FINRA Financial Industry Regulatory Authority

Investor Alerts

Initial Coin Offerings: Know Before You Invest

Some startup companies are using initial coin offerings, also called ICOs or token sales, to raise capital. In an ICO, a company creates a new virtual coin or token that they offer for sale and disseminate to purchasers using blockchain technology, also called distributed ledger technology. Investors should be aware that ICOs differ significantly from initial public offerings (IPOs). Unlike stocks, ICOs typically confer no ownership rights in the company; and unlike bonds, ICOs do not involve investors lending money to the issuer. Instead, ICOs involve new technologies and products that are highly technical and complex, and investors can lose some or all of the money they invest in an ICO.

Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities. As a new Investor Bulletin from the Securities and Exchange Commission (SEC) notes, if the tokens in an ICO are securities, the offer and sale of these virtual coins or tokens are subject to the federal securities laws.

FINRA is issuing this alert to inform investors about the potential risks of participating in ICOs.

What is an ICO?

An ICO involves the creation of a new virtual coin or token by a company looking to raise money. In general, the company announces a specified amount of funds that it wants to raise, and the fundraising continues until that amount is reached. ICOs are conducted online, and purchasers use fiat currency, like the U.S. dollar, or virtual currencies, like bitcoin and ether, to pay for the new tokens.

To date, companies using ICOs as a capital-raising method have generally been startups that use blockchain technology as part of their business model to provide a particular service or product. These companies disseminate the new ICO tokens to buyers via blockchain. Blockchain technology involves a distributed database maintained over a network of computers connected on a peer-to-peer basis. The network participants can share and retain identical, cryptographically secured records in a decentralized manner—meaning there is no centralized server or intermediary. The blockchain technology used for the tokens in ICOs is similar to the bitcoin network, which creates and tracks transactions in the virtual currency, bitcoin.

Companies that issue ICOs typically promote the offering through their own websites and through various online blockchain and virtual currency forums. Potential purchasers in an ICO may not receive a prospectus; instead, companies often publish a white paper describing the ICO.

According to the SEC's Bulletin, some sellers of ICOs might lead buyers to believe that they can expect a return on their investment or otherwise be able to participate in a share of the returns provided by the project. Buyers also might be told that there will be an opportunity to sell the tokens on a secondary market or an online virtual currency exchange, although such secondary market liquidation venues are not guaranteed.

Before You Invest in an ICO

Here are six questions to ask before you invest in an ICO.

1. **Is the ICO a securities offering?** This is important. As the SEC notes in its Investor Bulletin, if the offer and sale of tokens or coins in an ICO constitutes a securities offering, then the federal securities laws apply. This means the ICO (the offer and sale of the tokens) must be registered with the SEC or meet an exemption from registration. Offerings that are performed under an exemption from registration typically require investors to meet certain income or net worth thresholds to be eligible to invest. For example,

exempted offerings often are limited to accredited investors, those with a net worth in excess of $1 million or that maintain certain levels of income. Here are a few tips:

- Verify whether a company has registered an ICO (or any offering of securities) with the SEC by searching the SEC's Edgar system.
- If the ICO is not registered, it is likely only available to accredited investors, and most retail investors do not meet this standard.
- If the ICO is described as a crowdfunding investment opportunity, be aware, as the SEC notes, that the offering might not be operating in compliance with the requirements of Regulation Crowdfunding or with the federal securities laws generally.

2. Are the persons selling the investment registered financial professionals? Be sure to check the professional background of the individuals involved in the offering using BrokerCheck. If the tokens offered in an ICO are securities, then any investment professional offering to sell the tokens must maintain certain licenses and registrations under state and federal securities laws and FINRA rules.

3. What rights and benefits come with your ICO purchase? The rights and benefits of ICO tokens will vary depending on the offering. Thoroughly read and understand the terms and conditions of an ICO, as well as any white paper and the business plans offered by the company issuing tokens. It is important to know what you are receiving in exchange for your investment, including what rights and benefits the tokens may confer upon you. Tokens in an ICO might not represent an ownership stake in a company, so token holders may not have any voting rights or influence on a company, its governance and how funds are used. In addition, ICO purchases may be subject to liquidity issues as it is possible there will not be a market to sell or exchange your ICO tokens.

4. How can you get your money back? Information provided to investors about ICOs should clearly state how you can get your money back. Ask the company if you can cash in tokens for a refund, whether you are permitted to resell your tokens in a secondary market and what if any restrictions apply to any resale. Secondary markets for ICOs offering tokens that are securities must generally register as a national securities exchange or operate pursuant to an exemption from such registration. Also, as noted above, be aware that a secondary market may not exist for tokens purchased in an ICO.

5. What does the company do and what is it offering? ICOs involve highly technical and complex concepts. You should be able to read and understand any information provided to you by an ICO issuer or those promoting the offering, including how the company plans to use the funds raised in an ICO, plain English explanations of the technical details of the proposal, and a development roadmap with specific goals and timelines for the proposal. To date, most ICOs are being offered by startup businesses that have not rolled out a final product or platform to the market. This means that the information available to you at the time of an ICO may be incomplete, subject to change and, in any event, difficult to verify. The limited information that is shared may make it difficult to conduct adequate due diligence needed to make an informed investment decision prior to investing.

6. Are there protections in place to guard against hacking and other cybersecurity threats? As noted by the SEC in its Bulletin, virtual currency exchanges, virtual currency wallets and the platforms used by companies issuing ICOs may be susceptible to possible protocol breakdowns, hacking, malware and fraud. Be sure to inquire about steps these companies have taken to protect their platform and products from these threats.

Be Alert to the Warning Signs of Fraud

Investing in an ICO may seem like an exciting way to be a part of the virtual currency and blockchain startup markets, but use caution when you consider these investments. New technologies and topics that are the subject of media buzz are often used by fraudsters as an opportunity to dupe investors.

To stay on guard and avoid becoming drawn into a scam, look for the warning signs of investment fraud. For example, be suspect of anyone who makes guarantees that an investment will perform a certain way or makes pushy sales pitches that encourage you to "act now" or miss out. All investments have risks and no reputable investment professional should push you to make an immediate decision about an investment. Legitimate professionals should be able to explain the investment, including what it is, what the risks are and how the investment can make or lose money.

In addition, as noted by the SEC in its Investor Bulletin, be aware that if the tokens you purchase in an ICO are stolen or otherwise compromised, you may not be able to easily recover your investment. Other vendors helping to facilitate the ICO, such as third-party digital wallet providers (services that store digital tokens for customers online), payment processors and virtual currency exchanges, also may have access to the tokens, virtual currencies and fiat currencies involved in the ICO, and may be fraudulent, located overseas or operating unlawfully.

If you have concerns about ICOs, or suspect a scam related to ICOs or virtual currencies, 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.

Additional Resources

SEC Investor Bulletin: Initial Coin Offerings

SEC Investor Alert: Public Companies Making ICO-Related Claims

SEC Investor Alert: Bitcoin and Other Virtual Currency-Related Investments

FINRA Investor Alert: Bitcoin: More Than a Bit Risky

FINRA: The Alert Investor: Bitcoin Basics—9 Things You Should Know About the Virtual Currency

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