FINRA
Financial Industry Regulatory Authority

Investor Alerts

Initial Coin Offerings (ICOs)—What to Know Now and Time-Tested Tips for Investors

Your digital assets—those assets you have stored electronically on your computer or on the internet—take many forms: the unique logo you designed for your company, the photographs stored on your phone, and your eclectic iTunes music collections. Digital assets also include cryptocurrencies, and other crypto coins and tokens, which may be offered to you in an Initial Coin Offering, or ICO.

FINRA is issuing this alert to inform investors that investments in digital assets, such as ICO tokens and cryptocurrencies, can involve significant uncertainty, as well as risks that are different from more conventional assets like stocks or bonds. While ICOs, cryptocurrencies and the technologies that power them may hold great potential for legitimate innovations in capital raising and financial markets, it can be a challenge for investors to verify information about these products to make informed decisions. The markets for digital assets continue to display high levels of volatility, involve speculative risk and the potential for fraud. All investments come with some degree of risk, and ICOs and cryptocurrencies are no exception.

A Quick 411 on Digital Assets

Digital assets like cryptocurrencies and ICOs continue to evolve and spark interest from Main Street investors. With billions of dollars raised in ICO financings and over 1,500 different cryptocurrencies currently available, these rapidly changing markets are tempting for investors. It is also difficult for most individual investors to make sense of these complex products.

An ICO involves the creation of a new virtual coin or token by a company looking to raise money. ICO investors typically do not get a stake in the company like you do when you purchase an equity share in an initial public offering (IPO). Most ICO issuers use blockchain technology for some part of their business to provide a particular service or product and these companies disseminate the new ICO tokens to buyers via a blockchain network.

7 Things to Know Now About ICOs

With retail investors using real money to invest in digital assets, here are seven lessons worth sharing.

1. **ICOs offer little investor protection.** To date, many ICOs have been offered outside of existing regulatory systems. ICO promoters and issuers may be offering the tokens or coins to investors without typical disclosures and customer access to documents required by U.S. regulators like the Securities and Exchange Commission (SEC) that help investors make an informed investment decision. The lack of regulation increases the risk for fraudulent schemes and deceptive tactics—and leaves investors with little recourse to recover funds invested or hold parties accountable should a fraud occur. The SEC and Commodity Futures Trading Commission (CFTC) have released guidance and taken action against market participants that may be operating illegally or have engaged in alleged fraudulent actions with respect to ICOs and cryptocurrencies.

2. **ICO fraud is real.** Fraudsters tend to go where the money is, so it's no surprise that ICO fraud is happening, and regulatory authorities are cracking down. For example, the SEC recently halted a fraudulent ICO, alleging that the individuals and the firm promoting the ICO used websites and social media to lie about relationships with well-known and respected organizations, and included fake customer testimonials to attract investors. The SEC and criminal authorities also recently charged individuals with orchestrating a fraudulent ICO that raised millions of dollars from thousands of investors last year. The SEC alleges that these individuals offered and sold

unregistered investments with fictional claims about how the money would be used. These individuals allegedly used fake profiles of executives with impressive biographies, posted false or misleading marketing materials to the company's website, and paid celebrities to tout the ICO on social media. Here is an example of what a fraudulent ICO might look like.

3. Online platforms that facilitate trading in ICO tokens are not registered exchanges. And many of these platforms have a history of problems related to spoofing, insider trading and market manipulation. The SEC recently warned investors about online trading platforms that refer to themselves as "exchanges," which might make investors think that they are regulated entities or meet the regulatory standards of a national securities exchange. However, no ICO platforms are currently registered as exchanges and the SEC has stated that it does not regulate these platforms as exchanges or review the digital assets on these platforms.

4. Investors are losing millions to ICO theft. One study found that $400 million in funds raised in ICOs in 2017 was lost or stolen. In addition to stealing money and tokens, hackers also have accessed investors' personal information like addresses, phone numbers, bank details and credit card numbers. In an ICO, there are many touchpoints where something can go wrong (such as digital wallet providers), so be aware that cybersecurity vulnerabilities exist, and many of these entities might be operating internationally and without any regulatory oversight.

5. Receipt of future tokens is not a given in an ICO. The ability of investors to receive tokens in the future is typically contingent on certain triggering events, such as the development of a new enterprise and a related future public sale of tokens, which may not take place. Even if you do receive tokens in an ICO, they may be worth nothing or may be redeemable only for goods or services by the token issuer. Furthermore, there may be no ability to trade or exchange tokens.

6. "SAFTs" don't make ICOs safe. Some market participants have been using Simple Agreements for Future Tokens (or SAFTs) to offer their tokens to the public. SAFTs are investment contracts that appear to be modeled after SAFE (Simple Agreement for Future Equity) contracts that emerged with securities-based crowdfunding. Know that investing in a SAFT contract does not mean the offering is "safe" or compliant with applicable federal and state laws. In a SAFT, the issuer typically advertises that the token you purchase would start out as security interest (or "security token") offered subject to the federal securities laws but then transform over time into a "utility token" that operates outside of the federal securities laws. The issuer may indicate that the coin could be used for future access, rewards or discounts for a company's products or services. No matter what a company says about the ability of a token to change characteristics from a security to a non-security, there is no guarantee that the SEC or the courts would agree with a company's assessment. A determination of whether something is a security is a facts and circumstances analysis, and titles don't change that.

7. FOMO can inflate ICO valuations. If you are worried that not investing in an ICO now means you are missing out on a future windfall, you are not alone. According to a recent study, ICO valuations often are based on a fear of missing out (FOMO) rather than on market fundamentals, project development forecasts and the nature of tokens offered. With little information available about companies that undertake ICOs, investors are not in a strong position to make informed choices. Many ICO issuers publish a whitepaper that provides details about an offering, such as a description of its blockchain technology, team member bios and token information. White papers can be valuable to investors, but it is difficult for investors to verify the information included. Some papers may be misleading or even fraudulent. Even the most comprehensive ICO white paper tends to lack the features of prospectuses or other offering documents and disclosures required by the federal securities laws, such as audited financial statements, disclosures about the company and its officers, and risk factors to consider before investing.

Time-Tested Tips

ICOs and the markets for digital assets might seem like the next big thing, but a few basic, time-tested tips can serve you well before you make a decision to invest in any new product or market.

- Only invest with money you can afford to lose. ICOs are speculative, and you can lose some or all of your investment.
- Practice diversification. This is the equivalent to the proverbial "don't put all of your eggs in one basket." Spreading your money across different asset classes such as stocks, bonds, real estate and other investments helps control risk.
- Check out the background and registration status of any individual recommending or selling an investment, including ICOs. You can do that quickly, easily and at no charge with FINRA's BrokerCheck. Check the credentials of any promoters, salespeople, or those mentioned in a white paper: for example, if someone claims to have a PhD in computer science, verify that it is real using these tips from the Federal Trade Commission.
- Collect and review information about ICOs from regulators and trusted media outlets. Study the company, including financial documents, executives and employees, organizational structure and business lines.
- Run the investment by others. In the case of ICOs, this might include someone with a strong technology or mathematics background, as well as an experienced investor, CPA or registered investment professional.
- New technologies and media buzz are often the recipe for the latest pump-and-dump scheme. Look out for guarantees, unregistered products, claims of overly consistent returns, complex strategies, missing documentation, account discrepancies and pushy salespeople. All are red flags of potential fraud.

If you have concerns about ICOs or cryptocurrencies, or suspect a scam related to these investments, you can contact the SEC, file a complaint using FINRA's online Complaint Center or send a tip to FINRA's Office of the Whistleblower.

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