

## SEC Warns Investors Of IEO Dangers And Limited Remedies

By Philip Rosenstein

*Law360 (January 14, 2020, 7:32 PM EST)* -- Investors should be cautious about investing in initial exchange offerings, particularly when an exchange avoids discussion of how federal securities laws apply to its activities, the U.S. Securities and Exchange Commission said in an investor alert Tuesday.

Investors should be particularly wary of IEOs touting registration with requisite regulators, as “there is no such thing as an SEC-approved IEO,” the SEC said.

The alert comes about two and a half years after the SEC released a bulletin warning investors about the dangers of investing in initial coin offerings.

IEOs and ICOs are related in that they both involve the offering of digital tokens. However, rather than purchasing digital tokens directly from the issuer, in an IEO the exchange will agree to offer tokens on behalf of the issuer, with the tokens then available to be traded directly on the exchange. Companies usually pay a listing fee and a percentage of their proceeds to the exchange.

The immediate danger of investing in IEOs stems from the limited remedies available to investors who could end up falling victim to fraud. The SEC alert noted that investors should be particularly wary of IEOs that fail to address “the applicability of federal securities laws.”

“Noncompliance with the federal securities laws means the IEO and/or trading platform may be operating unlawfully and the investor and market protections and remedies these laws are intended to provide may be absent,” the alert said.

Attorneys who spoke with Law360 said the alert may foreshadow coming enforcement actions against IEOs.

“I wouldn't be surprised if the SEC starts cracking down, because the trend now is toward IEOs as people move away from ICOs,” Morgan Lewis & Bockius LLP partner Albert Lung told Law360.

Cathy Yoon, special counsel at Katten Muchin Rosenman LLP, also said SEC action against IEOs may be on the horizon.

“The SEC's prior warnings on ICOs came well after the height of the ICO craze,” Yoon told Law360.

“However, this could also mean that the commission has been reviewing IEOs, and perhaps we’ll see an enforcement action in the next few weeks.”

The SEC may have also wanted clarify that calling something an IEO doesn’t immediately change the legal calculus the agency will apply in analyzing the application of securities laws, Yoon said.

“As in the case of ICOs, depending on the facts and circumstances of the offering, the offering may involve the offer and sale of securities,” the SEC alert said. “This means the IEO may be subject to registration requirements that apply to offerings under the federal securities laws.”

Since 2017, the SEC has taken a number of actions and released guidance informing its views on ICOs, specifically whether they constitute a securities offering under the Securities Act of 1933.

One such guidance, the framework for "Investment Contract" Analysis of Digital Assets, which the SEC released April 3 alongside a no-action letter, expanded on the traditional interpretation of what a security is as derived from the U.S. Supreme Court's 1946 Howey decision, which defines it as an "investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others."

IEOs, however, raise concerns beyond the Howey test too, Lung said.

“There are three sets of regulations that are involved unlike with ICOs, in which really only Section 5 of the Securities Act applies,” Lung said. “You have broker-dealer regulation, you have regulations relating to the registration of a national securities exchange. It’s just a much more troublesome area for the SEC.”

The SEC outlined that investors in IEOs need to be aware of the offering’s registration requirements, as well as whether broker-dealer and securities exchange regulations apply.

“The commission’s main mandate is investor protection and this notice follows the same principals of warning potential investors in these investment schemes what they should look for and why certain investments may be risky,” Yoon said.

--Editing by Alanna Weissman.