SEC/NASAA: The position of US securities markets authorities with regard to Initial Coin Offerings and cryptocurrencies. February 2018.

Markets are currently seeing a proliferation of cryptocurrencies and initial coin offerings (ICOs). Due to the size that this phenomenon is starting to take on, some competent authorities from various States have issued statements warning investors about the risks involved in these transactions.

The aim of this article is to present the main messages launched by the Securities and Exchange Commission (SEC) – the securities regulatory and supervisory body in the United States – and by the North American Securities Administrators Association (NASAA) – the US Association of State agencies responsible for protecting investors in the field of securities – in their latest statements on these types of offerings.

Firstly, on 11 December 2017, SEC chairman Jay Clayton published a **statement on cryptocurrencies and initial coin offerings** on the organisation's website which sets out a series of considerations that summarise the position that the SEC has held to date.

On 4 January 2018, NASAA published a **reminder to investors to approach cryptocurrencies, initial coin offerings and other cryptocurrency-related investment products with caution**.

Finally, Jay Clayton and two SEC commissioners, Kara M. Stein and Michael S. Piwowar, published a new **statement commending the NASAA's recommendation to investors to act with caution** on the same date and following NASAA's press release.

Statement of the SEC chairman on Cryptocurrencies and ICOs (11 December 2017)

The statement sets out a series of considerations of the SEC chairman on markets for cryptocurrencies and the ICOs and is aimed at two main groups: "*Main Street*" investors and market professionals. It also includes additional comments on the matter, as well as a set of conclusions.

With regard to **investors**, the statement indicates: a) that a number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in traditional securities markets, with correspondingly greater opportunities for fraud and manipulation; b) the fact that to date no initial coin offerings have been registered with the SEC. Neither has the SEC approved, to date, any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies for listing and trading; and (c) the importance of obtaining information, being wary and bearing in mind the cross-border nature of cryptocurrency markets.

With regard to **market professionals**, the statement indicates that: a) any activity that involves an offering of securities must be subject to securities market law irrespective of whether it is made through tokens in a blockchain; b) a token is deemed to be a security when the token offering represents an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others; c) merely calling a token a "*utility*" or structuring it to provide some utility does not prevent the token from being a security; d) market participants must not promote or tout the offer and sale of coins without first determining whether the securities laws apply to those actions; and e) platforms that effect or facilitate transactions in cryptocurrencies may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act.

With regard to **cryptocurrencies**, it indicates that a) calling something a "*currency*" or a currency-based product does not mean that it is not a security and therefore before launching such a product, its promoters must be able to demonstrate that the currency product is not a security or comply with applicable registration and other requirements under securities laws; b) the use of cryptocurrencies in transactions should be subject to particular

caution, including ensuring that anti-money laundering and know-your-customer obligations are not being undermined; c) they purport to be items of inherent value (similar, for instance, to cash or gold) that are intended to provide many of the same functions as long-established currencies, but do not have the backing of a government or other body. This does not mean that they cannot be considered securities or that the offer and sale of cryptocurrencies are beyond the SEC's jurisdiction, as this will depend on the characteristics and use of that particular asset.

With regard to **ICOs**, in addition to recognising their potential for raising capital for companies and individuals, the statement highlights the key question for all those who wish to acquire them: Is the coin or token a security? Jay Clayton states that the answer depends on the features and circumstances of the offer. For example, he believes that when promoters emphasise the secondary market trading potential of these tokens, then this is a key characteristic of a security as potential purchasers are being sold on the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others.

The statement finishes with a series of **conclusions**. Firstly, it reaffirms the SEC's commitment to promoting capital formation by providing investment opportunities for institutional and Main Street investors in cryptocurrency-based technology. Secondly, it encourages Main Street investors who are considering investing in an ICO or in a cryptocurrency to ask good questions in order to discover the true nature of the investment. The statement includes a list of sample questions that should be asked, which include: who exactly am I contracting with? Who is marketing the product? Where is my money going? What specific rights come with my investment? Are there audited financial statements or not? Is there trading data? What are the conditions for selling my investment? If a digital wallet is involved, what happens if I lose the key? What are the features of the blockchain that support it and has there been an independent cybersecurity audit? What legal protections may or may not be available in the event of fraud, a hack, malware or a downturn in business prospect? etc. Thirdly, it reminds market participants and their advisers that they should thoughtfully consider the securities law framework and it encourages them to engage with SEC staff when analysing ICOs and cryptocurrencies.

Reminder to Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution (4 January 2018)

NASAA president Joseph P. Borg issued a statement urging Main Street investors to go beyond the headlines and hype to understand the risks associated with investments in ICOs and cryptocurrencies.

NASAA has identified Initial Coin Offerings (ICOs) and cryptocurrency-related investment products as an emerging investor threats for 2018 and has published a short animated video to help investors understand the risks associated with these investments.

NASAA lists a series of common **concerns** investors should consider before investing in any offering containing cryptocurrency, which include:

- Cryptocurrency is subject to minimal regulatory oversight, susceptible to **cybersecurity breaches or hacks**, and there may be no recourse should the cryptocurrency disappear.
- **Cryptocurrency accounts are not insured** by the Federal Deposit Insurance Corporation (FDIC), which insures bank deposits up to $250,000.
- The **high volatility** of cryptocurrency investments makes them unsuitable for most investors, especially those investing for long-term goals or retirement.
- Investors in cryptocurrency are highly reliant upon unregulated companies, including some that may lack appropriate internal controls and may be **more susceptible to fraud and theft** than regulated financial institutions.
- Investors will have to **rely upon the strength of their own computer security systems**, as well as security systems provided by third parties, to protect purchased cryptocurrencies from theft.

NASAA also reminds investors to keep watch for common **red flags** of investment fraud. Specifically:

- "***Guaranteed*" high investment returns**. There is no such thing as guaranteed investment returns,

and there is no guarantee that the cryptocurrency will increase in value.

- Cryptocurrency investment opportunities are promoted aggressively through social media and so investors should be very wary of an **unsolicited communication** about an investment opportunity.

- **Sounds too good to be true.** If the project sounds too good to be true, it probably is. Investors should therefore watch out for exaggerated claims about the project's future success.

- Take time to research an investment opportunity before handing over money. Investors should watch out for **pressure to act fast** or "*get in on the ground floor*" of a new tech trend.

- Many fraudulent investment schemes involve **unlicensed individuals or unregistered firms** and therefore investors should check license and registration status with their State or provincial securities regulator.

Statement of the SEC chairman and two commissioners commending the recommendation to exercise caution launched by NASAA to investors (4 January 2010)

Jay Clayton and two commissioners of the SEC, Kara M. Stein and Michael S. Piwowar, published another statement commending the above-mentioned NASAA reminder.

The statement highlights that the NASAA release recognises: a) that cryptocurrencies, while touted as replacements for traditional currencies, lack many important characteristics of traditional currencies, including sovereign backing and responsibility and b) that they are now being promoted more as investment opportunities than efficient mediums for exchange.

It also highlights that the NASAA release reminds investors that when they are offered and sold securities they are entitled to the benefits of State and federal securities laws. However, it is clear that many promoters of ICOs and others participating in the cryptocurrency-related investment markets are not following these laws.

The statement also indicates that the SEC and State securities regulators are pursuing violations, but they again caution investors that, if they lose money, there is a substantial risk that the supervisors' efforts will not result in a recovery of their investment.

Links of interest:

Statement by the SEC Chairman on Cryptocurrencies and Initial Coin Offerings (11 December 2017)

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