund development of a digital platform, software, or other projects and that the virtual tokens or coins may be used to access the platform, use the software, or otherwise participate in the project. Some promoters and initial sellers may lead buyers of the virtual coins or tokens to expect a return on their investment or to participate in a share of the returns provided by the project. After they are issued, the virtual coins or tokens may be resold to others in a secondary market on virtual currency exchanges or other platforms.

Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities. If they are securities, the offer and sale of these virtual coins or tokens in an ICO are subject to the federal securities laws.

On July 25, 2017, the SEC issued a Report of Investigation under Section 21(a) of the Securities Exchange Act of 1934 describing an SEC investigation of The DAO, a virtual organization, and its use of distributed ledger or blockchain technology to facilitate the offer and sale of DAO Tokens to raise capital. The
Commission applied existing U.S. federal securities laws to this new paradigm, determining that DAO Tokens were securities. The Commission stressed that those who offer and sell securities in the U.S. are required to comply with federal securities laws, regardless of whether those securities are purchased with virtual currencies or distributed with blockchain technology.

To facilitate understanding of this new and complex area, here are some basic concepts that you should understand before investing in virtual coins or tokens:

**What is a blockchain?**
A blockchain is an electronic distributed ledger or list of entries - much like a stock ledger - that is maintained by various participants in a network of computers. Blockchains use cryptography to process and verify transactions on the ledger, providing comfort to users and potential users of the blockchain that entries are secure. Some examples of blockchain are the Bitcoin and Ethereum blockchains, which are used to create and track transactions in bitcoin and ether, respectively.

**What is a virtual currency or virtual token or coin?**
A virtual currency is a digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account, or store of value. Virtual tokens or coins may represent other rights as well. Accordingly, in certain cases, the tokens or coins will be securities and may not be lawfully sold without registration with the SEC or pursuant to an exemption from registration.

**What is a virtual currency exchange?**
A virtual currency exchange is a person or entity that exchanges virtual currency for fiat currency, funds, or other forms of virtual currency. Virtual currency exchanges typically charge fees for these services. Secondary market trading of virtual tokens or coins may also occur on an exchange. These exchanges may not be registered securities exchanges or alternative trading systems regulated under the federal securities laws. Accordingly, in purchasing and selling virtual coins and tokens, you may not have the same protections that would apply in the case of stocks listed on an exchange.

**Who issues virtual tokens or coins?**
Virtual tokens or coins may be issued by a virtual organization or other capital raising entity. A virtual organization is an organization embodied in computer code and executed on a distributed ledger or blockchain. The code, often called a “smart contract,” serves to automate certain functions of the organization, which may include the issuance of certain virtual coins or tokens. The DAO, which was a decentralized autonomous organization, is an example of a virtual organization.

Some Key Points to Consider When Determining Whether to Participate in an ICO

If you are thinking about participating in an ICO, here are some things you should consider.

- Depending on the facts and circumstances, the offering may involve the offer and sale of securities. If that is the case, the offer and sale of virtual coins or tokens must itself be registered with the SEC, or be performed pursuant to an exemption from registration. Before investing in an ICO, ask whether the virtual tokens or coins are securities and whether the persons selling them registered the offering with the SEC. A few things to keep in mind about registration:
  - If an offering is registered, you can find information (such as a registration statement or “Form S-1”) on SEC.gov through EDGAR.
  - If a promoter states that an offering is exempt from registration, and you are not an accredited investor, you should be very careful - most exemptions have net worth or income requirements.
  - Although ICOs are sometimes described as crowdfunding contracts, it is possible that they are not being offered and sold in compliance with the requirements of Regulation Crowdfunding or with the federal securities laws generally.
  - Ask what your money will be used for and what rights the virtual coin or token provides to you. The promoter should have a clear business plan that you can read and that you understand. The rights the token or coin entitles you to should be clearly laid out, often in a white paper or development roadmap. You should specifically ask about how and when you can get your money back in the event you wish to do so. For example, do you have a right to give the token or coin back to the
company or to receive a refund? Or can you resell the coin or token? Are there any limitations on your ability to resell the coin or token?

- If the virtual token or coin is a security, federal and state securities laws require investment professionals and their firms who offer, transact in, or advise on investments to be licensed or registered. You can visit [Investor.gov](http://Investor.gov) to check the registration status and background of these investment professionals.

- Ask whether the blockchain is open and public, whether the code has been published, and whether there has been an independent cybersecurity audit.

- Fraudsters often use innovations and new technologies to perpetrate fraudulent investment schemes. Fraudsters may entice investors by touting an ICO investment “opportunity” as a way to get into this cutting-edge space, promising or guaranteeing high investment returns. Investors should always be suspicious of jargon-laden pitches, hard sells, and promises of outsized returns. Also, it is relatively easy for anyone to use blockchain technology to create an ICO that looks impressive, even though it might actually be a scam.

- Virtual currency exchanges and other entities holding virtual currencies, virtual tokens or coins may be susceptible to fraud, technical glitches, hacks, or malware. Virtual tokens or virtual currency may be stolen by hackers.

Investing in an ICO may limit your recovery in the event of fraud or theft. While you may have rights under the federal securities laws, your ability to recover may be significantly limited.

If fraud or theft results in you or the organization that issued the virtual tokens or coins losing virtual tokens, virtual currency, or fiat currency, you may have limited recovery options. Third-party wallet services, payment processors, and virtual currency exchanges that play important roles in the use of virtual currencies may be located overseas or be operating unlawfully.

Law enforcement officials may face particular challenges when investigating ICOs and, as a result, investor remedies may be limited. These challenges include:
• Tracing money. Traditional financial institutions (such as banks) often
are not involved with ICOs or virtual currency transactions, making it
more difficult to follow the flow of money.
• International scope. ICOs and virtual currency transactions and users
span the globe. Although the SEC regularly obtains information from
abroad (such as through cross-border agreements), there may be
restrictions on how the SEC can use the information and it may take
more time to get the information. In some cases, the SEC may be
unable to obtain information from persons or entities located overseas.
• No central authority. As there is no central authority that collects
virtual currency user information, the SEC generally must rely on other
sources for this type of information.
• Freezing or securing virtual currency. Law enforcement officials may
have difficulty freezing or securing investor funds that are held in a
virtual currency. Virtual currency wallets are encrypted and unlike
money held in a bank or brokerage account, virtual currencies may not
be held by a third-party custodian.

Be careful if you spot any of these potential warning signs of investment fraud.
• “Guaranteed” high investment returns. There is no such thing as
guaranteed high investment returns. Be wary of anyone who promises
that you will receive a high rate of return on your investment, with little
or no risk.
• Unsolicited offers. An unsolicited sales pitch may be part of a
fraudulent investment scheme. Exercise extreme caution if you receive
an unsolicited communication—meaning you didn’t ask for it and don’t
know the sender—about an investment opportunity.
• Sounds too good to be true. If the investment sounds too good to be
true, it probably is. Remember that investments providing higher returns
typically involve more risk.
• Pressure to buy RIGHT NOW. Fraudsters may try to create a false sense
of urgency to get in on the investment. Take your time researching an
investment opportunity before handing over your money.
• Unlicensed sellers. Many fraudulent investment schemes involve
unlicensed individuals or unregistered firms. Check license and
registration status on Investor.gov.
• No net worth or income requirements. The federal securities laws
require securities offerings to be registered with the SEC unless an
exemption from registration applies. Many registration exemptions require that investors are accredited investors; some others have investment limits. Be highly suspicious of private (i.e., unregistered) investment opportunities that do not ask about your net worth or income or whether investment limits apply.

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Before making any investment, carefully read any materials you are given and verify the truth of every statement you are told about the investment. For more information about how to research an investment, read our publication Ask Questions. Investigate the individuals and firms offering the investment, and check out their backgrounds on Investor.gov and by contacting your state securities regulator. Many fraudulent investment schemes involve unlicensed individuals or unregistered firms.

Appendix D: Securities and Exchange Commission (SEC) Statement on ICOs

Statement on Potentially Unlawful Online Platforms for Trading Digital Assets

Divisions of Enforcement and Trading and Markets

March 7, 2018

Online trading platforms have become a popular way investors can buy and sell digital assets, including coins and tokens offered and sold in so-called Initial Coin Offerings ("ICOs"). The platforms often claim to give investors the ability to quickly buy and sell digital assets. Many of these platforms bring buyers and sellers together in one place and offer investors access to automated systems that display priced orders, execute trades, and provide transaction data. A number of these platforms provide a mechanism for trading assets that meet the definition of a "security" under the federal securities laws. If a platform offers trading of digital assets that are securities and operates as an "exchange," as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration. The federal regulatory framework governing registered national securities exchanges and exempt markets is designed to protect investors and prevent against fraudulent and manipulative trading practices.

Considerations for Investors Using Online Trading Platforms

To get the protections offered by the federal securities laws and SEC oversight when trading digital assets that are securities, investors should use a platform or entity registered with the SEC, such as a national securities exchange, alternative trading system ("ATS"), or broker-dealer. The SEC staff has concerns that many online trading platforms appear to investors as SEC-registered and regulated marketplaces when they are not. Many platforms refer to themselves as "exchanges," which can give the misimpression to investors that they are regulated or meet the regulatory standards of a national securities exchange. Although some of these platforms claim to use strict standards to pick only high-quality digital assets to trade, the SEC does not review these standards or the digital assets that the platforms select, and the so-called standards should not be equated to the listing
standards of national securities exchanges. Likewise, the SEC does not review the trading protocols used by these platforms, which determine how orders interact and execute, and access to a platform's trading services may not be the same for all users. Again, investors should not assume the trading protocols meet the standards of an SEC-registered national securities exchange. Lastly, many of these platforms give the impression that they perform exchange-like functions by offering order books with updated bid and ask pricing and data about executions on the system, but there is no reason to believe that such information has the same integrity as that provided by national securities exchanges.

In light of the foregoing, here are some questions investors should ask before they decide to trade digital assets on an online trading platform:

- Do you trade securities on this platform? If so, is the platform registered as a national securities exchange (see our link to the list below)?
- Does the platform operate as an ATS? If so, is the ATS registered as a broker-dealer and has it filed a Form ATS with the SEC (see our link to the list below)?
- Is there information in FINRA's BrokerCheck ® about any individuals or firms operating the platform?
- How does the platform select digital assets for trading?
- Who can trade on the platform?
- What are the trading protocols?
- How are prices set on the platform?
- Are platform users treated equally?
- What are the platform's fees?
- How does the platform safeguard users' trading and personally identifying information?
- What are the platform's protections against cybersecurity threats, such as hacking or intrusions?
- What other services does the platform provide? Is the platform registered with the SEC for these services?
- Does the platform hold users' assets? If so, how are these assets safeguarded?

Resources for Investors

- Investor.gov Spotlight on Initial Coin Offerings and Digital Assets
Considerations for Market Participants Operating Online Trading Platforms

A platform that trades securities and operates as an "exchange," as defined by the federal securities laws, must register as a national securities exchange or operate under an exemption from registration, such as the exemption provided for ATSs under SEC Regulation ATS. An SEC-registered national securities exchange must, among other things, have rules designed to prevent fraudulent and manipulative acts and practices. Additionally, as a self-regulatory organization ("SRO"), an SEC-registered national securities exchange must have rules and procedures governing the discipline of its members and persons associated with its members, and enforce compliance by its members and persons associated with its members with the federal securities laws and the rules of the exchange. Further, a national securities exchange must itself comply with the federal securities laws and must file its rules with the Commission.

An entity seeking to operate as an ATS is also subject to regulatory requirements, including registering with the SEC as a broker-dealer and becoming a member of an SRO. Registration as a broker-dealer subjects the ATS to a host of regulatory requirements, such as the requirement to have reasonable policies and procedures to prevent the misuse of material non-public information, books and records requirements, and financial responsibility rules, including, as applicable, requirements concerning the safeguarding and custody of customer funds and securities. The overlay of SRO membership imposes further regulatory requirements and oversight. An ATS must comply with the federal securities laws and its SRO’s rules, and file a Form ATS with the SEC.
Some online trading platforms may not meet the definition of an exchange under the federal securities laws, but directly or indirectly offer trading or other services related to digital assets that are securities. For example, some platforms offer digital wallet services (to hold or store digital assets) or transact in digital assets that are securities. These and other services offered by platforms may trigger other registration requirements under the federal securities laws, including broker-dealer, transfer agent, or clearing agency registration, among other things. In addition, a platform that offers digital assets that are securities may be participating in the unregistered offer and sale of securities if those securities are not registered or exempt from registration.

In advancing the SEC’s mission to protect investors, the SEC staff will continue to focus on platforms that offer trading of digital assets and their compliance with the federal securities laws.

Consultation with Securities Counsel and the SEC Staff

We encourage market participants who are employing new technologies to develop trading platforms to consult with legal counsel to aid in their analysis of federal securities law issues and to contact SEC staff, as needed, for assistance in analyzing the application of the federal securities laws. In particular, staff providing assistance on these matters can be reached at FinTech@sec.gov.

Resources for Market Participants

Regulation of Exchanges and Alternative Trading Systems

Select Commission Enforcement Actions

- SEC v. Jon E. Montroll and Bitfunder
- In re BTC Trading, Corp. and Ethan Burnside.
- SEC v. REcoin Group Foundation, LLC et al.
- SEC v. PlexCorps et al.
- In re Munchee, Inc.
- SEC v. AriseBank et al.