Understanding Risk

Examining Some of the Risks Associated with
Compliant Stokens & Cryptocurrency Coins

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I believe that most Ethereum-based altcoins from the non-compliant crypto 1.0 era are illegal securities. When discussing risk, which always exists by default when speculating in the buying and selling of commodities and/or securities, we should start with the elephant in the room.

It's very easy to understand that there is risk when buying and selling ("trading") any asset. Prices go up and down in regular, regulated markets based on world events, supply & demand… …and the simple fact that most startups fail. According to a Harvard study, failure rates average 75% for most early startups, including those receiving venture or angel funding. From there it is common for 10% to return only the original investment, leaving 15% winners. Many funds, if not most, take a shotgun approach to investment that most small investors cannot afford. These venture and angel investors hope that of the 15% of winning investments will make up for the losing investments and provide a small upside.

The Failure Rate Amongst Startups with Funding is 75% in Regulated Markets, and Unregulated Coins May Be Worse.

The current greatest risk, in my opinion and <u>I am not a financial advisor nor attorney, and this is not financial nor legal advice</u>, is related to crypto and security tokens currently being primarily illegal securities, ICO consultants acting as illegal broker/dealers and the placement and trading in the United States of unregistered securities. Exchanges listing illegal securities are themselves unregistered & unlicensed, with the SEC and FINRA, to list, offer and charge trading fees or exist as an exchange. In my opinion laws are being broken by the vast majority of exchanges, entrepreneurs and communities who used ERC20 or other types of tokens to raise operational funding.

From thousands of altcoins few are compliant, and not dark web:

- Bitcoin– allowed volunteers to earn coins as payment for effort
- Bitcoin Cash– airdropped free on existing Bitcoin owners
- Litecoin– allowed volunteers to earn coins as payment for effort
- Ethereum– allowed volunteers to earn coins as payment for effort
- Ethereum Classic– airdropped free on existing Ethereum owners
- Stellar Lumens– allowed volunteers to earn coins as payment for effort
- Dogecoin– allowed volunteers to earn coins as payment for effort
- rLoop (RLP) – allowed volunteers to earn coins as payment for effort
- Stokens (STKN) – allowed volunteers to earn coins as payment for effort

In my opinion, ERC20 tokens make up the giant majority of non-compliant coins, placing a gray cloud over the entire coin market, adding tremendous risk to buying & selling coins.

The current market value of Bitcoin and altcoins combined is around $277 billion (it fell from $340B or by about 20% from the day I wrote this). The dozen (*in my opinion*) commodity coins listed above represent about $190 billion, or 68.4% of the value of the entire coin market. Ripple and other non-compliant security coins could see prices fall if/when regulators come knocking.

Ethereum, whose "killer app" was an EZ kit on how to perform an illegal ICO, used their own coin "ETH" as the investment token for purchase of the non-compliant ERC20 coins, which were sold to raise operational capital. Dash, which seemingly pays a dividend, could also be deemed a security even though they may have started life as a commodity before their name change and masternode scheme. Until these coins are taken down a black cloud of risk remains over the crypto & stoken (security token) market.

Let's consider a few things and discuss definitions.

Brokers & dealers ("B/D[s]") who engage in the sale of securities in the United States, and who receive a commission or some reward based on a successful trade or investment, are regulated by the non-governmental agency (appointed by the U.S. Congress) known as the Financial Industry Regulatory Authority ("FINRA").

Part of the risk of trading security tokens ("stokens") and commodity cryptocurrency ("crypto"), *which are digital representations of value on a blockchain known collectively as coins* ("Coins"), is that during the crypto 1.0 era of non-compliance most Initial Coin Offerings ("ICO[s]") were illegal public offerings of securities (by definition), now traded on illegal exchanges, extracting illegal B/D fees & commissions. These exchanges are by definition operating illegally by:

- Listing securities unregistered with the Securities & Exchange Commission ("SEC");
- Extracting commissions without proper B/D licensing and registration with FINRA;
- Not being registered as an Alternative Trading System ("ATS") with the SEC/FINRA.

A coin is a security if it fails the *Howey Test* or if it "acts" in other ways like a security. One way it might appear like a security is by paying a dividend. For instance, providing coin holders a guaranteed percentage of a block reward, which is known in the crypto community as a "masternode" payout, might turn a compliant crypto into an illegal security.

Background of the Howey Test

The Supreme Court heard a case in 1946 (*SEC v. Howey*) considering whether a leaseback agreement offered by two corporate defendants in Florida, which offered real estate contracts for tracts of land with citrus groves, was a security. Buyers were offered an option to lease any purchased land back to the land owners, in this case the defendants, who agreed to manage the land, harvest and pool the fruit and then find buyers for the citrus. Most of the buyers were not citrus-growing experts and so they agreed to lease the land back to defendants.

The SEC claimed that the defendants broke the law by failing to file a securities registration statement. The Supreme Court in their ruling developed a landmark analysis of determining whether types of financial transactions are security investments and therefore require SEC registration. Under *Howey*, a financial transaction is likely a security investment if there is:

- An investment of money;
- A common enterprise (funds were pooled);
- An expectation of profits from the investment;
- An expectation of work to be performed by a managing party, promoter or third party.

By these definitions most ICOs are illegal securities, most ICO sites are illegal broker/dealers taking success fees in the U.S. and most exchanges allowing U.S. citizens to trade and extracting trading fees when they trade are breaking the rules, regulations and laws of the SEC and FINRA. FULL STOP.

Once you take the elephant out of the room and shoot it we will rebuild with compliant coins. Safe harbor coins, like those listed above, could increase in value as bad coins are sold and money looks for a new home.

If we reach a point of strict (for the better) compliance, we could see a swarm of retail investors entering the market, which would be great for investors and entrepreneurs seeking capital. Family office, wealth preservation investments such as energy & real estate fractionalized and made liquid 24/7 could be in the not-so-distant future.

Early-to-late stage private company equity could be digitalized and traded to the public via Regulation A+ of the JOBS Act, allowing for a public offering & trading of equity as a digital stoken (security token). Likely, Regulation D offerings could also be traded amongst accredited investors in a fractional, global, 24/7, regulated environment.

***Normal* Investment Risk**

All investments are risky. All stocks, gold, bonds, and managed funds can and do lose value; some lose all of their value for a number of unforeseen reasons. Conservative, investments made by savvy, educated investors and even insured investments like certificates of deposit ("CDs") issued by credit unions and banks have inflationary risk.

What's Risk?

There are various types of risk associated with financial transactions. Often it is interpreted as downside risk, meaning that you could lose money on an investment.

Market conditions can cause entire markets to move up or down, with the moving tides lifting and lowering all boats. Decisions made by an organization may affect the value of an investment, which is business risk. Political situations, both domestic and global, create unknown risks in both the country and its fiat currency, which is political & currency risk. Being able to get funds out of a bad or thinly traded market creates liquidity risk. Not diversifying your portfolio vs. spreading your investments across several/many investment vehicles creates a concentration of assets risk, and this is one that is more difficult for smaller investors with less capital to spread around into separate investments.

Crypto comes with additional risks you don't typically see in non-crypto markets. For instance, if you lose your private keys to an online wallet, lose a cold-storage hardware wallet or access to the device, you can lock yourself away from your coins forever. Hackers and scammers abound and you could lose your coins to a phishing site, or someone breaking into your computer or mobile device. There are fake ICO sites that prey on new investors or trusting investors who fall for the glitzy over-promising hype of a marketer with bad intent. The community or people working on the mission or blockchain of a coin could lose interest and with a loss of momentum a project can just dry up and blow away.

A team can fail for MANY legitimate reasons including lack of access to funding or talent.

Competitors can win over important markets/clients. Insiders can dump coins and manipulate markets and then vanish as anonymous bad guys/gals.

So far in the world of crypto and stokens there has been little-to-no governance over coin issuance, management, ticker symbols and exchange listings, which allowed/s black hats to issue fake coins. The SEC is changing the tune of that song, and I expect/hope that very soon we will see the start of the ERC20 takedowns. It will be the best thing for the long-term of the market, and in my opinion the sooner the very much better.

The list of risks is literally endless. I will write more, but suffice it to say that **INVESTMENT, EVEN IN COMPLIANT CRYPTO OR STOKENS, IS HIGHLY RISKY**.

Do all the research you can and become a part of the community surrounding a coin. Expect that like any startup investment, you will likely lose 75% of the time and with unregulated crypto your chances of losing could be 99% or greater, specifically in regards to illegal ERC20 tokens.

One might hope crypto 2.0 (compliance-focused crypto & stokens) will increase investor success. Better investor and trading protections for people in the U.S. & globally is a good start.

Get to know the major players and tamp down your enthusiasm until you see results.

Anyone can make a promise. There are few that deliver.

Stay diligent, trust little and verify always.