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## The SEC KO's IEOs: Initial Coin Offerings Dressed Up as Initial Exchange Offerings Still Have to Comply with the U.S. Securities Laws

The U.S. Securities and Exchange Commission (“SEC”) has been targeting initial coin offerings (“ICOs”) of digital assets – called coins or tokens – for some time now. The SEC brought high-profile enforcement actions against Kik Interactive Inc. (“Kik”) and Telegram Group Inc. (“Telegram”) in 2019. The SEC alleged that the Kik and Telegram tokens were in fact securities within the meaning of the U.S. securities laws and that Kik and Telegram should have registered them under the Securities Act of 1933 (“Securities Act”).

Aside from non-compliance in many cases with the federal securities laws, ICOs have an abysmal track record, with some studies suggesting up to 80% of them have been scams.<sup>1</sup>

In an effort to avoid the stigma of ICOs, in the past year industry players have been promoting “initial exchange offerings” or “IEOs”. In an IEO, rather than tokens being distributed directly by the sponsors, the tokens are distributed by an online trading platform, colloquially called an “exchange.” This mechanism addresses a shortcoming of typical ICOs, which in many cases do not succeed in having their tokens listed for trading on an exchange.<sup>2</sup> Also, the idea is that an exchange will conduct “due diligence” and only host IEOs for serious projects, thereby lending an air of legitimacy to the IEO.

The SEC just issued an [investor alert](#) advising investors to exercise caution before investing in IEOs through online trading platforms. The SEC pointed out that these online trading platforms are not registered as exchanges with the SEC and that the IEOs may be conducted in violation of the Securities Act and other federal securities laws. If an IEO is not registered under the Securities Act, investors will most likely not have the benefit of important disclosures about the digital asset, the business and the terms of the offering.

Moreover, the online trading platform may need to register with the SEC separately as a national securities exchange or operate under an exemption as an alternative trading system (“ATS”).<sup>3</sup> An ATS must be a registered broker-dealer to operate legally in the U.S. To date, we are aware of only a few registered ATS exchanges which trade in digital assets in compliance with U.S. securities laws.

Further, the online trading platform conducting the IEO may be acting as an unregistered “broker” or “dealer” in violation of the federal securities laws. The Securities Exchange Act of 1934 (“Exchange Act”) defines a “broker” as any person engaged in the business of effecting transaction in securities for the account of others, a test likely to be met in an IEO involving securities.

Note that the key element in determining whether compliance with the Securities Act or Exchange Act is required is whether the tokens offered in the IEO comprise a security. The immediate ability to trade the tokens offered in the ICO on the online trading platform – the chief appeal of an IEO – would, in fact, make it more

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<sup>1</sup> Ana Alexandre, *New Study Says 80 Percent of ICOs Conducted in 2017 Were Scams*, Cointelegraph, July 13, 2018, <https://cointelegraph.com/news/new-study-says-80-percent-of-icos-conducted-in-2017-were-scams>.

<sup>2</sup> See Matthew Beedham, *Here's the Difference Between ICOs and IEOs*, The Next Web, Hard Fork, March 21, 2019, <https://thenextweb.com/hardfork/2019/03/21/initial-exchange-offering-ieo-ico/>.

<sup>3</sup> U.S. Securities and Exchange Commission, *Spotlight on Initial Coin Offerings*, Jan. 7, 2020, <https://www.sec.gov/ICO>.

likely that a token issued in an IEO would be considered a security, according to recent enforcement actions and the SEC's [Framework of Investment Contract Analysis of Digital Assets](#).

In sum, the "IEO" designation does not guarantee that an offering of digital assets is in compliance with the federal securities laws, and the involvement of an online trading platform in an IEO actually increases the opportunities for, and likelihood of, significant violations of federal law.

### **Additional Information**

If you have any questions regarding this Client Alert, please contact your Kutak Rock attorney or one of the authors listed below. For more information regarding our practices, please visit us at [www.KutakRock.com](http://www.KutakRock.com).

<b>Contacts</b>			
Kenneth S. Witt	Denver	(303) 292-7722	<a href="mailto:Ken.Witt@KutakRock.com">Ken.Witt@KutakRock.com</a>
Mark A. Staines	Denver	(303) 297-2400	<a href="mailto:Mark.Staines@KutakRock.com">Mark.Staines@KutakRock.com</a>

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