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Initial Coin Offerings Horrify a Former S.E.C. Regulator

By NATHANIEL POPPER NOV. 26, 2017

SAN FRANCISCO — Members of the Securities and Exchange Commission's staff have been hearing recently from a former colleague with an urgent question: Why aren't you cracking down on these initial coin offerings?

Initial coin offerings are a relatively new method that entrepreneurs have used to raise money for start-ups, by selling custom-built virtual currencies. The practice has taken off this year, despite the warnings of regulators and the uncertainty of the rules concerning the fund-raising method.

Joseph Grundfest, who was a commissioner at the S.E.C. in the 1980s and is now a law and business professor at Stanford, said he had been contacting current commission officials and staff to urge them to bring cases, and fast.

"I.C.O.s represent the most pervasive, open and notorious violation of federal securities laws since the Code of Hammurabi," Mr. Grundfest said in an interview.

“It’s more than the extent of the violation,” he said. “It’s the almost comedic quality of the violation.”

A spokeswoman for the S.E.C. did not respond to a request for comment.

Start-ups have raised more than $3 billion this year from investors through coin offerings. Most start-ups say the coins they are selling will be useful as a method of payment in the online services they are building.

Coin offerings generally happen without the involvement of financial institutions or regulators because investors pay for the coins using Bitcoin and other virtual currencies, which can be sent outside the traditional financial system.

Regulators in China and South Korea have recently banned such offerings outright.

In the United States, the S.E.C. has brought one case against a small fraudulent coin offering. The agency has also warned that at least some coins being sold could be considered securities, and would be in violation of securities law if not registered with the authorities — and few are.

But Mr. Grundfest, who is also a co-director of the Rock Center for Corporate Governance, said the continuing flow of new coin offerings showed that the warnings were not nearly enough.

“We’re waiting to see a whole bunch of enforcement actions in this space, and we wonder why they haven’t happened yet,” he said. “I hope what they are doing is planning on a sweep of 50 I.C.O.s.”

Mr. Grundfest is far from the only voice who has criticized the frenzy around coin offerings. Chamath Palihapitiya, a venture capitalist who has expressed enthusiasm about Bitcoin, has said he thinks that “99 percent of I.C.O.s are a scam,” a sentiment that other leading venture capitalists have echoed.

But Mr. Grundfest’s words could carry more weight, both because he is close to the technology world near Stanford and because he knows what it takes to bring federal securities cases.

He said the most obvious way for regulators to go after initial coin offerings would be to label them as securities and punish them for not registering with the authorities.

The chairman of the S.E.C., Jay Clayton, said in a talk this month that the agency was planning to crack down on offerings that violated securities law, including virtual coins that should be categorized as securities but have not been registered with the authorities.

“Where we see fraud, and where we see people engaging in offerings that are not registered, we are going to pursue them because these types of things have a destabilizing effect on the market,” Mr. Clayton said in a meeting at the Federal Reserve Bank of New York.

Mr. Grundfest said that he would welcome this, but that he did not think it should have taken this long.

“These are not hard cases,” he said. “You don’t need teams of accountants poring over complex financing documents.”

Many companies offering coins have argued that they are not securities because they will have utility on the networks the companies are building.

But Mr. Grundfest said it was clear that almost everyone buying tokens at this point was buying them with the hope that their value would go up, not because the buyer wanted to use them on some future computer network.

Mr. Grundfest said he thought that the concept of a coin offering could be a useful innovation for certain types of fund-raising. It could, he said, make sense for a company building a decentralized cloud storage network, which could then use the coin as a means of payment and record keeping on the network.

But he said almost none of the projects currently raising money through coin offerings had a need for the novel structure.

“Is this amazing technology? Yes,” he said. “But most of the stuff we see today is total crap.”

Mr. Grundfest said several teams looking at doing offerings had approached him to ask how to do it right.

"I say, 'Look, you are at very high risk for violating the securities law,' and explain why," he said. "Then they go find another lawyer."

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