

Are You An Informed Investor?

What to Know about ICOs

Initial Coin Offerings (ICOs) are attracting investors interested in new trends in technology investing. Regulation of ICOs is evolving and complex. With considerably fewer investor protections than in traditional securities markets, investors considering participating in an ICO investment should be aware of the growing potential for fraud and manipulation these offerings present. Investors need to approach ICOs with extreme caution. ICOs are very risky and are not suitable for many investors. You could lose all of your investment. Before parting with your hard-earned money, make sure you know what you're getting into.

What is an Initial Coin Offering?

An Initial Coin Offering (ICO), also sometimes referred to as an Initial Token Offering (ITO), is a method used by an individual, group of individuals or organization to raise capital for a planned project. Most ICO's involve projects that are at the "idea" stage and in many instances may lack a prototype or "real world" implementation of the idea. To finance the idea or project through an ICO, promoters create a new virtual "coin" or "token," which is then sold online to participants in the ICO in exchange for fiat currency, such as the U.S. or Canadian dollar or Mexican peso.

The facts and circumstances of each ICO are different. For example, if the ICO is considered to include the offer and sale of securities, the offer and sales of the coins or tokens in the ICO must be registered with appropriate securities

regulators or have an exemption from registration. Most exemptions require sales only to accredited investors, or those with net worth of more than \$1 million. Use extreme caution when dealing with promoters who claim their ICO offering is exempt from securities registration yet does not ask about your income, net worth or level of investing sophistication.

Before participating in an ICO, potential investors should ask whether the "coins" or "tokens" are considered securities and whether the offering itself has been registered with appropriate securities regulators. If properly registered in the United States, free information about the offering is available on the "Form S-1" in the U.S. Securities and Exchange Commission's online EDGAR system. Also, virtual "coins" or "tokens" considered to be securities must comply with securities laws, which require the

individuals or firms selling them to be licensed or registered with securities regulators. Potential purchasers can check the registration status and background of those selling "coins" and "tokens" by contacting their state or provincial securities regulator or by visiting Investor.gov.

While some may tout ICOs as a new form of crowdfunding, it is important to remember that crowd-funded offerings must comply with the requirements of the federal Regulation Crowdfunding and securities laws in general. It also is important that potential participants understand that an ICO should not to be confused with an Initial Public Offering (IPO), which requires potential offerings to undergo a very rigorous and robust process before they can attempt to raise capital on regulated securities markets.

What is Blockchain Technology?

Many of the projects for which tokens are issued seek to leverage blockchain technology, which stores transaction information, similar to a ledger. Unlike a traditional ledger, blockchain is distributed through the internet and transaction information is duplicated on many computers connected on a network.

A blockchain has no central authority to maintain and update the ledger of transaction information. This function is instead performed by software stored on each of the computers on the network that uses cryptographic techniques to ensure entries in the ledger cannot be changed and that only valid transactions are added to the blockchain "ledger."

What Types of Coins or Tokens are There?

In an ICO, promoters generally create a new virtual "coin" or "token." There are two main types of tokens: utility and equity.

Utility tokens enable the holder to exchange the coin for a good or service in the future.

Equity tokens entitle the holder to an interest in the revenue or ownership of the underlying venture.

The regulatory treatment of tokens is evolving. Equity tokens are more likely to be regulated as securities than utility tokens. However, if a utility token is issued for a non-operational project or if it is planned to be traded on an exchange, it may also fall under the purview of securities regulation.

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Considerations for Investors

Investors should be aware of the following risks when considering whether to participate in an ICO:

Phony Initial Coin Offerings: There is a real risk that the ICO you are considering is a fraud. Federal and state regulators are daily uncovering new scams involving these products. Here are two examples of potential ICO frauds:

- ▶ Scammers create a fake ICO and simply steal investors' money, either outright or through a Ponzi-style prolonged investment scheme.
- ▶ Computer hackers "spoof" a legitimate ICO and trick investors into paying them instead of the company behind the ICO.

Lack of Investor Protection. If a "token" or "coin" does not qualify as a security, the investor protections available under the securities laws will not apply. Also, unlike brokerage accounts where third-party custodians hold investors' funds, "coins" or "tokens" created for an ICO may be held in an encrypted "wallet," which may be difficult for enforcement authorities to freeze or access. Because ICOs are conducted over the internet, the promoters could be anywhere in the world, greatly increasing the risk that you will be unable to recover any losses.

Lack of Disclosure. Individuals launching an ICO usually do so through their own websites or through various online blockchain and cryptocurrency forums. Unlike in a registered securities offering, potential purchasers in an ICO likely will not receive a prospectus with important disclosures required by the securities laws. Instead, the promoters behind an ICO may include a "white paper" describing the project and their goals on a website created specifically for the ICO project.

Unproven projects: Unlike traditional capital raising processes, most ICOs are at the "idea" stage and usually not implemented in any real way. Recent data shows that 46 percent of ICOs initiated in 2017 failed, and more than half of these unsuccessful ICOs failed after fundraising had already begun.

Unclear terms. What an investor actually receives when purchasing a coin or token varies greatly from ICO to ICO. Some ICO tokens may have little to no resale value or may constitute nothing more than a donation. If a token is not a security, investor protections available under the securities laws will not apply.

Lack of liquidity. Some promoters may tell potential participants that they can sell their "coins" or "tokens" on a second-

ary market or alternative trading system. There is no guarantee that secondary markets or alternative trading exchanges would accept the "coins" or "tokens" of a particular ICO. Moreover, if the exchanges are not registered, they will not provide investor protections similar to those of investors who purchase stocks listed on an exchange.

Price volatility: The value of the token could swing up or down drastically.

Lack of liquidity: It could be hard to find a buyer to sell the token at a favorable price.

How do investors protect themselves?

Don't Invest Money You Can't Afford to Lose. ICOs are not the same as other asset classes like traditional stocks and bonds. Investing in ICOs should be seen as entirely speculative.

Read the fine print. Don't assume all ICOs are the same or have the same terms.

Research the ICO on the web. Particularly on popular sites such as reddit.com, bitcointalk.org. Research the individuals behind the ICO. Ask questions and be skeptical.

Focus on the token features. Consider whether the token has any value outside of the ICO. Also consider whether the tokens can be traded on virtual currency exchanges. This could help determine whether you will be able to convert the tokens to cash.

Watch for scams. Individuals could organize a pump-and-dump scheme to urge investors to buy into the ICO, promote it to elevate the price, and then sell it off in a coordinated sale. The price plummets and those unaware of the scheme are left with devalued tokens.

Don't be star struck. Sometimes ICOs are promoted by celebrities or "industry insiders" who encourage the public to get in on the deal fast.

Think with your head, not your heart. Scammers often use language intentionally designed to provoke some emotional reaction in their targets. Whatever the appeal, remember that investing is a business decision. Ask yourself, "Is this investment right for me?"

The Bottom Line:

Before making any financial decisions, do your homework and contact the Maryland Securities Division at 410-576-6882 if you have any questions about the product or the person selling it.

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