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ICO Token Purchasers May Be Entitled To A Refund

By **John Reed Stark**

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Purchasing an investment is not like buying a pair of shoes at Zappos. You can't return the investment for a refund if you don't like the fit. That is, unless you bought tokens in an initial coin offering. ICO token purchasers may indeed have the right to a full refund, and perhaps even more.

ICOs provide a virtual driver's ed film of possible securities law violations, raising legal questions and regulatory issues from every angle. Above all else, the federal securities laws apply to those who offer and sell securities in the U.S., regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless of whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through the distributed ledger technology of cryptocurrencies.

Issuers, promoters, curators, sponsors, facilitators, so-called "finders," investment banks, law firms, affiliates and anyone else connected to ICOs, the method by which startups or other parties can issue cryptographic tokens in an effort to fund or bootstrap a new blockchain network, should be on notice. Thanks to a range of U.S. securities statutes, rules and regulations, ICO token subscribers may have so-called "rescission rights."

Rescission rights essentially to a put option for their ICO investment, i.e., ICO token purchasers would have the right to sell their tokens back to ICO sponsors and obtain a full refund, plus interest from the company and sometimes its officers and directors.

It all boils down to a fairly straightforward legal analysis:

1. Even if an ICO is somehow registered with the U.S. Securities and Exchange Commission or structured somehow to be SEC-exempt, the ICO is still likely offering what the law would deem "securities";

2. Anyone connected to an ICO who is marketing securities (who for example is receiving any form of transaction based compensation) must be registered with the SEC as a broker-dealer;

3. If there is any unregistered person or entity connected to the ICO and marketing the ICO, then the unregistered broker-dealer actions have permanently and irrevocably tainted the ICO; and

4. Once an ICO becomes irrevocably and permanently tainted, per SEC rules and regulations, investors are entitled to rescission, that is, a refund of their initial investment.

In short, for anyone who lost money in an ICO, the SEC might very well have your back.

As the excitement of ICOs spreads throughout the business and financial sectors, so too have the concerns that lack of regulation render the new-age currency susceptible to fraud, manipulation, and to being used as a vehicle for money laundering. The loudest voice among them: none other

and to being used as a vehicle for money laundering. The loudest voice among them: none other than the newly appointed chairman of the SEC, Jay Clayton.

Speaking on Nov. 9, 2017, at this year's Institute on Securities Regulation in New York City, Clayton warned ominously that ICOs in many cases looked like securities. Veering off-script, Clayton reportedly stated bluntly,

> I have yet to see an ICO that doesn't have a sufficient number of hallmarks of a security. [Moreover], there is also a distinct lack of information about many online platforms that list and trade virtual coins or tokens offered and sold in initial coin offerings.

Clayton, a seasoned securities regulation veteran and expert cautioned that many ICO platforms were susceptible to manipulation and other fraudulent practices by ICO insiders, management and better-informed traders.

Clayton's stern and plain ICO admonition comes as no surprise. Recent efforts by the SEC and other U.S. enforcement and regulatory agencies indicate an upcoming effort to enforce financial regulations in the ICO space, placing ICOs and other cryptocurrency-based transactions under greater scrutiny than ever before.

As the SEC proceeds with its oncoming ICO dragnet, there will inevitably be a slew of potential rights and remedies for aggrieved ICO investors. But for the purposes of this analysis, the focus will be on two of the most relevant securities regulations pertaining to rescission rights, the laws pertaining to the unlawful sale of ICOs (failure to register ICO tokens per the Securities Act of 1933) and the unlawful marketing of ICOs (failure of ICO promoters and other affiliates to register as broker-dealers per the Exchange Act of 1934).

What is Cryptocurrency?

Understanding cryptocurrency and ICOs remains a challenge for even the most seasoned financial professionals and legal scholars. For one thing, it is beyond the imagination of most experts that a financial transaction can occur with such an extraordinary level of anonymity, complexity and lack of transparency. Yet that is precisely what cryptocurrency allows — with the added convolution of a monetary foundation embedded within computer code on a server somewhere, rather than within a safe and secure haven like Fort Knox.

Like PayPal or credit cards, cryptocurrencies are digital currencies that can be used to send or receive payment via the internet. But unlike PayPal or credit cards, which are based on actual legal tender such as dollars, euros, pounds or yen, cryptocurrencies are wholly unregulated and completely unmonitored, operating through intricate networks of decentralized computer systems.

Cryptocurrency transfers are encrypted and purportedly recorded on what is known as a "digital ledger," and are hyped as a low-cost alternative to using banks, money transfer companies or brokers, who charge fees for transactions.

In September, cryptocurrency trading posted a record $11 billion in trading volume, according to CryptoCoinsNews, an industry tracking website. According to CNBC, software developers have raised close to $1.3 billion in 2017 from the sale of new virtual currencies with names like Tezzies, Atoms and Basic Attention Tokens.

Several large companies, including Microsoft, Overstock.com and DISH Network, along with hundreds of thousands of other vendors worldwide, now accept cryptocurrencies. Overstock has taken cryptocurrencies a step further, announcing plans for an exchange for trading cryptocurrencies, and unveiling plans for an ICO through its tZero subsidiary. If Overstock successfully completes the ICO, it will be the first major public company to achieve this milestone.

But there is a dark side to cryptocurrency that has quickly emerged. Given their anonymous and unregulated nature, cryptocurrencies have evolved into the payment mechanism of choice for unlawful transactions — from buying a fake I.D. or a bottle of opiates, to receiving a cache of credit card numbers or stolen identities, to collecting a ransomware payment demand or evading taxes. It is this dark side that has obviously captured the attention of regulators and criminal law enforcement authorities as well.

What is an ICO?

The broader adoption of the cryptocurrency payment has spawned the concept of using cryptocurrency to fund businesses and investments, and has generated cryptocurrency exchanges around the world. These exchanges, such as Coinbase and Bitfinex, allow people to buy, sell and transfer funds across cryptocurrencies and central bank-backed currencies, such as dollars and euros.

Along these lines, so-called "ICOs" emerged as a novel form of capital raising, whereby startups sell digital tokens to investors to help fund projects, facilitated by the same blockchain technology that powers digital currencies such as bitcoin.

In an ICO, virtual coins or tokens are distributed by a company to the public in exchange for another cryptocurrency or fiat currency. These coins or tokens come with particular rights, which could range from a right to access software, redeem the token for a currency or service, or receive future earnings from the company (like a dividend).

ICO growth has been nothing short of astonishing. Before 2017, ICOs had raised a total of about $300 million going back to 2014. Fast forward to 2017, where according to CoinSchedule and as reported in Bloomberg, there have been more than 200 ICOs raising over $3 billion, including over $800 million in ICOs during the month of September alone. The ICO calendar remains a busy one — close to 40 more ICOs are scheduled for the remainder of 2017.

Some ICO platforms take any project regardless, while other ICO platforms go so far as to have an ICO to raise money for their ICO platform — an ICO of an ICO if you will. Many ICOs are built on top of Ethereum's platform, which enables the creation of decentralized "smart contracts" that can carry out higher-level functions beyond simple transfers of value.

Equally astonishing is that ICOs have grown largely outside of regulatory oversight and without the investor protections and disclosure requirements that apply to traditional investment offerings. But that is soon to change.

ICOs Unlawfully Offering Securities for Sale to the Public

To determine how traditional securities regulation applies to ICOs, the SEC will undoubtedly apply the four-pronged Howey test, derived from the 1946 U.S. Supreme Court decision in SEC v. W.J. Howey Co., which states that a security is an investment contract in which a person 1) invests their money; 2) in a common enterprise; 3) with an expectation of profits; 4) based on the efforts of the promoter or a third party. In order to be considered a security, an offering must meet all four prongs.

Typically, an ICO involves the sale of a cryptocurrency "token" in return for which a purchaser might receive anything ranging from simple access to a future service once it is launched to rights in the profits generated by the venture.

Most token purchasers expect that they will earn a profit by selling their tokens once they appreciate in value. While some token issuers have acknowledged that they are offering and selling securities under U.S. law, the majority of token issuers have taken the position that their transactions do not involve the offer or sale of any security. Rather than prospectuses, token issuers put out so-called "white papers" describing the platform, software or product they are trying to build, and then people buy those tokens using widely accepted cryptocurrencies (like bitcoin and ethereum) or fiat currencies like the U.S. dollar. These issuers also often employ a litany of promoters and facilitators to generate interest, excitement and participation in the ICO.

Historically, the courts and the SEC have taken an extremely broad view of whether any kind of investment is a security. Indeed, the definition of "security" under Section 2(a)(1) of the Securities Act of 1933 (and the nearly identical definition under Section 3(a)(10) of the Exchange Act of 1934) includes not only a number of specific types of financial instruments, such as notes, bonds, debentures and stock, but also broad categories of financial instruments, such as evidences of indebtedness and investment contracts. The definition of security was plainly crafted

to contemplate not only known securities arrangements at the time, but also to include any prospective instruments created by those who seek the use of the money of others on the promise of profits.

With respect to ICOs, the critical area of inquiry for the SEC is whether investors were relying on the managerial efforts of others. On July 25, 2017, the SEC provided important initial guidance on its views of whether ICOs are securities when it released a Section 21(a) report of investigation on its findings regarding the token sale by the DAO.

The bottom line from the DAO 21(a) report is that the SEC views ICOs as selling securities. In making this determination, the SEC focused on whether the efforts of others were "the undeniably significant ones ... that affect the failure or success of the enterprise."

The SEC found that the so-called curators of the DAO played the requisite role. The curators held themselves out as experts in, among other matters, the blockchain protocol, determined which projects would be voted on by DAO token holders, addressed security issues and more generally held itself out in marketing materials as a group that investors could rely on for their managerial efforts.

The SEC also concluded that the voting rights of the DAO token holders were limited. In a critical sentence, the SEC noted: "[e]ven if an investor's efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter's significant managerial efforts or control over the enterprise." The SEC concluded that the voting rights of DAO token holders was largely "perfunctory." Since they could only vote on projects approved by the curators, token holders did not receive sufficient information to vote in a meaningful way, and there were no means to obtain additional information.

Equally important, the SEC noted that the widely dispersed DAO token holders could not identify and effectively communicate with each other; that there was a large number of them; and that they could not be deemed to be in a position to effectuate meaningful control.

In sum, because DAO tokens were determined to be securities that were offered and sold to individuals in the U.S. without the benefit of a valid exemption from registration, the SEC concluded that the DAO was required to register the offer and sale of DAO tokens, which it had failed to do.

While ICOs may not, by default, trigger SEC jurisdiction, given the DAO 21(a) report, any potential ICO issuer who was ignoring the Howey test in structuring its offering is now on firm notice that it can no longer do so. Arguably, there is also now an overwhelming presumption that the SEC will deem current iterations and variants of ICOs securities offerings.

The bottom line with respect to the purveyors of ICOs: They are very likely selling plain-old shares of stock fancifully masquerading as tokens — and their offer and sale would need to be registered under the Securities Act or qualify for an exemption from registration.

If the token offering is exempt from registration, the offering likely would need to be made to accredited investors, the tokens would be subject to limitations on resales or transfers, and any general solicitation would likely be prohibited. Regardless of whether the offering is registered or exempt, careful consideration would also have to be given to ensuring that prospective investors receive sufficient disclosure about the offering, including associated risks.

ICOs Unlawfully Involving Unregistered Broker-Dealer Activity

One of the more critical federal and state regulatory registration requirements that may emerge when participating in the operation of an ICO is that of broker-dealer activity. If tokens are deemed securities, intermediaries such as token exchanges and promoters would likely need to comply with broker-dealer registration requirements.

For example, when a company is engaged in facilitating or helping conduct the ICO (for example by promoting the ICO or by helping find ICO investors), the company may be required to register as a broker dealer with the SEC.

Specifically, Section 15(a)(1) of the Securities Exchange Act of 1934 makes it unlawful for a person to “effect a transaction in securities” or “attempt to induce the purchase or sale of, any security” unless they are registered as a broker or dealer under the rules and regulations of the Financial Industry Regulatory Authority Inc. FINRA is the regulatory organization designated by the SEC to license and regulate broker-dealers.

The ramifications for failure to register as a broker-dealer are severe, even criminal. Section 29(b) of the Exchange Act provides that every contract made in violation of any provision of the broker-dealer registration requirements “shall be void” as to rights of persons who made or engaged in the performance of such contract. It results in the underlying purchase of securities becoming a voidable transaction that gives the investor a right of rescission, so for purchasers losing money on the investment, there is an instantaneous and simple claim to get a refund of their investment.

Moreover, Section 20(e) of the Exchange Act, under which the SEC may impose aiding-and-abetting liability on any person that knowingly or recklessly provides substantial assistance in a violation of the Exchange Act, creates additional potential liability. Finally, merely retaining and permitting an unlicensed intermediary to help facilitate or effect a securities transaction (such as an ICO) may be a violation of federal and many state laws, and may subject the issuer to possible civil and criminal penalties.

Most ICO promoters and affiliates negotiate payment of “success fees” upon completion of a financing transaction or arrange for some other iteration of transaction-based compensation. Even if the arrangement masquerades the true intent of the relationship, payment of transaction-based compensation is treated by U.S. securities regulators as a nearly conclusive indication that a person is engaged in the securities business and should be registered as a broker-dealer.

Thus, when an unregistered person or entity is involved as a broker, finder, etc. of an ICO, the ICO could become immediately and irrevocably tainted. This notion makes a lot of sense. Broker-dealers are supposed to provide a gatekeeper to protect investors in the marketplace and are required to “observe high standards of commercial honor and just and equitable principles of trade” in the conduct of its business, including determining if an investment is “suitable” for its customer and maintaining meticulous records of communications, representations, transactions and other important information. Broker-dealers also are subject to SEC and FINRA examination together with a broad range of regulations and rules of conduct.

The SEC considers the principle of gatekeeper registration sacrosanct and broadly construes the broker-dealer laws while narrowly construing the few permitted exceptions.

State “Blue Sky” Laws

In addition to the federal securities laws, every state has its own set of securities laws — commonly referred to as "blue sky laws" — that are designed to protect investors against fraudulent sales practices and activities. In fact, the DAO 12(a) report highlights this issue, whether ICOs cut across state lines, which could result in violations of the securities laws by transmitting offering documents into states where the issuer had failed to satisfy state regulatory blue sky requirements.

While blue sky laws do vary from state to state, most state laws typically require companies making offerings of securities to register their offerings before they can be sold in a particular state, unless a specific state exemption is available. The laws also license brokerage firms, their brokers and investment adviser representatives, often mirroring similarly purposed SEC statutes. Thus, in addition, various state laws may provide ICO subscribers with rescission rights as well, even where the unregistered person or entity did not contract directly with investors.

As an aside, most states have statutes that provide a detailed rescission offer process to cure securities laws violations, and generally, offerees who reject a rescission offer lose the right of action to a refund (though not necessarily other rights, such as those stemming from fraudulent or other unlawful conduct).

Rescission Waivers

In an attempt to mitigate the risk of a rescission offer in the event that an ICO token is later

In an attempt to mitigate the risk of a rescission offer in the event that an ICO token is later deemed to be a security, some token purchase agreements for ICOs may have gone so far as to contain presale provisions attempting to "disclaim" liability and somehow prospectively remove the possibility of rescission. These waiver provisions require the token recipient to agree that token purchases are irreversible and there is "no refund under any circumstances." Other token issuers characterize the payments received from token buyers as nonrefundable donations, using a Switzerland foundation as the legal entity. However, caveat emptor or "buyer beware" has its limitations, and token issuers cannot contract out of compliance with securities laws, especially rescission.

Rescission cannot even be used to eliminate liability, so if ICO token recipients were to receive rescission, the ICO could still be liable to the SEC for securities violations. Indeed, Section 29 (a) of the Exchange Act of 1934 also expressly provides that "any condition, stipulation, or provision binding any person to waive compliance with any provision of [the laws] *shall be void*." (Emphasis added).

Some ICO purchase agreements require that the purchaser waive the right to receive a return of their cryptocurrency paid for the token and limit liability to the equivalent value in U.S. dollars paid at the time of purchase. The enforceability of these provisions is similarly suspect. Historically, the SEC does not allow securities law violators to dictate the nature and amount of an investor remediation, such as a rescission offer.

Final Thoughts

In U.S. capital markets, when an investor orders 100 shares of his or her favorite stock, a proper, transparent and meticulous transaction will occur. That's because — and this is no coincidence — U.S. markets, in addition to being the most heavily regulated, are also the most efficient, most robust and most secure in the world. ICOs turns this traditional notion of safety and security on its head, which is troubling.

Despite similar sounding names, ICOs bare little semblance to IPOs, which have historically (and quite mistakenly) enjoyed far too much allure as "get rich quick" opportunities. The valuations of ICOs eerily resemble those of the many failed companies of the early days of the dot-com boom initial public offerings, when many investors lost their life savings to investments encompassing little more than a sales pitch with the word "internet" in the description.

Although innovation and creativity have made U.S. securities markets the best capital formation system in the world, careful and thoughtful government intervention from entities such as the SEC has ensured that U.S. markets also have the highest level of integrity and safety.

Of course, the SEC should not discourage modernization or technological advances, but it should ferret out the abuses while offering assistance and guidance to the pioneers of the securities markets. In that vein, purveyors of ICOs must provide the same customer protections and capital safeguards often taken for granted in the context of the traditional trading of securities, such as with a registered U.S. exchange. This includes enlisting only registered broker-dealers to assist with the marketing and sale of ICOs.

As the former chief of the SEC's Office of Internet Enforcement (and also because my last name is Stark), my take is that for the ICO industry, winter is coming. This means that in the next several years, the SEC will initiate a slew of ICO-related enforcement actions, perhaps even a sweep, where a multiple and variety of matters are all announced and filed at the same time, causing a virtual earthquake in the ICO industry.

What will follow won't be pretty: There will be some blood on the floor in the form of lost investments from good, honest wide-eyed investors who had tried to capitalize on the cryptocurrency phenomena.

But for ICO token subscribers, there may be some immediate relief, among other things, in the form of rescission rights, which, while costly and burdensome for ICO promoters, curators and the like, may turn out to be a life jacket for certain disgruntled token investors.

And rescission rights may also only be the remedial tip of the iceberg. In addition to rescission, if

ICO issuers are caught lying or making misrepresentations (in addition to selling unregistered securities), class action lawyers are already knocking on the door. In the first ICO class action, blockchain startup Tezos has been hit with a potentially groundbreaking class action alleging that its recent massive $232 million ICO violated U.S. securities laws and misled investors. For those Tezos class action claimants, their remedies are not merely rescission, but the entire gamut of civil remedies, including punitive damages, interest, attorneys' fees and "any other fair and equitable relief."

In the aftermath of the inevitable SEC ICO onslaught, when the smoke clears, ICO token subscribers will owe a well-deserved shoutout to perhaps the most unlikeliest of teammates: Chairman Jay Clayton and his crew at the U.S. Securities and Exchange Commission.

The SEC's DAO 21(a) report, and the many other SEC actions in the ICO arena, together with Clayton's leadership, will undoubtedly pave the way for a more fulsome, more transparent, more reliable, more efficient and far healthier cryptocurrency marketplace.

Want proof of the SEC as wingman? Check out Exhibit A of the Tezos class action, its none other than the SEC's DAO 21(a) report. Go figure ....

John Reed Stark is president of John Reed Stark Consulting LLC, a data breach response and digital compliance firm. He previously served for almost 20 years in the Enforcement Division of the U.S. Securities and Exchange Commission, the last 11 of which as chief of its Office of Internet Enforcement. He also worked for 15 years as an adjunct professor of Law at the Georgetown University Law Center, and for five years as managing director of a global data breach response firm. He is the author of "The Cybersecurity Due Diligence Handbook."

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