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PERSPECTIVE

BLOCKCHAIN AND THE LAW

SEC warns about ICO promotion

By Gail Podolsky

Following numerous incidents of celebrities taking to social media to discuss their upcoming investments in initial coin offerings, the Securities and Exchange Commission has released a statement and investor alert warning about the unlawful promotion of initial coin offerings and other investments by celebrities and others.

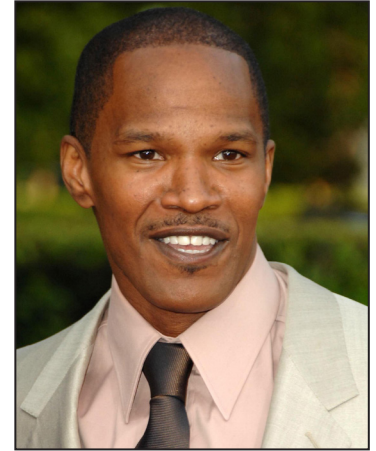
In one recent example, Floyd Mayweather posted a picture of himself and a suitcase full of cash on Instagram boasting about how much money he was going to make in the upcoming Stox.com ICO. In another, hotel heiress Paris Hilton tweeted that she was “looking forward to participating in the new @Lydian-CoinLtd Token!” She specifically included “#ThisIsNotAnAd...” And Jamie Foxx recently tweeted that he was, “Looking forward to participating in the new @cobinhood Token! ZERO fee trading!”



MAYWEATHER



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The SEC said, “endorsements may be unlawful if they do not disclose the nature, source, and amount of any compensation paid, directly or indirectly, by the company in exchange for the endorsement.” The statement is based in part on a report from earlier this year investigating a decentralized autonomous organization known as “the DAO.” The SEC report found that virtual tokens issued by the DAO were securities under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The SEC notes that celebrities are sometimes linked to products or services without their consent, so the celebrity may not even have endorsed the investment and, even if the celebrity endorsement is genuine, each person must evaluate whether the investment is appropriate for them.

While the SEC did not proclaim that all virtual tokens or coins sold in ICOs are securities, it warns that a “celebrity or

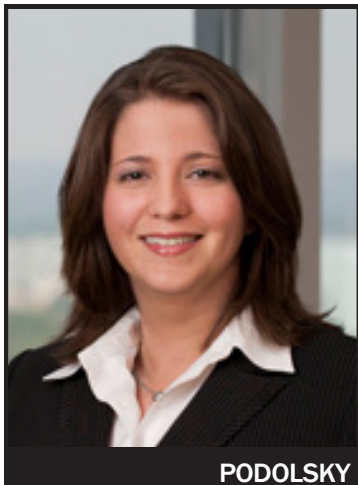
other individual who promotes a virtual token or coin that is a security must disclose the nature, scope and amount of compensation received in exchange for the promotion.” Failure to do so may violate the anti-touting and anti-fraud provisions of the federal securities laws and potentially subject these celebrity endorsers to substantial civil monetary penalties, an order prohibiting them from endorsing securities in the future, jail time, and other penalties.

The SEC did provide guidance on whether an ICO would be considered a security. Specifically, that an ICO would be considered a security if it meets the following four-factor test, commonly known as the Howey test: The commission will consider an ICO to be a security if it is (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits; and, (4) to be derived from the entrepreneurial or managerial efforts of others. *SEC v.*

W.J. Howey Co., 328 U.S. 293, 301 (1946).

The first three prongs are generally easy to apply, especially when the marketing materials and endorsers highlight the benefits of investing in the tokens. However, the fourth prong may be problematic as it will likely depend significantly on the specific facts and circumstances of the offering, the function of the token, and the operation of the underlying enterprise. Also, the test used by the courts generally requires such efforts to be solely or substantially derived from the entrepreneurial or managerial efforts of others.

If the ICO is deemed an offer and sale of securities, then the offering must be registered with the SEC under the Securities Act or an exemption from registration must be available. Registration involves a lengthy process that requires preparing and filing a detailed disclosure document with the SEC (i.e., a registration statement) that will include the



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Warning issued to celebrities, others promoting coin offerings

prospectus must be distributed to investors before accepting any offers to purchase the tokens. After reviewing the filing, the SEC frequently requests revisions to and support for various statements included in the documents. Alternatively, the ICO may fall under one of the various registration exemptions. However, all of these exemptions are subject to specific requirements and restrictions, namely, limitations on the manner of the offering, the purchasers of the securities, and the resale of the securities. Further, even if the offering is exempt from registration under the federal securities laws, it must still comply with anti-fraud provisions of the Securities Act and applicable state securities law registration re-

quirements or exemptions therefrom.

To the extent the ICO is deemed a security, its endorser must clearly and conspicuously disclose the nature, scope, and amount of compensation received in exchange for the promotion. Even if the token is not deemed a security, companies and endorsers should be aware of the truth-in-advertising laws and standards, including the Federal Trade Commission's Endorsement Guides, as the FTC has recently been cracking down on social media endorsers, also known as "influencers," "brand ambassadors" and "promoters."

Early this year, the FTC sent out over 90 letters reminding influencers and marketers that influencers must disclose their re-

lationship with the brand owners when promoting or endorsing products through social media. Those who received letters include Naomi Campbell, Lindsay Lohan, Vanessa Hudgens, Sofia Vergara and Amber Rose. Fortunately, the FTC provided specific guidance on how to comply with the truth-in-advertising laws on social media. For example, #ad, #paid, or #sponsored will suffice for Twitter. For other social media, including phrases like "this post is sponsored by," "this product was given to me by," or "paid for by" will satisfy the truth-in-advertising laws.

The securities and truth-in-lending laws were created to protect consumers and provide them with all material information necessary to make an investment

and/or purchasing decision. Both the SEC and FTC recognize the vast impact celebrities and influencers have on consumers and are actively policing their social media accounts to ensure proper disclosures are being made. Notably, the SEC's statement "encourages investors to research potential investments rather than rely on paid endorsements from artists, sports figures, or other icons."

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