The Legal Risk to ICOs That No One's Talking About

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OPINION

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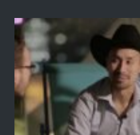
With the rise and rise of initial coin offerings (ICOs), much attention has been paid to how the U.S. Securities and Exchange Commission (SEC) and federal prosecutors view this innovation. And rightfully so, as those enforcement systems carry stiff penalties and even the potential for jail.

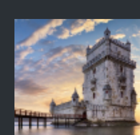
But investors and companies should also know that buyers can sue sellers privately under the federal securities laws based on similar theories. Sellers should know about these laws to understand the risks they face, and buyers should know their remedies if treated unfairly.

I wrote this article a few years ago about how to identify whether a coin is a security (back when we were calling ICOs "token pre-sales"), and the bottom line is that it can be tricky. The important thing to know, however, is that if an ICO does constitute a security offering, then federal law requires that the seller register the security or find an exception. Failure to do so can result in SEC enforcement or criminal sanction.

But here's what not everyone realizes: the Securities and Exchange Act of 1933 says that a person who buys an unregistered security can sue the seller *on his own* to get his money back. That's important for a number of reasons.

First, it means that the SEC and the Department of Justice are not the only parties who can allege that an ICO is a securities offering. Some argue these days that there have been so many ICOs and





that the SEC is so understaffed that it will never bring enforcement actions against the vast majority of sellers. But this doesn't mean a private party won't sue. And if a private person does, it is not the SEC, but a judge who decides if the ICO was a securities offering.

Second, the private right of action is important because the remedy is to entirely unwind the original sale. That means that a company that raised $15 million in its ICO might have to give every penny (satoshi?) back to its buyers, even if it has since spent much of what it raised.

That kind of outcome is also made possible by federal class action rules, which allow one person to sue on behalf of all of the people who bought a particular security.

When the money's gone

What about the blood-from-a-turnip problem? That is, how do you get money back from a company that has since spent it or moved it elsewhere? Things were bad enough during the Great Depression that the drafters thought of that, too.

The 1933 Act provides for *personal liability* for those who control a company that sells an unregistered security. So the ordinary protections of the corporate form don't necessarily apply.

The bad news for buyers (and the good news for sellers) is that the time in which a private party must sue is very short. The statute of limitations for this particular violation is only one year from the date of sale, and claims beyond that time are barred.

Buyers and sellers should also know, however, that this is not the end of the story. The securities laws provide additional causes of action for *misstatements* that a seller makes when selling a security. Likewise, other state and federal laws provide remedies for the same under general fraud statutes. And even if an ICO does not constitute a sale of a security, those same laws generally provide for remedies if the seller made material misstatements to induce the sale.

So, wherever the SEC ends up on ICOs, investors and sellers should be aware of this broader legal landscape, either to protect their businesses or to help vindicate their rights.

Disclaimer: This *is not legal advice and is not intended to establish an attorney-client relationship. You can reach Jared at jmarx@hwglaw.com.*

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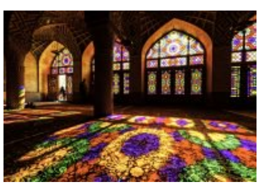

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This applies to ICOs founded and launched by USA citizens and residents. USA SEC laws have no extra-territorial rights. Have not read of a class action or individual lawsuit that succeeded to file its claims against any foreign parties not operating in USA. USA residents purchasing goods, services and investments from foreign firms do so under their own risks.

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In general, the policies from 1933 are ill-suited for the 21st century, at least in the sense that they did not anticipate a thing such as a utility token. The policies ought to be updated and a clear exception made for utility tokens, even if utility tokens are sold and distributed prior to the DAPP being completed.

While the original drafters of the rules might have been very smart in their day, when the policies are applied to present-day situations, they come across as inadequate and in fact dangerous, given that they have the potential to drive innovation away to friendlier jurisdictions.

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They aren't policies, but laws... a huge difference.

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Policies and laws are intertwined. Laws tend to embody public policy, although certainly not perfectly. The laws that grew out of the policies that were heavy laden by the aftermath of the great depression nearly a century ago are not necessarily ones that are fit for today's technologies and circumstances.

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Policies and Laws are twisted together...? If you say so.

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Not sure why your line of attack. Are you a firm believer in the U.S. securities laws as they stand today?

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