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SECURITIES OFFERINGS

Seeing Past the ICO Sparkles: A Due Diligence Cautionary Tale

BY BETH-ANN ROTH

The SEC's recent enforcement action against Centra Tech, Inc. is noteworthy: not for any conclusions it reaches relating to coin offerings or blockchain technology, but rather for the brazenness of the persons engaged in the misrepresentations alleged by the SEC. In short, this is a straightforward case of securities fraud. It does, however, remind us of the importance of undertaking due diligence, regardless of how shiny that ''new penny'' may appear to be.

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The SEC's Charge of Fraud in Connection With Centra Tech's ''ICO'' Capital Raise

According to the SEC's complaint, filed in federal court in the Southern District of New York on April 2, 2018, the principals of Centra Tech raised $32 million from the sale of unregistered securities issued by the company in what they termed an ''initial coin offering'' (''ICO''). However, the product the company claimed it was developing with the proceeds of the money raise did not exist. The company was not creating a technology by which it could facilitate credit card transactions with Visa and Mastercard. The company also did not have a way to provide access to resources for ''2 Billion Unbanked Adults Worldwide,'' including 16 million people in Nigeria.

This was not a credible ICO, but the promising technology held forth by the company's principals under the guise of the next hot new market made investors forget to look at the basics. The untruths were so blatant and easily fact-checked that it seems incredible that the principals were able to con so many into parting with their money. The offering was a fraud, pure and simple.

Securities offerings are subject to the registration and antifraud provisions of the federal securities laws. As such: (1) all offerings must either be registered or offered pursuant to an available exemption from registration; and (2) all statements made in connection with an offering must be true, complete, and not misleading.

In the case of the Centra offering, neither one of those two basic criteria was met. Based on what we know from the SEC's complaint, Centra did not have a relationship with the credit card companies, so that the promised revenue-sharing payments from Visa and Mastercard could never occur. Further, the executives pictured on Centra's website were fictionalized persons

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and the photographs used were either stock images from the Internet, or pictures of the defendants' relatives. Finally, there was no registration statement, yet the details of the offering were made public for the world to see, which is a violation of the private offering exemption.

Unanswered Questions: Celebrity Endorser Liability and Token-Trading Platforms

Apart from the fraud, there are two interesting questions raised by this case, neither of which is answered by the SEC's filing: one is whether the SEC will take any action relating to celebrities paid to promote Centra's ICO, and the other is what trading platforms were involved in trading the tokens, and whether they will be deemed as having been exempt from registering as securities exchanges. Neither the celebrities nor the trading platforms were named, but instead were referred to indirectly.

Can the Celebrity Endorsers Be Liable? Aiding & Abetting, Touting and Private Offerings

One of the devices Centra's principals used to ply their fraud was to pay celebrity endorsers to hype the offering. The celebrities would tweet about having gotten in on the deal, suggest that people ought to get on the bandwagon, and then the company would retweet the endorsement. A securities offering is not the typical place one would expect to find a celebrity endorser, but the technology is so promising, and the prospect of getting in on a deal early so enticing, that the principals cleverly and correctly understood the appeal of the celebrity endorsement.

While the celebrities themselves were likely not the direct perpetrators of the fraud, they do need to worry about whether the other shoe is about to drop. While it is impossible to know whether the SEC will choose to pursue a case against the celebrities, the case certainly looms as a cautionary tale not to get involved in these types of engagements. There are potentially at least two theories under which a celebrity endorser could be liable:

> First, the question of celebrity endorsement raises the possibility of a charge of aiding and abetting the fraud, and the SEC might choose at some point to amend the complaint to charge them. In order to do so, the staff would need to conclude that the endorsers were either reckless in not detecting the fraud, or that they willfully turned a blind eye to the facts and yet continued to provide ''substantial assistance'' to those who engaged in the fraud.
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> While the law of aiding and abetting is well settled, it remains to be seen whether one can conclude that the celebrities undertook reasonable due diligence prior to promoting the product, yet were not able to detect that the offering was problematic. In this particular case they likely did not even realize they had an obligation to do so. But that does not legally relieve them of the obligation.
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> A second potential source of liability is that the celebrity endorsers likely violated the Section 17(b) ''anti-touting'' provisions of the Securities Act of 1933. That section requires that anyone giving publicity to a securities offering must disclose whether they received compensation, and must also disclose the amount they received. It is unclear whether the SEC would have an interest in pursuing that violation.
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> Rather, it seems the SEC could potentially gain more traction by using this case to highlight the dangers of providing endorsements.

Another potential pitfall includes the prohibition on public advertising for private offerings. To date, no ICOs have been publicly-registered offerings, so no one should be tweeting about ICOs. Liability for that prohibition likely rests with the issuer (i.e., the company) rather than with the endorser, but awareness of the prohibition could help highlight the need for legal advice when considering whether to endorse a product. Apart from an action alleging liability, the celebrity endorsers could also be named as ''relief defendants.'' In such a case, the celebrities would not be charged with legal liability, but might still be required to turn over to the government any amounts they were paid by the company to endorse the ICO.

Such monetary ''disgorgement'' could become part of a restitution fund if one were set up to compensate defrauded investors. According to the complaint, the fiat money accounts associated with Centra have already been emptied by the company's principals in advance of their attempted getaway (which was stymied in very dramatic style by authorities intercepting one of the defendants as he attempted to board a plane to leave the country). An interesting side note is that the cryptocurrency account held by the principals appears still to have assets, though the SEC did not elaborate.

Celebrity endorsers are less likely than securities professionals to recognize that these types of engagements are problematic. That fact does not shield them from liability. But rather than bringing an enforcement action against the technical violations of those who were likely as duped by the fraudsters as the rest of the investors, it might make better sense for authorities to use this opportunity to send a very strong message that the potential for liability is real, and that it is best to stay away from securities offerings as a potential resource for endorsement income.

Are the Trading Platforms Potentially Exchanges That Should Have Been Registered?

The question of exchanges on which tokens are traded is perhaps the single aspect of the case that does bear directly on the substantive law relating to ICOs. The SEC stated that once the company's promotional campaign helped raise interest in the ICO, the tokens they issued ''became listed on 8 to 10 different exchanges,'' raising the price from an initial price of $0.15 per share to about $4 per share. The SEC did not name the exchanges, and it is unclear from the complaint whether it is examining them for compliance and potential legal action.

When it comes to tokens, technology has yet to be aligned with the law – or perhaps vice versa. In its 2017 release relating to the DAO investigation, the SEC concluded that the platform used to trade the DAO tokens ''appeared to satisfy the criteria'' for the exemption from registration as a national securities exchange. It will be interesting to see whether the SEC undertakes a

similar analysis of the ''exchanges'' on which the Centra tokens were traded.

All That Glitters. . .

This case will likely attract attention because the device used to lure unsuspecting investors was an emerging technology that holds great promise. Unfortunately, when such things happen, the technology potentially takes on an unseemly association. However, it is essential to remember that here the alleged crime was not related to the technology itself. While there is still a steep learning curve and the technology is still under development, the principals of Centra took advantage of those eager to participate in the technology's growth. While the law relating to coin offerings is not yet settled, the elements of the fraud in this case had nothing to do with those grey areas associated with coin offerings. Rather, the principals made outright misrepresentations.

Nevertheless, the hype associated with the lure of participating in an emerging technology facilitated the success of the fraudulent marketing scheme. The case should serve as a reminder that investors as well as money managers serving as stewards of their clients' financial resources (not to mention their own reputations) need to take reasonable steps to undertake due diligence when researching the viability of an investment. Read the documents. If the offering is advertised publicly, check the SEC's website for the filings. If the product is supposedly being offered pursuant to an exemption from registration, read the offering document thoroughly and with a critical eye. And if you see a private offering being advertised publicly, put that in your ''red flag'' column and follow up.

Finally, if your questions are not adequately answered in the official, final version of the disclosure document, contact management and seek answers, gauging for yourself the veracity of their statements. As an investor or a money manager you will likely not be liable for the misrepresentations of a fraudulent ICO issuer. Nevertheless, the fallout from the collapse of a company in which you invested is never going to be in your best interest.

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The SEC provides investors with a sample list of questions to ask when considering an investment in cryptocurrency or an ICO. The list can be found at the bottom of the public statement issued by SEC Chairman Jay Clayton in December 2017.