

First of Its Kind Lawsuit Involving ICO's

Many companies and individuals have recently attempted to raise funds through the sale of cryptocurrencies, coins or tokens. These fund-raising activities are generally called initial coin offerings (ICO) and take advantage of the interest in cryptocurrencies such as bitcoin whose rise in value the past year has been meteoric. In October, the first-class action lawsuit involving an ICO was filed in federal district of California.

ICOs have become popular because they are relatively easy to conduct, there have traditionally been few regulations and the law surrounding them is not particularly clear, at least not yet. Here's how they work: a cryptocurrency is created and then sold to early backers of a project in exchange for legal tender or other cryptocurrency like bitcoin. The investors then hope for a return from the increased value of the cryptocurrency or in some cases, a share of the returns from the project. There is typically no Prospectus although the terms may be set out in a Whitepaper or other literature.

Many of these ICOs don't employ traditional safeguards like you see with initial public offerings or with registered securities. The industry has attracted a large number of operators and consultants some with more experience and credibility than others.

The SEC Position

The Securities and Exchange Commission ([SEC](#)) recently issued two pieces of guidance related to ICOs: a [DAO report](#) and an [Investor Bulletin](#). The DAO Report states that whether cryptocurrency generally qualifies as a security is a fact-based inquiry. (If the cryptocurrency is a security, a number of requirements with respect to such things as disclosure must be met). According to the SEC, the key question is how the future value of the cryptocurrency will be determined; if it is tied to the promoter's efforts, it will likely be considered a security. So, for example, where the cryptocurrency is essentially worthless unless future development occurs or a promised dividend stream is established, the chances are better that the SEC would consider such cryptocurrency a security.

The Investor Bulletin provides more practical advice for ICO promoters and participants and suggests that for promoters, consideration of various risk factors, such as an ability to recover under federal securities laws if fraud occurs or theft, may be appropriate.

The Tezzie Suit

The SEC's position on whether ICO's involve the sale of securities will likely be at issue in a proposed class action filed against Dynamic Ledger Solutions, Inc. ([DLS](#)) and several other related entities regarding an [ICO](#) for tokens called "Tezzies." Tezzies are tokens related to the Tezos blockchain. According to Tezos [overview](#), the Tezos blockchain would facilitate formal verification of smart contracts by mathematically proving the correctness of the code governing transactions. This network was to launch in Summer 2017.

The [Complaint](#) alleges that the DLS launched the ICO in July 2017, and that over 607 million Tezzies were thereafter sold. In exchange, according to the Complaint, DLS and the other defendants received digital currency worth about \$232 million (now worth approximately \$475 million, according to the Plaintiff).

The plaintiff generally alleges that the Defendants:

- Failed to register the offer and sale of securities in violation of federal securities laws;
- Committed fraud in the offering or sale of securities in violation of federal securities laws;
- Committed false advertising in violation of California statutory law;
- Engaged in unfair competition in violation of California statutory law; and
- Acted as alter-egos of one another and all actions could be imputed to each Defendant separately or to all Defendants severally.

More specifically, the Plaintiff also claims that the projected launch of Tezos network in December 2017, was postponed to February 2018; since Tezzies derive their value from the usefulness and the popularity of the Tezos network, that delay, according to the

Plaintiff devalued the assets. Also according to Plaintiff, none of the development steps laid out in the overview document were met, and many terms were not even shown to the purchasers. Finally, Plaintiff asserts that the Tezos' characterization as a donation is refuted by "significant investments made by cryptocurrency hedge funds."

Plaintiff seeks restitution and disgorgement of gains, rescission of the purchases of Tezzies, and punitive damages, among other relief.

What's at Stake?

The Tezzie case will likely raise questions of whether and under what circumstances an ICO will be considered a security offering subject to security related rules and regulations and the validity of the SEC views set out in the DAO Report and Investor Bulletin. The plaintiff has squarely alleged that the token's value was related to future development and that no risk factors were included in the ICO materials – two factors specifically mentioned in the DAO Report and the Investor Bulletin. How this case and any subsequent ones will no doubt impact ICO marketplace and popularity.