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Analysis

Onus Is On Celebrity ICO Pitchmen For Greater Due Diligence

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Law360 (April 4, 2018, 10:42 PM EDT) -- Celebrities who get paid to tout initial coin offerings, highly speculative investment products based on blockchain technology that have garnered an unprecedented level of scrutiny from U.S. securities regulators, should redouble their due diligence to avoid potential liability should the offering they endorse turn out to be a scam, legal experts say.

The offerings' popularity among mainstream investors has led issuers to recruit celebrities as pitchmen, including boxer Floyd Mayweather and music producer DJ Khaled, both of whom recently touted an ICO by Centra Tech, whose two founders [now face criminal charges](#) and civil charges leveled by the [U.S. Securities and Exchange Commission](#) for allegedly soliciting \$32 million to fund a cryptocurrency payment card they falsely claimed was backed by major payment processors including [Visa Inc.](#)

ICOs — in which issuers offer investors blockchain-based digital tokens, often in exchange for digital currency or cash, to pay for projects that will ostensibly help build their business — have captured the imagination of the investing public for their newness and because digital currencies such as bitcoin and ethereum have been showered with media attention as their values have roller-coastered.

But because of uncertainty as to how digital currencies should be regulated and the high potential for fraud resulting from that uncertainty, legal experts say celebrities should be extra careful in scrutinizing issuers before signing on as ICO pitchmen to avoid being swept up in any subsequent claims of fraud.

“Sooner or later someone is going to take a fall on one of these,” said Ira Matetsky, a partner at [Ganfer & Shore LLP](#). “If a celebrity knew that a fraud was taking place or was highly reckless in claiming not to know, then he may have an issue with securities regulators. He may also face scrutiny from consumer protection authorities.”

David Chase, a former SEC prosecutor and now principal in his own Florida-based defense firm, said celebrities who are merely paid to read a script would be unlikely to face liability even if the script turned out to be fraudulent, assuming regulators found no prior knowledge of a fraud on the part of the endorser, nor any finding of “extreme recklessness.”

“But that being said, a celebrity spokesman should exercise greater vigilance and engage in more thorough due diligence when considering pitching particular investments, specifically ICOs because it’s a particular investment that’s under extreme scrutiny by the SEC,” he said.

According to Chase, a celebrity spokesman who pitched a fraudulent offering may have liability for securities law violations if “he knew the statements he was making about the investment and its prospects were untrue, or if he was extremely reckless in making such statements.” With regard to the latter example, Chase said a pitchman could potentially be held liable if securities regulators determined the celebrity “turned a blind eye” to glaring “red flags” that the offering and its issuers were sketchy.

Beth-ann Roth, an investment funds partner at Capital Fund Law Group, said it behooves celebrity endorsers to consult with a securities attorney if they are invited to promote an ICO, or any investment offering, for that matter.

“They have an obligation before accepting that kind of engagement to do their due diligence. They need to make sure they’re getting the right answers,” Roth said.

Celebrities, according to Roth, need to know that their due diligence obligations are heightened when they promote investment products since those products are regulated under the securities laws.

“They have to understand that their endorsements matter to many people and could influence peoples’ decisions,” Roth said. “Technically, they could be found liable, so they need to exercise extra caution when undertaking these types of representations.”

While Centra Tech’s is perhaps the highest-profile ICO fraud case so far to involve celebrity promoters, Mayweather and Khaled are just two among an array of actors, musicians and other celebrities who have used social media primarily to endorse ICOs. For instance, an ICO endorsed by actor Steven Seagal was recently the subject of a [cease-and-desist order](#) by New Jersey securities regulators. And Oscar-winning actor Jamie Foxx and celebrity heiress Paris Hilton have also promoted ICOs.

Mayweather, who has used his social media accounts to endorse several ICOs, and Khaled weren’t named in the criminal and civil complaints announced earlier this week against Centra Tech co-founders Sohrab “Sam” Sharma, 26, and Robert Farkas, 31, who were arrested Sunday in Florida on fraud and conspiracy charges. The government claims the pair faked relationships with financial institutions and fictitious executives to attract investors.

The SEC also filed a civil suit against Sharma and Farkas on Monday, noting in the complaint that Sharma and Farkas paid celebrities to promote the Centra ICO. Centra’s coin offering began July 30, five days after the SEC issued a report stating that digital currencies were likely subject to securities regulations, according to the regulator.

On Sept. 17, Mayweather posted on [Twitter](#), “Centra’s (CTR) ICO starts in a few hours. Get yours before they sell out, I got mine.”

SEC Chairman Jay Clayton has made the protection of retail investors a primary focus of the agency and, due to

their popularity among mainstream investors, has taken particular aim at cryptocurrencies, releasing numerous warnings through bulletins, public statements and a full-scale investigative report in July targeting ICO issuers.

Clayton has vigorously argued that nearly all ICOs are securities offerings and as such should be subject to federal transparency and disclosure laws. When the SEC has determined issuers were flouting federal regulations, the agency has been quick to act, including the complaint filed Monday against Centra Tech.

In November, the SEC's Division of Enforcement issued a warning to investors specifically urging caution with regard to ICOs touted by celebrity endorsers.

“Persons making these endorsements may also be liable for potential violations of the anti-fraud provisions of the federal securities laws, for participating in an unregistered offer and sale of securities, and for acting as unregistered brokers,” the statement said.

An SEC spokeswoman declined to comment for this story.

While no celebrity has yet been named in an SEC complaint related to ICOs, legal experts say the potential is real and that celebrities should take the threat seriously.

And as the SEC continues to file enforcement actions against allegedly fraudulent ICOs, the question for potential celebrity endorsers becomes what the celebrity did to make sure they were satisfied that what they were endorsing was a valid product, Roth said. And since most of these offerings are “private,” as a practical matter no public statements are permitted at all, she added.

“They should do their due diligence, and where that due diligence should probably land them is to not get involved in promoting securities offerings at all,” Roth said.

The SEC is represented in the Centra case by Jon A. Daniels, Luke M. Fitzgerald and Alison R. Levine.

The government is represented by Negar Tekeei and Samson Enzer of the [U.S. Attorney's Office](#) for the Southern District of New York.

Sharma is represented by Sharon L. McCarthy of [Kostelanez & Fink LLP](#).

Farkas is represented by Daniel Horwitz of [McLaughlin & Stern LLP](#).

The cases are SEC v. Sharma et al., case number 1:18-cv-02909, and U.S. v. Sharma et al., case number 1:18-mj-2695, both in U.S. District Court for the Southern District of New York.

--Additional reporting by Jody Godoy. Editing by Brian Baresch and Alanna Weissman.

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