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Peter J. Henning

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ABSTRACT

This article looks at how the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) have pursued cases involving cryptocurrencies. A number of prosecutions have been brought against defendants who misled investors into believing that they were obtaining cryptocurrencies when in fact there were simply false statements and schemes to defraud, such as Ponzi schemes. When a company has attempted to issue a cryptocurrency to investors, the SEC has relied on Section 5(a) and 5(c) of the Securities Act of 1933 to require that issuers file a registration statement with the Commission. This is not an easy process and requires extensive disclosures that issuers of cryptocurrencies have found confounding. One possible way around those restrictions is if an issuer relies on Regulation D or Regulation A+ to issue the cryptocurrency. However, this route is risky because it may require approval by the SEC before proceeding. Will we see broader issuance of cryptocurrencies? The short answer is "no" because the SEC, apart from Commissioner Hester Peirce, has shown a distinct hostility toward companies trying to issue cryptocurrencies. Is there a way around this? Perhaps, if a firm is willing to follow all the rules for a Regulation D or Regulation A+ offering it might be possible, but no one should be holding their breath for the SEC to approve the issuance of a cryptocurrency.

INTRODUCTION

> *"The market just doesn't care. This community has an immense tolerance for pain."*[1]

Cryptoassets have certainly attracted more than their fair share of interest from regulators and investors. Facebook announced that it would issue a type of cryptocurrency called Libra,[2] which would be pegged to a bundle of assets, including government securities. Libra is run by a separate company in Switzerland called the Libra Association. Facebook touts Libra as empowering "billions of people" who do not have access to regular banking channels.[3] The cryptocurrency was initially backed by companies like

* Professor of Law, Wayne State University Law School.

1. Paul Vigna, *Cryptocurrency Investors Shrug Off Tether Woes*, WALL ST. J. (Apr. 29, 2019, 6:42 PM), https://www.wsj.com/articles/cryptocurrency-investors-shrug-off-tether-woes-11556568466.

2. LIBRA, https://libra.org/en-US/ (last visited Jan. 17, 2020).

3. Paul Vigna, *Facebook's Libra Bets on the Unbanked*, WALL ST. J. (Aug. 22, 2019, 7:00 AM), https://www.wsj.com/articles/facebooks-libra-bets-it-can-bank-the-unbanked-11566471601 ("The unbanked represent a big potential customer base for crypto. Roughly 1.7 billion adults

Vodafone, Visa, Mastercard, and Uber, but since its announcement Visa, Mastercard, and others have reconsidered their involvement in the project.[4]

The Libra announcement immediately drew attacks from Congress and even President Trump, who tweeted "I am not a fan of Bitcoin and other Cryptocurrencies, which are not money, and whose value is highly volatile and based on thin air," and said that Libra "will have little standing or dependability."[5] As two commentators noted, "[b]etween Facebook hacks and third-party developers gaining access to unsuspecting users profiles (e.g. Cambridge Analytica scandal), Facebook is no stranger to having a problem keeping consumer's personal information 'private.'"[6] In other words, are you willing to trust Facebook with your financial information, especially after the company paid a $5 billion penalty to the Federal Trade Commission (FTC) for eight separate privacy-related violations of a 2012 order?[7] Sigal Mendelker, the Under Secretary of the Department of the Treasury for Terrorism and Financial Intelligence, pointed out that "we have impressed upon [Facebook] a number of times . . . that in order for them to operate they have to have the right anti-money laundering and countering terrorist

around the world don't have an account at a financial institution or through a mobile money provider, according to the World Bank.").

4. AnnaMaria Andriotis & Peter Rudegeair, *Visa, Mastercard, Others Reconsider Involvement in Facebook's Libra Network*, WALL ST. J. (Oct. 2, 2019), https://www.wsj.com/articles/visa-mastercard-others-reconsider-involvement-in-facebook-s-libra-network-11569967023. Since the announcement of the Libra cryptocurrency, Visa and Mastercard both dropped their involvement in the project. AnnaMaria Andriotis & Peter Rudegeair, *Mastercard, Visa, eBay Drop Out of Facebook's Libra Payments Network* WALL ST. J. (Oct. 11, 2019), https://www.wsj.com/articles/mastercard-drops-out-of-facebook-s-libra-payments-network-11570824139.

5. Donald J. Trump (@realDonaldTrump), TWITTER (July 11, 2017, 8:15 PM), https://twitter.com/realdonaldtrump/status/1149472284702208000?lang=en.

6. Aaron Swerdlow & Joel Sherwin, *INSIGHT: Libra—Should We Protect Ourselves From Facebook's Controversial Cryptocurrency?*, BLOOMBERG L. (Aug. 20, 2019, 4:00 AM), https://news.bloomberglaw.com/privacy-and-data-security/insight-libra-should-we-protect-ourselves-from-facebooks-controversial-cryptocurrency. The chairwoman of the House Financial Services Committee, Representative Maxine Waters, traveled to Switzerland to inspect how Facebook will manage Libra. In a statement, she continued to raise questions about the issuance of Libra. She said, "While I appreciate the time that the Swiss government officials took to meet with us, my concerns remain with allowing a large tech company to create a privately controlled, alternative global currency. I look forward to continuing our Congressional delegation, examining these issues, money laundering, and other matters within the Committee's jurisdiction." *US Lawmakers Return From Switzerland Still Wary of Facebook's Libra*, CRYPTO.IQ (Aug. 27, 2019), https://cryptoiq.co/us-lawmakers-return-from-switzerland-still-wary-of-facebooks-libra/.

7. *See* Press Release, Fed. Trade Comm'n, FTC's $5 Billion Facebook Settlement: Record-Breaking and History-Making (July 24, 2019), https://www.ftc.gov/news-events/blogs/business-blog/2019/07/ftcs-5-billion-facebook-settlement-record-breaking-history. The company also paid a $100 million penalty for "making misleading disclosures regarding the risk of misuse of Facebook user data" *See* Press Release, U.S. Sec. & Exch. Comm'n, Facebook to Pay $100 Million for Misleading Investors About the Risks It Faced from Misuse of User Data (July 24, 2019), https://www.sec.gov/news/press-release/2019-140.

financing sanctions programs in place."[8] Since Libra was announced, five companies (Stripe, Mastercard, Visa, Ebay, and PayPal) have withdrawn from the coalition backing Facebook's effort to generate a new digital currency.[9] In addition, implementing the proper anti-money laundering program may well slow down the roll-out of Libra.[10] *The Wall Street Journal* noted that the goal of Libra was "to change the world," but with no small irony pointed out that "changing the world isn't so easy."[11]

The most famous cryptocurrency is Bitcoin,[12] which has attracted great interest from investors over the past few years because there is only a limited supply of the cryptocurrency.[13] Unfortunately, Bitcoin has been used more for purchases on the dark web for stolen credit card information and illegal drugs.[14] However, other cryptocurrencies exist, including Dash, Ripple, Bitcoin Cash, and NEO.[15] Investors need to ask how much each is worth

8. Hugo Miller, *Facebook's Libra Will Be Under U.S. Money-Laundering Scrutiny*, BLOOMBERG (Sept. 10, 2019, 10:49 AM), https://www.bloomberg.com/news/articles/2019-09-10/facebook-s-libra-on-u-s-radar-terrorist-financing-chief-warns.

9. Erin Griffith & Nathaniel Popper, *Facebook's Libra Cryptocurrency Faces Exodus of Partners*, N.Y. TIMES, Oct. 12, 2019, at B1.

10. A joint statement by leaders of the Commodity Futures Trading Commission, the Financial Crimes Enforcement Network, and the Securities and Exchange Commission warned that "persons engaged in activities involving digital assets of their anti-money laundering and countering the financing of terrorism (AML/CFT) obligations under the Bank Secrecy Act (BSA)." Heath Tarbert, Chairman, U.S. Commodity Futures Trading Comm'n, Kenneth A. Blanco, Dir., Fin. Crimes Enf't Network, Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets (Oct. 11, 2019), https://www.sec.gov/news/public-statement/cftc-fincen-secjointstatementdigitalassets.

11. AnnaMaria Andriotis, Peter Rudegeair & Liz Hoffman, *Inside Facebook's Botched Attempt to Start a New Cryptocurrency*, WALL. ST. J., Oct. 17, 2019, at A1. Ultimately, in April 2020, "Facebook and its partners rolled out a less ambitious design for Libra after the effort encountered numerous hurdles and heavy regulatory scrutiny." Nathaniel Popper & Mike Isaac, *Facebook-Backed Libra Cryptocurrency Project Is Scaled Back*, N.Y. TIMES (Apr. 16, 2020), https://www.nytimes.com/2020/04/16/technology/facebook-libra-cryptocurrency.html.

12. Bitcoin is "a decentralized digital currency that uses a peer-to-peer computer network to move bitcoins around the world. Developed in 2009 by an anonymous programmer or programmers, bitcoin is a privately-issued digital currency that exists only as a long string of numbers and letters in a user's computer file." *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, VIRTUAL ECONOMIES AND CURRENCIES: ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS 5 (2013).

13. Under the design of Bitcoin, only 21 million Bitcoins can be mined.

> Illegal transactions have been a central part of the Bitcoin story since the first online black market, the Silk Road, helped give people a reason to begin using Bitcoin in 2011. Bitcoin was useful for the Silk Road because the structure of Bitcoin, without any central authority, makes it possible for a user to create a Bitcoin wallet and use the tokens without registering an identity with anyone.

Nathaniel Popper, *Bitcoin Has Lost Steam. But Criminals Still Love It*, N.Y. TIMES (Jan. 28, 2020), https://www.nytimes.com/2020/01/28/technology/bitcoin-black-market.html.

14. *Id.*

15. Nathan Reiff, *The 10 Most Important Cryptocurrencies Other Than Bitcoin*, INVESTOPEDIA (Jan. 8, 2020), https://www.investopedia.com/tech/most-important-cryptocurrencies-other-than-bitcoin/.

because cryptocurrencies are usually quoted in dollars rather than having their own independent value. In 2017, the CME Group (CME) even introduced a Bitcoin futures contract[16] that allows investors to hedge their holdings or invest in a future increase in value. Additionally, CME began to list options on the Bitcoin futures contracts in March 2020.[17] The Intercontinental Exchange, which also owns the New York Stock Exchange, launched its own Bitcoin futures contracts on September 20, 2019.[18] Thus, the proliferation of cryptocurrencies has invaded the 'in' world of investors.

The pervading question is whether investments in cryptoassets are considered safe. There have been a number of hacks in recent years in which millions of dollars were stolen from accounts located overseas.[19] There is almost no recourse to recover money lost when the holders of cryptocurrency wallets are the target of a theft. The Department of Justice (DOJ) can do little to those who are responsible for the thefts because tracing the offender may be nearly impossible.[20] As famed investor Warren Buffet pointed out about cryptocurrencies, "it's a gambling device . . . there's been a lot of frauds connected with it. . . . Bitcoin hasn't produced anything.*"*[21]

A persistent concern has been the use of cryptocurrencies to engage in criminal conduct.[22] As two scholars have noted, "[b]ecause blockchains are

16. *See generally* CME Group, https://www.cmegroup.com/trading/bitcoin-futures.html (last visited Jan. 24, 2020) ("In response to growing interest in cryptocurrencies and customer demand for tools to manage bitcoin exposure, CME options on Bitcoin futures (BTC) are now trading.").

17. *CME Group Set to Launch Bitcoin Options in First Quarter of 2020*, CRYPTO.IQ (Sept. 25, 2019), https://cryptoiq.co/cme-group-set-to-launch-bitcoin-options-in-first-quarter-of-2020/.

18. Alexander Osipovich, *Bitcoin Futures Market Set to Launch*, WALL ST. J., Sept. 23, 2019, at N.4.

19. John Biggs, *Hackers Are Shuffling Binance's Stolen Bitcoin*, COINDESK (May 8, 2019, 17:59 UTC), https://www.coindesk.com/hackers-are-shuffling-binances-stolen-bitcoin ("At 4:11 AM on May 8 the hacker or hackers moved 1214 BTC ($7.16 million) to new addresses and then moved another 1337 'to 2 new addresses held by the hacker.' This is the fourth major exchange hack of the year, following Cryptopia, DragonEx and Bithumb.").

20. *Id.*

> The hack took place at 5:15:24PM on May 7 when hackers dragged over 7,000 bitcoin from a single Binance hot wallet [into] a number of smaller wallets in a single transaction. The hackers then moved small amounts into smaller wallets. Given the nature of the BTC blockchain it's easy to see where each Binance bitcoin is going but it is difficult to perform real forensics on the wallets in order to understand who–or what–created them.

Id. "Outright thefts as well as scams and other misappropriation of funds from cryptocurrency users and exchanges continued apace, netting criminals and fraudsters approximately $4.26 billion in aggregate for 2019." CIPHERTRACE, CRYPTOCURRENCY ANTI-MONEY LAUNDERING REPORT, 2019 Q2, at 4 (2019), https://ciphertrace.com/q2-2019-cryptocurrency-anti-money-laundering-report/.

21. Yun Li, *Warren Buffett Says Bitcoin Is a 'Gambling Device' with 'a Lot of Frauds Connected with It*', CNBC (May 4, 2019, 9:59 AM), https://www.cnbc.com/2019/05/04/warren-buffett-says-bitcoin-is-a-gambling-device-with-a-lot-of-frauds-connected-with-it.html.

22. *See* Lawrence J. Trautman & Alvin C. Harrell, *Bitcoin Versus Regulated Payment Systems: What Gives?*, 38 CARDOZO L. REV. 1041, 1050 (2017) ("Virtual or cyber-currencies present particularly difficult transactional, regulatory, and law enforcement challenges because of such issues as: their anonymity due to encryption; their ability to transcend national borders in the fraction

pseudonymous and have a tamper-resistant data structure supported by decentralized consensus mechanisms, they can be used to coordinate socially unacceptable or criminal conduct, including conduct facilitated by autonomous software programs."[23] Arguably the best known case involving illegal use of cryptocurrency was *United States v. Ulbricht*,[24] in which the "Silk Road" website was used for drug trafficking, money laundering, and "murder for hire" schemes.[25] One of the founders of Silk Road, Ross Ulbricht, who went by the nickname Dread Pirate Roberts (from the film *The Princess Bride*), was convicted in February 2015 of all seven charges[26] and sentenced to life in prison based on six deaths from drug purchases and five "murder for hire" schemes.[27]

The growth of cryptocurrencies has drawn the interest of the Internal Revenue Service, which has designated them as "property" subject to capital

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of a second; and their unique jurisdictional issues."). On August 23, 2019, Kunal Kalra pleaded guilty to a criminal information accusing him of distributing drugs and operating an unlicensed money transmission business that exchanged up to $25 million in cash and cryptocurrencies through a kiosk in which customers could conduct virtual currency transactions exceeding $10,000. The charges included operating an unregistered money remitting business through the kiosk. United States v. Kalra, 10 CR00484 (Aug. 23, 2019); *see also* Press Release, U.S. Dep't of Justice, Westwood Man Agrees to Plead Guilty to Federal Narcotics, Money Laundering Charges for Running Unlicensed Bitcoin Exchange and ATM (Aug. 23, 2019), https://www.justice.gov/usao-cdca/pr/westwood-man-agrees-plead-guilty-federal-narcotics-money-laundering-charges-running. In May 2019, three German nationals were charged with being the administrators of "Wall Street Market," a dark web marketplace that allowed vendors to sell an array of illegal narcotics and counterfeit goods. Press Release, U.S. Dep't of Justice, 3 Germans Who Allegedly Operated Dark Web Marketplace with Over 1 Million Users Face U.S. Narcotics and Money Laundering Charges (May 3, 2019), https://www.justice.gov/usao-cdca/pr/3-germans-who-allegedly-operated-dark-web-marketplace-over-1-million-users-face-us.

23. PRIMAVERA DE FILIPPI & AARON WRIGHT, BLOCKCHAIN AND THE LAW 34 (Harvard Univ. Press, 2018).

24. United States v. Ulbricht, 858 F.3d 71, 82–88 (2d Cir. 2017).

25. *Id.* at 82.

> Silk Road was a massive, anonymous criminal marketplace that operated using the Tor Network, which renders Internet traffic through the Tor browser extremely difficult to trace . . . According to the government, between 2011 and 2013, thousands of vendors used Silk Road to sell approximately $183 million worth of illegal drugs, as well as other goods and services. Ulbricht, acting as DPR, earned millions of dollars in profits from the commissions collected by Silk Road on purchases. In October 2013, the government arrested Ulbricht, seized the Silk Road servers, and shut down the site.

Id.

26. Ulbricht was convicted of charges for: (1) distribution/aiding and abetting the distribution of narcotics; (2) distribution/aiding and abetting the distribution of narcotics by means of the Internet; (3) conspiracy to distribute narcotics; (4) continuing criminal enterprise; (5) conspiracy to commit or aid and abet computer hacking; (6) conspiracy to traffic in fraudulent identity documents; and (7) conspiracy to commit money laundering. The jury also found the statutory minimums for quantities of heroin, cocaine, LSD, and methamphetamine had been met on all counts. Sarah Jeong, *Jury Finds Ross Ulbricht Guilty of Running Silk Road Marketplace*, FORBES (Feb. 4, 2015), https://www.forbes.com/sites/sarahjeong/2015/02/04/jury-finds-ross-ulbricht-guilty-of-running-silk-road-marketplace/#7065e14f44b0.

27. *Ulbricht*, 858 F.3d at 92–94.

gains tax reporting.[28] The Securities and Exchange Commission (SEC) has pursued a number of cases involving fraudulent cryptocurrency offerings and even legitimate initial coin offerings (ICO) on the grounds that they constitute an offering of securities that must meet the disclosure requirements established by Section 5 of the Securities Act of 1933,[29] which is the core registration provision of the federal securities laws. The SEC has largely relied on the four-part test from *SEC v. W.J. Howey Co.*[30] to find that initial coin offers are in fact securities because they are "investment contracts." Under the *Howey* test, the Supreme Court held that an investment constitutes a security when it is [1] "a contract, transaction or scheme whereby a person invests [2] his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, [3] it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."[31] In June 2018, William Hinman, the Director of the SEC's Division of Corporation Finance, asserted:

> Just as in the *Howey* case, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit. And, as in *Howey*–where interests in the groves were sold to hotel guests, not farmers–tokens and coins typically are sold to a wide audience rather than to persons who are likely to use them on the network.[32]

By finding that cryptocurrencies are securities, unless an issuer of securities has filed a registration statement with the SEC, it is neither unlawful to make use of "any means or instruments of transportation or

28. I.R.S. Notice 2014-21, 2014-16 I.R. 938 ("For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency."). In November 2016, the federal district court in San Francisco authorized a "John Doe Summons" issued to Coinbase Inc., the largest provider of cryptocurrency wallets, for information about the identity of the owners of the wallets. This has helped the I.R.S. identify those who have failed to report cryptocurrency transactions. *See* Press Release, U.S. Dep't of Justice, Court Authorizes Service of John Doe Summons Seeking the Identities of U.S. Taxpayers Who Have Used Virtual Currency (Nov. 20, 2016), https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used.

29. 15 U.S.C. § 77e (2018).

30. *See generally* SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (laying out the four-part test for a security).

31. *Id.* at 298–99.

32. William Hinman, Dir., Division of Corporation Finance, U.S. Sec. & Exch. Comm'n, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418. On July 2019, SEC Commissioner Hester Peirce, a fierce opponent of most regulations, asserted that "[a]nother notable feature of U.S. law is that the definition of what constitutes a security is a bit nebulous. Unlike many other countries, we do not have an exclusive list of what counts as a 'security.'" Hester M. Peirce, Comm'r, U.S. Sec. & Exch. Comm'n, Renegade Pandas: Opportunities for Cross Border Cooperation in Regulation of Digital Assets (July 30, 2019), https://www.sec.gov/news/speech/speech-peirce-073019.

communication in interstate commerce" to distribute the security nor to cause the securities to be "carried through the mails or in interstate commerce" for the purpose of sale or delivery after a sale.[33] Section 5 also contains a broad prohibition on selling securities without a registration statement, providing:

> It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.[34]

Thus, under the federal securities laws, attaching the label "investment contract" to cryptocurrencies means that they are in violation of the law if they are sold to investors via any means of interstate commerce.[35] However, this violation may be circumvented if the "investment contracts" are accompanied by a registration statement—in effect via Form S-1—[36] that includes information about possible risk factors in the investment and a description of corporate earnings.[37]

Part I of this Article looks at how perpetrators conduct fraudulent schemes in which the SEC and DOJ have pursued cases involving purported investments in cryptocurrency was in fact just a sham. These stories typically involve charges involving criminal wire fraud and civil securities fraud based on the *Howey* test. Part II of this Article looks at how the SEC has pursued enforcement actions involving ICOs in which there was a failure to register the sale under Section 5 of the Securities Exchange Act of 1933. Part III considers whether issuers of cryptocurrencies can use Rule 144A, a provision of the Jump-Start Our Business Startups Act (JOBS Act) that allows for a type of mini-IPO, to allow private companies to raise as much as $50 million from the public. Whether the SEC will try to crack down on these types of offerings remains to be seen, and this Article will examine how issuers can comply with the securities laws while also serving those who wish to hold and invest in cryptocurrencies.

33. 15 U.S.C. § 77e(a) (2018).
34. 15 U.S.C. § 77e(c).
35. *See* 15 U.S.C. § 77e.
36. *See* U.S. SEC. & EXCH. COMM'N, FORM S-1 REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933.
37. *Id.*

I. SCHEMES TO DEFRAUD: "THERE IS A SUCKER BORN EVERY MINUTE" (P.T. BARNUM)[38]

Fraudulent schemes know few bounds when there is the chance to convince investors to spend their money, especially on something as alluring as cryptocurrency. Given how much Bitcoin increased in value in 2017, there is a perceived advantage to owning cryptocurrencies that may not pan out. The sudden rise of bitcoin in 2017 has exacerbated the demand for cryptocurrencies, which operate much like penny stocks in that they can rise or fall in just a few days and often are easily manipulated.[39]

In *SEC v. Blockvest LLC*,[40] the SEC obtained a preliminary injunction to block the offer of securities that were promised to generate passive income and double-digit returns.[41] The defendants even created a fake regulatory agency, called the "Blockchain Exchange Commission," with the same address as and a seal similar to the SEC's to give the impression that the operation was all on the up-and-up.[42] Needless to say, there is no "Blockchain Exchange Commission," despite the hope that, perhaps, someday there will be one.[43] The defendants used this rouse to give the ICO investors the understanding that the transactions had the imprimatur of the SEC and another government agency, which only furthered the effort to raise money from unsuspecting investors.[44] In deciding that the ICO involved a security, the district court held that "the SEC has demonstrated that the promotion of the ICO of the BLV token was a 'security' and satisfies the *Howey* test."[45] The district court found that the ICO offering was a violation of Section 17(a) of the Securities Act of 1933, which prohibits the use of any "device, scheme or artifice to defraud."[46]

38. THE LINGUIST LIST (Apr. 11, 2014, 4:20 PM UTC), http://listserv.linguistlist.org/pipermail/ads-l/2014-April/131801.html.

39. Paul Vigna, *Large Bitcoin Player Manipulated Price Sharply Higher, Study Says*, WALL ST. J. (Nov. 4, 2019), https://www.wsj.com/articles/large-bitcoin-player-manipulated-price-sharply-higher-study-says-11572863400 ("A single large player manipulated the price of bitcoin as it ran up to a peak of nearly $20,000 two years ago, a new study concludes."); JOHN M. GRIFFIN & AMIN SHAMS, IS BITCOIN REALLY UN-TETHERED (2019), https://ssrn.com/abstract=3195066 ("Cryptocurrencies grew from nearly nothing to over $300 billion in market capitalization in only a few years and fit the historical narrative of previous bubbles quite well–an innovative technology with extreme speculation surrounding it.").

40. Blockvest LLC, Litigation Release No. 24400, 2019 WL 653714 (Feb. 14, 2019).

41. 2 ROBERT J. HAFT, ARTHUR F. HAFT & MICHELE HAFT HUDSON, VENTURE CAP. & BUS. FIN. § 2:34 (2019) ("Specifically, copyrights, mineral and oil and gas royalties, and active computer software royalties are excluded from passive investment income if they are excluded from the definition of personal holding company income.").

42. Blockvest LLC, Litigation Release No. 24400, 2019 WL 653714 (Feb. 14, 2019).

43. *Id.*

44. Order Granting Plaintiff's Motion for Partial Reconsideration at 15, SEC v. Blockvest, No. 18CV2287-GPB(BLM) (S.D. Cal. Feb. 14, 2019), ECF No. 61.

45. *Id.*

46. *Id.* at 19 ("On reconsideration, the Court concludes that Plaintiff has presented a prima facie showing of previous violations of Section 17(a)."); 15 U.S.C. § 77q(a)(1) (2018).

The DOJ has relied on the federal wire fraud statute, 18 U.S.C. § 1343, to pursue criminal cases against defendants who have used cryptocurrencies to scam investors. In *United States v. McDonnell*,[47] the defendant was charged with wire fraud, in March 2019, through a company known as CabbageTech Corp. The scheme involved customers sending money and cryptocurrency to Mr. McDonnell in exchange for trading advice, since he claimed to manage Bitcoin for investors.[48] According to the indictment, Mr. McDonnell stopped communicating with the customers and misappropriated the funds for his personal use. In June 2019, he pleaded guilty to wire fraud.[49]

Cryptocurrency has even been used to help perpetrate a Ponzi scheme, in which early investors are repaid by those lured in later. In *Securities and Exchange Commission v. Natural Diamonds Investment Co.*, the SEC sued Jose Angel Aman, Harold Seigel, and Jonathan Seigel for orchestrating a Ponzi scheme by raising $30 million from 300 investors in part through a cryptocurrency called "Argyle Coin."[50] They promised investors that Natural Diamonds would generate investment returns of 24% and would fully return investors principal within two years.[51] The SEC alleged that Natural Diamonds was a Ponzi scheme and that Mr. Aman "used investor funds to pay prior investors their purported returns."[52] Among the uses for the money taken from investors were purchases of horses and riding lessons for Mr. Aman's oldest son, payments to his church and pastors of more than $1.5 million, and payment of more than $3 million for Mr. Aman's personal expenses.[53] When the bank accounts were drained in 2017, Mr. Aman created

47. Indictment, United States. v. McDonnell, No. 19-148 (E.D.N.Y. Mar. 25, 2019).

48. Press Release, U.S. Dep't of Justice, Staten Island Man Pleads Guilty to Defrauding Investors in Virtual Currency (June 21, 2019), https://www.justice.gov/usao-edny/pr/staten-island-man-pleads-guilty-defrauding-investors-virtual-currency.

49. *Id.*

50. Complaint at 2, SEC v. Nat. Diamonds Inv. Co., No. 9:19-cv-80633-RLR (S.D. Fla. May 13, 2019).

51. *Id.*

52. *Id.*

> The Securities and Exchange Commission announced it has obtained a court order halting an ongoing $30 million Ponzi scheme targeting more than 300 investors in the U.S. and Canada. The SEC complaint unsealed Monday charges South Florida-based Argyle Coin, LLC, a purported cryptocurrency business, and its principal Jose Angel Aman with using investor funds to run a Ponzi scheme.

Press Release, U.S. Sec. & Exch. Comm'n, SEC Obtains Emergency Order Halting Alleged Diamond-Related ICO Scheme Targeting Hundreds of Investors (May 21, 2019), https://www.sec.gov/news/press-release/2019-72.

53. Complaint, *supra* note 50, at 3; *see also* Press Release, U.S. Sec. & Exch. Comm'n, SEC Obtains Emergency Order Halting Alleged Diamond-Related ICO Scheme Targeting Hundreds of Investors (May 21, 2019), https://www.sec.gov/news/press-release/2019-72.

> According to the complaint, in October 2017, Aman and Jonathan H. Seigel continued the scheme by luring investors to invest in Argyle Coin, falsely claiming the investment was risk-free because it was backed by fancy colored diamonds, and promising to use investor funds to develop the cryptocurrency business. Instead, according to the

"Argyle Coin" on the promise that the tokens were backed by "fancy colored diamonds" and promised that an investment was "risk-free."[54] Instead, the money raised from the sale of "Argyle Coin" was used to repay investors of Natural Diamonds and another company, Eagle Financial Diamond Group Inc. In his answer to the SEC's complaint, Mr. Aman asserted his Fifth Amendment privilege and did not respond directly to the claims. A federal district judge froze Mr. Aman's assets.[55]

In March 2019, Konstantin Ignatov, a Bulgarian, was arrested in Los Angeles on a charge of wire fraud conspiracy for his role as the leader of what the DOJ described as "an international pyramid scheme that involved the marketing of a fraudulent cryptocurrency called 'OneCoin.'"[56] In addition, Ignatova's sister, Ruja Ignatova, was charged for the same crimes of "wire fraud, securities fraud and money laundering" with a third defendant, Mark S. Scott, who was accused of helping to "launder the proceeds of the [fraudulent] scheme."[57]

In September 2019, the SEC sued Jonathan C. Lucas for a fraudulent ICO that raised approximately $63,000 from 100 investors for unregistered digital securities in Fantasy Market that would provide live adult entertainment performances.[58] In the SEC complaint, he was accused of making misstatements about "the achievement of significant business development milestones," the experience of the Fantasy Market team that was "entirely fictional and Lucas's own credentials were embellished," and that significant funds had been raised from large investors in a "private token pre-sale" when in fact no funds were ever raised.[59] Mr. Lucas was charged with orchestrating

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> complaint, Aman, Natural Diamonds, Eagle, and Argyle Coin, misused or misappropriated more than $10 million of investor funds to pay other investors their purported returns and for Aman's personal expenses, including rent on his home, purchases of horses, and riding lessons for his son.

Id.

54. *See* Natural Diamonds Investment Co., Litigation Release No. 24473, 2019 WL 2247507 (May 21, 2019), https://www.sec.gov/litigation/litreleases/2019/lr24473.htm.

55. Press Release, U.S. Sec. & Exch. Comm'n, SEC Obtains Emergency Order Halting Alleged Diamond-Related ICO Scheme Targeting Hundreds of Investors (May 21, 2019), https://www.sec.gov/news/press-release/2019-72 ("On May 20, 2019, the Honorable Judge Robin L. Rosenberg of the U.S. District Court for the Southern District of Florida granted the SEC's request for a temporary restraining order and temporary asset freeze against Aman, Argyle Coin and other companies charged by the SEC as relief defendants.").

56. Press Release, U.S. Dep't of Justice, Manhattan U.S. Attorney Announces Charges Against Leaders Of "OneCoin," A Multibillion-Dollar Pyramid Scheme Involving The Sale Of A Fraudulent Cryptocurrency (Mar. 8, 2019), https://www.justice.gov/usao-sdny/pr/manhattan-us-attorney-announces-charges-against-leaders-onecoin-multibillion-dollar.

57. *Id.*

58. The "Fantasy Market" was "a purported online adult entertainment marketplace, with orchestrating a fraudulent initial coin offering (ICO)." Jonathan C. Lucas, Litigation Release No. 24607, 2019 WL 4596722 (Sept. 23, 2019).

59. Final Judgment as to Defendant Jonathan C. Lucas, SEC v. Lucas, No. 19-cv-8771 (S.D.N.Y. Oct. 2, 2019).

a fraudulent ICO, and he ultimately agreed to pay a civil penalty of $15,000 and accepted a five-year ban from serving as an officer or director of a public company, along with a five-year injunction barring him from making any unregistered offering of securities.[60]

In February 2019, Randall Crater was charged with wire fraud and money laundering for creating a fraudulent cryptocurrency called "My Big Coins" that were marketed to investors.[61] Mr. Crater claimed that My Big Coins was a functioning cryptocurrency backed by gold and other "valuable assets" and further claimed that the cryptocurrency could be exchanged for regular currency.[62] Unfortunately, there were no assets backing My Big Coins, and Mr. Crater was accused of misappropriating over $6 million of investor funds for his own use.[63]

In September 2019, Homero J. Garza was sentenced to twenty-one months in prison after pleading guilty to one count of wire fraud for his role in setting up companies to act as virtual currency miners for a cryptocurrency called "PayCoin."[64] According to statements to miners, Mr. Garza claimed that PayCoin would not drop below $20 per unit because he had a reserve of $100 million to purchase PayCoins to stabilize the price. As anticipated, the $100 million reserve did not exist, and prosecutors alleged that Mr. Garza defrauded individuals out of more than $9 million.[65]

In December 2019, three defendants were charged with conspiracy to commit wire fraud and conspiracy to sell unregistered securities for their role in creating "BitClub Network," which solicited money from investors in exchange for participation in pooled investments of Bitcoin mining.[66] According to the indictment filed by the DOJ, four defendants–Matthew B. Goettsche, Jobadiah S. Weeks, Hoseph F. Abel, and Silviu C. Balaci–made "materially false and fraudulent pretenses, representations, promises, and omissions" in soliciting investments in BitCoin Network.[67] Prosecutors allege that the scheme was in effect a Ponzi scheme, and it defrauded

60. Jonathan C. Lucas, Litigation Release No. 24607, 2019 WL 4596722 (Sept. 23, 2019).

61. Press Release, U.S. Dep't of Justice, New York Man Charged with Cryptocurrency Scheme (Feb. 27, 2019), https://www.justice.gov/opa/pr/new-york-man-charged-cryptocurrency-scheme.

62. *Id.*

63. *Id.*

64. Press Release, U.S. Dep't of Justice, Former Virtual Currency CEO Involved in $9 Million Fraud Scheme Sentenced to Prison (Sept. 13, 2018), https://www.justice.gov/usao-ct/pr/former-virtual-currency-ceo-involved-9-million-fraud-scheme-sentenced-prison.

65. *Cryptocurrency Fraudster Sentenced Virtual Currency Scam Defrauded Investors of Millions*, FED. BUREAU INVESTIGATION NEWS (Feb. 11, 2019), https://www.fbi.gov/news/stories/cryptocurrency-fraudster-sentenced-021119.

66. Bitclub: U.S. v. Matthew Brent Goettsche et. al., U.S. DEP'T OF JUSTICE, https://www.justice.gov/usao-nj/bitclub (last visited Feb. 20, 2020).

67. *See* Indictment, United States v. Goettsche, No. 19-877 (CCC) (D.N.J. 2019).

investors of $722 million by misrepresenting the "mining earnings" that was used to promote the sale of bitcoin mining shares in BitCoin Network.[68]

The wire fraud statute and conspiracy to commit wire fraud are appealing to prosecutors because the law makes it a crime to transmit or cause to be transmitted across state lines any "wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice . . ."[69] Most cryptocurrency fraud schemes involve transferring funds via bank wires or advertising over the Internet, which are sufficient to establish a wire transmission and has been used for the purpose of executing the fraudulent scheme.[70] One benefit to using the wire fraud statute is that it carries a maximum penalty of twenty years imprisonment, and each wire can be a separate count of an indictment,[71] so prosecutors can pile many different charges to try to entice a guilty plea from a defendant.

Another avenue federal prosecutors have pursued for cryptocurrency cases is to charge the facilitators of virtual currency exchanges who have created bank accounts that can be used to transfer funds, which effectively sets up a "shadow bank" for cryptocurrency exchanges. [72] In *United States v. Fowler*,[73] the DOJ charged Reginald Fowler and Ravid Yosef with bank fraud and operating an unlicensed money transmitting business.[74] They were

68. U.S. DEP'T OF JUSTICE, *supra* note 66 ("Goettsche, Balaci, Weeks, and others conspired together to solicit investment in BitClub Network through fraudulent means, including by providing false and misleading figures that BitClub investors were told were "bitcoin mining earnings" purportedly generated by BitClub Network's bitcoin mining pool. Goettsche, Balaci, Weeks, and others obtained the equivalent of at least $722 million from BitClub Network investors.").

69. 18 U.S.C. § 1343 (2018).

70. *See id.*

71. *See* United States v. Williams, 527 F.3d 1235, 1243 (11th Cir. 2008) ("Each resultant wire fraud count requires proof of a separate wire transmission made in furtherance of Williams's scheme to defraud—an element not required by the others. We hold that each wire fraud offense was complete upon each wire disbursement that Williams caused CNCS to make in furtherance of her scheme to defraud."); United States v. Garlick, 240 F.3d 789, 790 (9th Cir. 2001) ("Each use of the wires constitutes a separate violation of the wire fraud statute. This concept is well established in the context of mail fraud, and today we hold it applies with equal force in wire fraud cases.").

72. *See* Kinglite Holdings Inc. v. Micro-Star Int'l Co., No. CV-14-03009 JVS (PJWx), 2015 WL 6437836, at *10 (C.D. Cal. Oct. 16, 2015) ("[T]he representative method claim recited steps for a practitioner, more specifically an intermediary, to create "shadow" bank accounts that mirrored the balances of two parties' real-world accounts.").

73. Sealed Superseding Indictment at 3–4, United States v. Fowler, (S.D.N.Y 2019) (No. 19 Crim. 254).

74. An unlicensed money transmitting business is defined in the statute as:

> [A] money transmitting business which affects interstate or foreign commerce in any manner or degree and—
>
> (A) is operated without an appropriate money transmitting license in a State where such operation is punishable as a misdemeanor or a felony under State law, whether or not the defendant knew that the operation was required to be licensed or that the operation was so punishable;

accused of providing banking services to cryptocurrency exchanges, and Mr. Fowler was specifically accused of making false or misleading statements to banks in order to open accounts that received deposits from individuals purchasing cryptocurrencies.[75] Additionally, the defendants were accused of falsifying wire transfer instructions to conceal the true nature of the cryptocurrency exchanges, effectively running a shadow bank to process unregulated payments on behalf of cryptocurrency exchanges.[76] As of April 2019, Mr. Fowler is fighting the case, and Ms. Yosef remains at large.[77]

When the SEC pursues an investigation, it usually takes testimony of those involved under oath.[78] In February 2018, Jon Montroll was charged with perjury and providing false documentation to the SEC about a theft of bitcoins from two online services he operated: WeExchange Australia, Pty Ltd. and BitFunder.com.[79] According to the charges, hackers were able to exploit a weakness in BitFunder's code that caused the wrongful withdrawal of 6,000 Bitcoins, worth more than $60 million at the time.[80] Mr. Montroll showed the SEC a balance statement indicating that the firm had over 6,000 Bitcoins, but the government deemed the information was misleading.[81] He later transferred his own Bitcoin holdings to WeExchange to conceal the losses.[82] Mr. Montroll pleaded guilty in July 2018 to securities fraud and obstruction of justice, and he was sentenced to fourteen months imprisonment.[83]

> (B) fails to comply with the money transmitting business registration requirements under section 5330 of title 31, United States Code, or regulations prescribed under such section; or
>
> (C) otherwise involves the transportation or transmission of funds that are known to the defendant to have been derived from a criminal offense or are intended to be used to promote or support unlawful activity . . .

18 U.S.C. § 1960(b).

75. Sealed Superseding Indictment, *supra* note 73, at 1–2.

76. *Id.* at 3–4.

77. Press Release, U.S. Dep't of Justice, Arizona Man And Israeli Woman Charged In Connection With Providing Shadow Banking Services To Cryptocurrency Exchanges (Apr. 30, 2019), https://www.justice.gov/usao-sdny/pr/arizona-man-and-israeli-woman-charged-connection-providing-shadow-banking-services.

78. U.S. SEC. & EXCH. COMM'N, ENFORCEMENT MANUAL 65 (2017) ("The staff should make its own independent decision about what documents to request, what investigative testimony to take, what questions to ask during testimony, the location of testimony and similar matters.").

79. Press Release, U.S. Dep't of Justice, Former Operator Of Bitcoin Investment Platform Sentenced For Securities Fraud And Obstruction Of Justice (July 12, 2019), https://www.justice.gov/usao-sdny/pr/former-operator-bitcoin-investment-platform-sentenced-securities-fraud-and-obstruction.

80. *Id.*; John Edwards, *Bitcoin's Price History*, INVESTOPEDIA (Nov. 3, 2019), https://www.investopedia.com/articles/forex/121815/bitcoins-price-history.asp.

81. Press Release, U.S. Dep't of Justice, *supra* note 79.

82. *Id.*

83. *Id.*

II. REGULATING CRYPTOCURRENCY OFFERINGS

A. THE DAO REPORT

The SEC's first response to the distribution of cryptocurrency was in The DAO Report, issued in July 2017.[84] In the Report, the agency decided not to pursue an enforcement action,[85] but instead, it was likely a warning to others who might issue cryptocurrencies and digital tokens that the federal securities laws apply to them.

The investigation involved the sale of 1.5 billion "DAO Tokens" in exchange for 12 million Ether coins, another type of cryptocurrency.[86] The DAO Tokens offered investors a share in the profits from projects that would be funded.[87] In a White Paper issued by Slock.It,[88] the DAO entity would be a "crowdfunding contract" that would raise "funds to grow [a] company in crypto space."[89] Those who acquired DAO Tokens would have certain voting and ownership rights, and The DAO would "earn profits by funding projects that would provide DAO Token holders a return on investment."[90]

Before the projects could be funded, a hacker stole approximately one-third of The DAO's assets.[91] The issue in the investigation was whether the federal securities laws applied to the tokens.[92] The SEC concluded that "other

84. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, 117 SEC Docket 5 at 1 (July 25, 2017) [hereinafter DAO Report]; Public Statement, U.S. Sec. & Exch. Comm'n, Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on the DAO (July 25, 2017), https://www.sec.gov/news/public-statement/corpfin-enforcement-statement-report-investigation-dao.

> Today, the Commission issued a Report of Investigation ("Report") relating to an offering by The DAO—a decentralized autonomous organization that used distributed ledger or blockchain technology to operate as a "virtual" entity. The DAO sold tokens representing interests in its enterprise to investors in exchange for payment with virtual currency. Investors could hold these tokens as an investment with certain voting and ownership rights or could sell them on web-based secondary market platforms. Based on the facts and circumstances of this offering, the Commission, as explained in the Report, determined that the DAO tokens are securities.

Id.

85. *See* DAO Report, *supra* note 84.

86. *Id.* at 16.

87. *Id.* at 1.

88. Public Statement, U.S. Sec. & Exch. Comm'n, supra note 84.

89. DAO Report, *supra* note 84, at 4.

90. *Id.* at 5.

91. *Id.* at 1.

92. *Id.* at 10; Public Statement, U.S. Sec. & Exch. Comm'n, *supra* note 84 ("Finally, we recognize that new technologies also present new opportunities for bad actors to engage in fraudulent schemes, including old schemes under new names and using new terminology. We urge the investing public to be mindful of traditional "red flags" when making any investment decision, including: deals that sound too good to be true; promises of high returns with little or no risk; high-pressure sales tactics; and working with unregistered or unlicensed sellers. In that regard, the SEC's website for individual investors, Investor.gov, has a number of relevant resources—including an

distributed ledger or blockchain-enabled means for capital raising" must take "steps to ensure compliance with the U.S. federal securities laws."[93] The Report of Investigation asserted that "virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities" were subject to the securities registration requirements.[94] Applying the *Howey* test,[95] the SEC found that it met all four requirements to constitute an investment contract subject to the federal securities laws.[96] Finding that the tokens represented a "reasonable expectation of profits," the SEC concluded that "a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH[er] in The DAO."[97] The Report further noted that "[i]nvestors had little choice but to rely on"[98] the expertise of the co-founders of Slock.It to generate a return on the investment. Thus, the SEC found that "The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was 'crucial' to The DAO Token holders' investment decision."[99]

The DAO Report sent a clear signal to those who sought to raise money through the issuance of cryptocurrencies and initial coin offerings: the federal securities laws would apply because the items constituted an investment contract subject to the registration requirements in Section 5 of the Securities Act.[100] In an effort to educate investors about the dangers of purchasing cryptocurrencies, the SEC set up a mock website, called "Howeycoins,"[101] to

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Investor Bulletin that the SEC's Office of Investor Education and Advocacy issued today regarding Initial Coin Offerings.").

93. DAO Report, *supra* note 84, at 2; Public Statement, U.S. Sec. & Exch. Comm'n, *supra* note 84.

> We welcome and encourage the appropriate use of technology to facilitate capital formation and provide investors with new investment opportunities. We are particularly hopeful that innovation in this area will facilitate fair and efficient capital raisings for small businesses. We are also mindful of our obligation to protect investors and recognize that new technologies can offer opportunities for misconduct and abuse.

Id.

94. DAO Report, *supra* note 84, at 2.

95. SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946).

> Section 2(1) of the Act defines the term 'security' to include the commonly known documents traded for speculation or investment. This definition also includes 'securities' of a more variable character, designated by such descriptive terms as 'certificate of interest or participation in any profit-sharing agreement,' 'investment contract,' and, 'in general, any interest or instrument commonly known as a security.

Id.

96. DAO Report, *supra* note 84, at 2.

97. *Id.* at 12.

98. *Id.* at 13.

99. *Id.* at 16.

100. *Id.* at 16 ("Moreover, those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5.").

101. HOWEYCOINS, https://www.howeycoins.com/index.html (last visited Jan. 25, 2019).

mimic websites that tout investments in ICOs. Among the benefits of purchasing Howeycoins was a claim that they are "officially registered with the U.S. government" and can be "exchanged for cryptocurrencies and cash."[102] Neither claim is true, but the SEC's goal was to show how investors should not trust a website touting the benefits–and government imprimatur–for an investment through an ICO.[103]

In a December 2017 statement, Jay Clayton, the Chairman of the SEC, stated that "[a] number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation."[104] Mr. Clayton noted that "replacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance."[105] Reiterating the agency's view that token offerings are securities, the Chairman asserted that "[m]erely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security."[106] Thus, the SEC has taken the lead in pursuing enforcement actions targeting cryptocurrencies

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102. *Id.*

103. The SEC and the Commodity Futures Trading Commission issued an investor alert in October 2018 that warned those interested in cryptocurrencies to be cautious about any claims of government approval. The alert stated:

> [F]ederal government agencies, including the SEC and CFTC, do not endorse or sponsor any particular securities, issuers, products, services, professional credentials, firms, or individuals. Real government officials or staff would never:
>
> - Ask for money over the phone or by email
> - Ask for money because of new regulation or tax
> - Try to collect fees for trades or transactions
> - Demand immediate payment
> - Suggest payment by virtual currency, prepaid credit cards, or gift cards
> - Request copies of your Social Security card, Passport, or tax forms via email
> - Endorse an investment, product, or service

Investor Alert: Watch Out for False Claims About SEC and CFTC Endorsements Used to Promote Digital Asset Investments, U.S. SEC. & EXCH. COMM'N (Oct. 11, 2018), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-watch-out-false-claims-about-sec.

104. Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 [hereinafter Statement of Chairman Clayton].

105. *Id.*

106. *Id.* Mr. Clayton also warned about the potential for price manipulation, noting that "[s]elling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of 'scalping,' 'pump and dump' and other manipulations and frauds." *Id.*

and ICOs when there is insufficient disclosure to potential investors or when the digital token is a means for a company to raise money, much like any offering of securities to investors.

B. KIK INTERACTIVE INC.

One of the highest profile cases filed by the SEC involved a lawsuit alleging that Kik Interactive Inc., a private Canadian company, conducted an illegal $100 million securities offering of digital tokens called "Kin."[107] In the complaint, the SEC alleged that Kik offered and sold one trillion tokens to more than 10,000 investors, with over half of the investments coming from the United States.[108] In public announcements, the Kin tokens would be part of the "Kin Ecosystem" that could be used to buy goods and services or traded on secondary trading platforms, similar to Bitcoin and other cryptocurrencies.[109] To sell the Kin tokens, Kik offered to accredited investors a "Simple Agreement for Future Tokens [(SAFT)]," which "rais[ed] approximately $50 million."[110]

The SEC alleged that Kik violated Section 5(a) and 5(c) of the Securities Act[111] by failing to file a registration statement for the offering. Kik has argued that at least part of the offering was permissible under SEC Regulation D because the tokens were first sold only to accredited investors.[112] The SEC takes the position, however, that the public offering of Kin should be

107. Complaint at 1, SEC v. Kik Interactive Inc., No. 19-cv-5244 (S.D.N.Y. June 4, 2019).

108. *Id.*

109. In an email to Kik employees, the company's CEO outlined his vision for how Kin would operate:

> [I]f you buy some Kik Points today when the demand is low, then you will be able to sell them at a higher price tomorrow when the demand is higher, creating a return. This potential return encourages investors to "buy in" at an ICO. An ICO is where Kik takes a portion of its reserves from its Fort Knox (say 100 million of the 1 billion Kik Points that we initially created and put in our Fort Knox) and sells them in an auction. The value proposition to investors is that if they buy in today at the ICO, and then the demand for the currency goes up because of all the things we do to create demand for them, then they will be able to sell their points at a higher price in the future, and make a return. The money taken in from investors for the ICO is used by Kik to fund development to create more and more demand by both growing the community, and by growing the demand for the currency within the community.

Id. at 3.

110. Kik Interactive Inc., Litigation Release No. 24493, 2019 WL 2387042 (June 4, 2018).

111. 15 U.S.C. §§ 77e(a), 77e(c) (2018).

112. Under SEC Rule 501 in Regulation D, 17 C.F.R. § 230.501, an accredited investor is any bank, a private business development company, an organization with total assets in excess of $5 million, any director, executive officer or partner of the issuer of the securities, any natural person with an individual net worth exceeding $1 million, or any person with an individual income in excess of $200,000 in the two most recent year or joint income with a spouse of more than $300,000 per year, or a trust with total assets in excess of $5 million. For individual investors, the person's primary residence cannot be included as an asset to meet the $1 million net worth. 17 C.F.R. § 230.501(5)(i)(A) (2019).

integrated with any prior offering; therefore, the public sale is a violation of Section 5.[113]

To establish the violation, the SEC claimed that the Kin tokens were investment contracts under the *Howey* test.[114] The complaint alleges that Kik tried what a board member described as a "hail Mary pass" by offering the Kin tokens in return for cash to fund the company operations.[115] According to the complaint:

> Kik did not provide important information to investors regarding the investment opportunity promoted by Kik, such as information about Kik's current financial condition . . . future plans of operation and budget, the proposed use of investor proceeds, and detailed disclosure of material trends and the most significant factors that made the offering speculative and risky.[116]

All of that information should be contained in a registration statement, but Kik never filed one with the SEC or made it available to investors in advance of the offering of Kin tokens.[117] The SEC asked the district court to issue a judgment enjoining Kik from engaging in future offerings of digital tokens and requiring the company to disgorge its gains along with a civil monetary penalty.[118]

In response to the SEC's complaint, Kik argued that there were really two offerings of securities:

> (1) a pre-sale of contractual rights, pursuant to SAFTs ('Simple Agreements for Future Tokens') and (2) the sale of Kin to the public (the 'TDE'), pursuant to 'Terms of Use.' Because of substantial differences between the pre-sale and the TDE, Kik decided to structure the pre-sale as a sale to accredited investors exempt from registration with the Commission under SEC Regulation D.[119]

The company denies that Kin was an offer to sell a security, and therefore it did not violate Section 5 of the Securities Act.[120] In its answer to the SEC's complaint, the firm asserts that the SEC "badly mischaracterizes the totality of the facts and circumstances leading up to Kik's sale of Kin in 2017."[121]

113. Complaint at 47, SEC v. Kik Interactive Inc., No. 19-cv-5244 (S.D.N.Y. June 6, 2019) [hereinafter Kik Complaint].

114. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

115. Kik Complaint, supra note 113, at 3.

116. *Id.*

117. *Id.* at 5.

118. Kik Interactive Inc., Litigation Release No. 24493, 2019 WL 2387042 (June 4, 2018) ("As alleged in the SEC's complaint, Kik had lost money for years on its sole product, an online messaging application, and the company's management predicted internally that it would run out of money in 2017.").

119. Answer to Complaint at 4, SEC v. Kik Interactive Inc., No. 19-cv-5244 (S.D.N.Y. Aug. 6, 2019).

120. *Id.* at 5–6.

121. *Id.* at 1.

The case is ongoing, so it remains to be seen whether the SEC will prevail by showing that the Kin tokens are investment contracts under *Howey*.

C. OTHER ENFORCEMENT ACTIONS

When the SEC finds that there have been misstatements in an ICO, such as touting the potential benefits of an investment or ties to established financial companies, the agency will add in claims that there was a violation of Section 17(a) of the Securities Act of 1933[122] and Section 10(b) of the Securities Exchange Act of 1934.[123] These are the primary anti-fraud provisions of the federal securities laws. When the SEC wants to show that there were lies or misleading information provided to investors, then it will add violations under these provisions to its complaint.

The SEC has pursued a number of enforcement actions involving ICOs by asserting they are in violation of Section 5 and, in certain instances, a violation of the anti-fraud provisions in Section 17(a) and Section 10(b).[124]

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122. *See* 15 U.S.C. § 77q(a) (2018). 15 U.S.C. § 77q(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities (including security-based swaps) or any security-based swap agreement (as defined in section 78c(a)(78) [1] of this title) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Id.

123. 15 U.S.C. § 78j(a)–(b) (2018). Specifically, this section provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (a)
>
> (1) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security other than a government security, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> (2) Paragraph (1) of this subsection shall not apply to security futures products.
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement [1] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

124. 15 U.S.C. §§ 77q, 77j (2018).

In February 2018, the SEC sued Shrab Sharma, Robert Farkas, and Raymond Trapani for raising over $32 million from thousands of investors with the sale of Centra Tech Inc.'s unregistered securities in an ICO.[125] According to the SEC's complaint, Centra Tech claimed that there were relationships with financial institutions, including Visa and MasterCard, which the SEC claimed were nonexistent.[126] Centra Tech claimed that it would allow token owners to convert their tokens into legal tender, giving token owners the ability to spend cryptocurrencies through a Visa and MasterCard backed 'Centra Card' that would operate as a debit card.[127] In May 2018, the three defendants were also charged with securities fraud and wire fraud offenses by the DOJ.[128] Then in July 2019, Mr. Trapani pleaded guilty to ten counts of the indictment.[129]

In March 2018, the SEC charged AriseBank and two of its officers, Jared Rice Sr. and Stanley Ford, for failing to register their new cryptocurrency "Arisecoin" and for making misstatements to potential investors.[130] AriseBank was to be the world's first "decentralized"[131] bank, offering banking products and services to customers. It even had a celebrity endorser, boxer Evander Holyfield, who touted AriseBank, stating that he planned to use the cryptocurrency to fund humanitarian relief efforts.[132] Two of the false claims alleged by the SEC of Arisebank were: 1) it had purchased a commercial bank that would offer customers accounts insured by the FDIC

125. Sohrab Sharma, Litigation Release No. 24117, 2018 WL 1907129 (Apr. 20, 2018) ("The Securities and Exchange Commission today announced additional fraud charges stemming from an investigation of Centra Tech, Inc.'s $32 million initial coin offering.").

126. *Id.* ("The SEC's amended complaint alleges that Trapani was a mastermind of Centra's fraudulent ICO, which Centra marketed with claims about nonexistent business relationships with major credit card companies, fictional executive bios, and misrepresentations about the viability of the company's core financial services products.").

127. Amended Complaint at 3, SEC v. Sharma, No. 18 Civ. 02909 (DLC) (S.D.N.Y. Apr. 20, 2018), https://www.sec.gov/litigation/complaints/2018/comp24117.pdf.

128. Press Release, U.S. Dep't of Justice, Founders Of Cryptocurrency Company Indicted In Manhattan Federal Court With Scheme To Defraud Investors (May 14, 2018), https://www.justice.gov/usao-sdny/pr/founders-cryptocurrency-company-indicted-manhattan-federal-court-scheme-defraud.

129. *Id.*; *see also* Sealed Complaint, U.S. v. Trapani, 18 MAG 3271 (S.D.N.Y. Apr. 18, 2018), https://www.justice.gov/usao-sdny/press-release/file/1055106/download. Mr. Trapani pleaded guilty, on July 17, 2019, to securities fraud and wire fraud charges. *See Centra COO Pleads Guilty In $25M Crypto ICO Scheme Case*, LAW360 (July 17, 2019), https://www.law360.com/articles/1179395/centra-coo-pleads-guilty-in-25m-crypto-ico-scheme-case.

130. Arisebank, Litigation Release No. 24088, 2018 WL 1532152 (Mar. 29, 2018).

131. First Amended Complaint at 1, SEC v. Arisebank, No. 3:18-00186-M (N.D. Tex. Feb. 2, 2018), https://www.sec.gov/litigation/complaints/2018/compa24088.pdf [hereinafter Arisebank Amended Complaint] ("AriseBank purports to be the world's first 'decentralized' bank, allegedly offering a variety of consumer-facing banking products and services and supporting more than 700 different virtual currencies.").

132. Ken Crawford, *Four Time World Heavyweight Boxer, Evander Holyfield, Signs Deal with AriseBank*, CISION PRWEB (Jan. 9, 2018), https://www.prweb.com/releases/2018/01/prweb15066177.htm.

and 2) it would provide customers with an AriseBank Visa card that they could use to spend any of 700 cryptocurrencies wherever Visa cards were accepted. In an amended complaint, the SEC noted that AriseBank failed to disclose that Mr. Rice was on probation for a federal indictment of theft and tampering with government records, under an indictment for assault in Dallas, and the subject of at least one unpaid civil judgment. According to the SEC, "Rice is not the highly-competent professional and community activist Defendants held him out to be."[133]

In November 2018, Mr. Rice was arrested by the FBI and charged with obtaining more than $4 million in the cryptocurrency scheme for lying about: 1) AriseBank being authorized to conduct banking in Texas, 2) that it was insured with FDIC, and 3) that it did not have any partnership with Visa.[134] According to the charges, Mr. Rice "quietly converted investor funds for his own personal use, spending the money on hotels, food, transportation, a family law attorney, and even a guardian ad litem–facts he failed to disclose to investors."[135] Mr. Rice was charged with three counts of securities fraud for his misstatements and omissions.[136] In March 2019, he pleaded guilty in the case, and the U.S. Attorney's Office in Dallas asserted that "[h]is plea makes this case one of the first in which an individual has pleaded guilty to securities fraud involving a cryptocurrency in U.S. federal court."[137] The likely basis for this claim is that the Arisebank's Arisecoin constituted a security under the *Howey* test, thus it was an investment contract that was required to be registered with the SEC before it was distributed to investors and subject to the anti-fraud provisions of the federal securities laws.

In May 2018, the SEC obtained a preliminary injunction and an order freezing assets related to an ICO that raised as much as $21 million from investors through Titanium Blockchain Infrastructure Services, Inc.[138] The SEC's complaint alleged that Michael Stollery lied about business relationships with the Federal Reserve, PayPal, Verizon, Boeing, and The Walt Disney Company through fabricated testimonials.[139] In a video touting

133. Arisebank Amended Complaint, *supra* note 131, at 11. Mr. Rice and Mr. Ford settled the SEC enforcement action on November 29, 2018, and a final judgment was entered on December 11, 2018. Final Judgement as to the Defendants Jared Rice Sr. and Stanley Ford, SEC v. Arisebank, No. 3:18-00186-M (N.D. Tex. Dec. 11, 2018).

134. Sealed Indictment at 4, United States v. Rice, No. 3:18-00587-K (N.D. Tex. Nov. 20, 2018).

135. Press Release, U.S. Dep't of Justice, Cryptocurrency CEO Pleads Guilty to Securities Fraud in $4 Million Crypto Scheme (Mar. 20, 2019), https://www.justice.gov/usao-ndtx/pr/cryptocurrency-ceo-pleads-guilty-securities-fraud-4-million-crypto-scheme [hereinafter Arisebank Press Release].

136. Press Release, U.S. Dep't of Justice, Cryptocurrency CEO Indicted After Defrauding Investors of $4 Million (Nov. 28, 2018), https://www.justice.gov/usao-ndtx/pr/cryptocurrency-ceo-indicted-after-defrauding-investors-4-million.

137. Arisebank Press Release, *supra* note 135.

138. Titanium Blockchain Infrastructure Services Inc., Litigation Release No. 24160, 2018 WL 2735419 (May 22, 2018).

139. *Id.*

the coin offering, Mr. Stollery promoted it by comparing an investment to putting money into Intel or Google.[140] The complaint alleged violations of Section 5 and Section 17(a), along with violations of Section 10(b).[141] Although Mr. Stollery and Titanium Blockchain settled this case in May 2019, in which each was permanently enjoined from future violations of the federal securities laws, the settlement contained no admission or denial of liability—the standard means of settling a civil enforcement action.[142]

In September 2019, the SEC settled an enforcement action against Block.one for conducting an unregistered ICO that the agency alleged "raised the equivalent of several billion dollars over approximately one year."[143] Block.one agreed to settle the case by paying a $24 million civil penalty, one of the largest civil penalties assessed against a cryptocurrency firm, based on the finding that the company violated the registration provisions of Sections 5(a) and 5(c) by not providing the requisite information in advance to investors.[144]

In October 2019, the SEC filed an emergency action to stop Telegram Group Inc. from raising $1.7 billion in investor funds for its "Telegram Open Network or TON Blockchain."[145] The SEC accused the company of selling 2.9 billion digital tokens called "Grams" to 171 purchasers, including sales to thirty-nine investors in the United States.[146] The SEC based its complaint on the company's failure to file a registration statement in violation of Section 5(a) and 5(c) of the Securities Act of 1933, continuing to use those provisions to strike at the heart of ICOs.[147] The complaint further notes that the initial purchasers "will be able to resell billions of Grams on the open

140. *Id.*

141. *Id.*

142. *See* Joint Report Regarding Bifurcated Settlements and Stipulation To Vacate Scheduling Order, SEC v. Titanium Blockchain, No. CV18-4315-DSF (C.D. Cal. May 10, 2019).

143. Press Release, U.S. Sec. & Exch. Comm'n, SEC Orders Blockchain Company to Pay $24 Million Penalty for Unregistered ICO (Sept. 30, 2019), https://www.sec.gov/news/press-release/2019-202.

> The Securities and Exchange Commission today announced settled charges against blockchain technology company Block.one for conducting an unregistered initial coin offering of digital tokens (ICO) that raised the equivalent of several billion dollars over approximately one year. The company agreed to settle the charges by paying a $24 million civil penalty.

Id.

144. Block.one, Securities Act Release No. 10714, 2019 WL 4793292 (Sept. 30, 2019), https://www.sec.gov/litigation/admin/2019/33-10714.pdf.

145. Complaint, SEC v. Telegram Group, Inc., No. 19-9439 (S.D.N.Y. Oct. 11, 2019), https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf [hereinafter Telegram Group, Inc. Complaint]; Press Release, U.S. Sec. & Exch. Comm'n, SEC Halts Alleged $1.7 Billion Unregistered Digital Token Offering (Oct. 11, 2019), https://www.sec.gov/news/press-release/2019-212.

146. Telegram Group, Inc. Complaint, *supra* note 145, at 2.

147. *Id.* at 3.

market to the investing public,"[148] effectively creating a secondary market in Grams. The SEC requested a permanent injunction against the company plus an order requiring it to disgorge its "ill-gotten gains and to pay prejudgment interest" and civil monetary penalties.[149]

In August 2019, the SEC took a different approach in an administrative proceeding settlement against ICO Rating, a cryptocurrency rating firm in St. Petersburg, Russia, that agreed to pay disgorgement and a civil penalty totaling $268,998 to settle charges that it failed to disclose to investors that it took payments from issuers of cryptocurrencies to publicize their offerings.[150] The firm charged a fee to rate and publish research on ICOs through its website, www.icorating.com.[151] Under Section 17(b) of the Securities Act of 1933, it is unlawful to:

> give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.[152]

This provision was originally designed to prevent stock tip sheets from being used by issuers to tout their shares by making secret payments to put out information promoting the tokens.[153] This provision requires that a newsletter or ratings firm fully disclose the amount and nature of any compensation received, and the promotors could be held liable for any misstatements or omissions.[154] With the advent of the Internet as a means to put out information to a wide variety of investors, this provision has become much more important as investors must know that information may be part of a cryptocurrency promotion scheme rather than an unbiased rating. By using Section 17(b), the SEC is policing not just the issuers of cryptocurrencies but also those who can play a role in promoting them to unsuspecting investors.

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148. *Id.* at 2.

149. *Id.* at 4.

150. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges ICO Research and Rating Provider with Failing to Disclose It Was Paid to Tout Digital Assets (Aug. 20, 2019), https://www.sec.gov/news/press-release/2019-157.

151. *See id.*

152. 15 U.S.C. § 77q(b) (2018).

153. ICO Rating, Securities Act Release No. 10673, 2019 WL 3947981 (Aug. 20, 2019), https://www.sec.gov/litigation/admin/2019/33-10673.pdf ("ICO Rating's research reports, ratings, and social-media postings publicized offerings of blockchain-based digital assets, including "tokens" or "coins" that were investment contracts, which are securities pursuant to Section 2(a)(1) of the Securities Act.").

154. ICO Rating was ordered to pay to the SEC "disgorgement of $100,572, prejudgment interest of $6,426, and civil money penalty of $162,000" and "an initial installment of $201,748.50 for transfer to the general fund of the United States Treasury . . . ." *Id.* at 3.

III. IS RULE 144A OR REGULATION A+ THE ANSWER TO ISSUING CRYPTOCURRENCIES?

The Wall Street Journal reported that Van Eck Securities Corp. and SolidZ Management LLC were planning to sell shares in a cryptocurrency exchange traded fund (ETF).[155] A firm can sell securities to an investment bank, which can then offer the securities to "qualified institutional buyers"[156] that does not require a registration statement be filed with the SEC. The securities can then be resold by the purchasers. Note that the issuer of the cryptocurrency cannot be the seller because that would require registration under Section 5, but the use of an intermediary to resell the securities is permissible.

Another means to sell cryptocurrencies is under Regulation A+, a provision adopted as part of the JOBS Act. The SEC adopted rules in March 2015 that implements Section 401 of the JOBS Act by expanding Regulation A to permit offerings in two tiers: Tier 1 allows offerings of up to $20 million in a twelve-month period, while Tier 2 permits a company to raise up to $50 million in a twelve-month period.[157]

There is speculation as to whether this will work for offering cryptocurrencies to investors. The regulations require that a company making a Tier 2 offering include audited financial statements in their offering documents, which is a potentially significant cost for a small issuer.[158] In addition, those making a Tier 2 offering must file annual, semiannual, and current reports with the SEC on an ongoing basis.[159] The offering statement must contain information about the issuer and the use of proceeds from the

155. Paul Vigna, *Van Eck, SolidX to Offer Limited Version of Bitcoin Exchange-Traded Fund*, WALL ST. J. (Sept. 3, 2019), https://www.wsj.com/articles/van-eck-solidx-to-offer-limited-version-of-bitcoin-exchange-traded-fund-11567503003.

156. A "qualified institutional buyer" includes any insurance company, an investment company registered under the Investment Company Act, a Small Business Investment Company licensed by the Small Business Administration, an employee benefit plan, a trust fund whose trustee is a bank or trust company, a business development company, an organization organized under section 501(c)(3) of the Internal Revenue code, and any investment adviser registered under the Investment Advisers Act. 17 C.F.R. § 230.144A(7)(a)(1) (2013).

157. *Regulation A*, U.S. SEC. & EXCH. COMM'N (Sept. 18, 2019), https://www.sec.gov/smallbusiness/exemptofferings/rega.

> Regulation A is an exemption from registration for public offerings. Regulation A has two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period. For offerings of up to $20 million, companies can elect to proceed under the requirements for either Tier 1 or Tier 2.

Id.

158. *See Overview of Exemptions*, U.S. SEC. & EXCH. COMM'N (Feb. 12, 2019), https://www.sec.gov/smallbusiness/exemptofferings/exemptofferingschart. An Issuer must file a Form D with the Securities and Exchange Commission. *See id.*

159. *Id.*

offering.[160] Furthermore, those who can purchase in a Tier 2 offering must be either an accredited investor or subject to certain limitations on the amount of their investment in the offering.[161] If the purchaser is not an accredited investor, then the amount they can purchase in a Tier 2 offering is no more than the greater of 10% of their annual income or net worth for an individual, or 10% of the greater of annual revenue or net assets for an organization.[162]

Under Regulation A+, only companies organized in the United States and Canada can make an offering, which means that foreign issuers are barred from using this avenue to sell to shareholders.[163] In addition, only securities listed in Section 3(b)(3) of the Securities Act of 1933 can be offered to

160. Specifically, the offering statement must contain the following information:

> Item 1. (Issuer Information) requires information about the issuer's identity, industry, number of employees, financial statements and capital structure, as well as contact information.
>
> Item 2. (Issuer Eligibility) requires the issuer to certify that it meets various issuer eligibility criteria.
>
> Item 3. (Application of Rule 262 ("bad actor" disqualification and disclosure)) requires the issuer to certify that no disqualifying events have occurred and to indicate whether related disclosure will be included in the offering circular.
>
> Item 4. (Summary Information Regarding the Offering and other Current or Proposed Offerings) includes indicator boxes or buttons and text boxes eliciting information about the offering.
>
> Item 5. (Jurisdictions in Which Securities are to be Offered) requires information about the jurisdiction(s) in which the securities will be offered.
>
> Item 6. (Unregistered Securities Issued or Sold Within One Year) requires disclosure about unregistered issuances or sales of securities within the last year.

Amendments to Regulation A: A Small Entity Compliance Guide, U.S. SEC. & EXCH. COMM'N (June 18, 2015), https://www.sec.gov/info/smallbus/secg/regulation-a-amendments-secg.shtml#3. SEC Form 1-A must be filed with the Commission. Among the information required by Form 1-A is current financial information, information about the issuer of the securities, and the name of the company's auditor. *See* U.S. SEC. & EXCH. COMM'N, FORM 1-A REGULATION A OFFERING STATEMENT UNDER THE SECURITIES ACT OF 1933, https://www.sec.gov/files/form1-a.pdf.

161. Rule 501(a), 17 C.F.R. § 230.501(a), provides that:

> An accredited investor, in the context of a natural person, includes anyone who: earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, OR has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

Id. There are other categories of accredited investors, including the following, which may be relevant to you: any trust, with total assets in excess of $5 million, not formed specifically to purchase the subject securities, whose purchase is directed by a sophisticated person, or any entity in which all of the equity owners are accredited investors. *See Updated Investor Bulletin: Accredited Investors*, U.S. SEC. & EXCH. COMM'N (Jan. 31, 2019), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-accredited-investors.

162. If the securities will be listed on a national securities exchange, then those limitations do not apply. *Amendments to Regulation A*, *supra* note 160.

163. *Id.*

investors, so "[o]nly the following types of securities may be exempted under a rule or regulation adopted pursuant to paragraph (2): equity securities, debt securities, and debt securities convertible or exchangeable to equity interests, including any guarantees of such securities."[164]

For those who want to use Regulation A+ to issue securities, they can make a non-public submission of the offering statement to the SEC for review by the staff.[165] Securities cannot be offered to the public until the offering statement has been "qualified" by the SEC through a "notice of qualification" issued by the Division of Corporation Finance.[166] A significant advantage of a Regulation A+ offering is that the issuer can "test the waters" by soliciting interest in an offering from potential investors.[167]

One limitation from using Regulation A+ is the "bad actor" disqualification provisions in Rule 262 of Regulation A.[168] If a director, executive officer, or other officer participating in the offering has been convicted within ten years of any felony or misdemeanor, or is subject to a SEC cease-and-desist order enjoining the person from engaging or continuing to engage in any conduct involving a false filing with the SEC or arising out of conduct involving an underwriter, broker, dealer, municipal securities dealer, or investment advisor, then they cannot take advantage of Regulation A+.[169] There is an exception to the "bad actor" disqualification provision if the issuer can show that it did not know, or in the exercise of reasonable care, could not have known that a person with a disqualifying event participated in the offering.[170] In addition, the SEC staff can

164. 15 U.S.C. § 77c(b)(3) (2018).

165. On June 29, 2017, the Division of Corporation Finance announced that it would accept certain draft registration statements for nonpublic review. The Division has prepared these questions and answers to address preliminary questions about the expanded procedures. The answers to these questions are not rules, regulations or statements of the Commission. Further, the Commission has neither approved nor disapproved them.

Voluntary Submission of Draft Registration Statements - FAQs, U.S. SEC. & EXCH. COMM'N (June 30, 2017), https://www.sec.gov/corpfin/voluntary-submission-draft-registration-statements-faqs.

166. *Amendments to Regulation A*, *supra* note 160.

167. *Id.*

168. 17 C.F.R. § 230.262 (2020). Among the bases for disqualifying an issuer or anyone affiliated with the issuer from using Regulation A+ is if the issuer or any promotor has been convicted in the previous ten years of any felony or misdemeanor involving the purchase or sale of a security, is subject to an order, judgment or decree entered within the previous five years that restrains or enjoins a person from engaging in conduct related to the purchase or sale of a security, or an order of the Commission that suspends or revokes a person's registration as a broker, dealer, municipal securities dealer or an investment adviser, or an order within the previous five years that directs the person to cease and desist from any violation of the scienter-based anti-fraud provisions of the federal securities laws. *See* 17 C.F.R. § 230.262 (1)-(5) (2020).

169. 17 C.F.R. § 230.262 (1)-(5) (2020).

170. *Id.* 17 C.F.R. § 230.262 (2020) provides:

> (1) No exemption under this section shall be available for a sale of securities if the issuer; any predecessor of the issuer; any affiliated issuer; any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer's outstanding voting equity securities,

recommend a waiver of the disqualification provision if good cause can be shown by the issuer.[171]

Will Regulation A+ work for cryptocurrencies? Recently, the SEC's staff approved two token offerings under Regulation A+ for Blockstack Inc. and YouNow, Inc.[172] This may indicate a softening of the agency's fairly consistent opposition to cryptocurrency offerings that will allow some firms to use the mini-IPO rules to their advantage. The SEC staff also issued "no action" letters[173] for two offerings of digital tokens.[174] As a result, the consistent opposition to ICOs may be softening at the SEC.

Nevertheless, the SEC has been unwilling to approve ETFs based on Bitcoin and other cryptocurrencies because of concerns on how the value of

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> calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of such sale; any investment manager of an issuer that is a pooled investment fund; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; any general partner or managing member of any such investment manager or solicitor; or any director, executive officer or other officer participating in the offering of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor:
>
> (i) Has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:
>
> (A) In connection with the purchase or sale of any security;
>
> (B) Involving the making of any false filing with the Commission; or
>
> (C) Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities . . . .

17 C.F.R. § 230.262 (2020).

171. *Id.*

172. *See* Blockstack Inc., Offering Statement (Form 1-A/A) (July 8, 2019), https://sec.report/Document/1693656/000110465919039476/a18-15736_1partiiandiii.htm; YouNow, Inc., Offering Statement (Form 1-A/A) (July 10, 2019), https://www.sec.gov/Archives/edgar/data/1725129/000162827919000254/younow1-aa2a.htm.

173. The SEC defines a "no action" letter as:

> An individual or entity who is not certain whether a particular product, service, or action would constitute a violation of the federal securities law may request a 'no-action' letter from the SEC staff. Most no-action letters describe the request, analyze the particular facts and circumstances involved, discuss applicable laws and rules, and, if the staff grants the request for no action, concludes that the SEC staff would not recommend that the Commission take enforcement action against the requester based on the facts and representations described in the individual's or entity's request. The SEC staff sometimes responds in the form of an interpretive letter to requests for clarifications of certain rules and regulations.

No Action Letters, U.S. SEC. & EXCH. COMM'N (Mar. 23, 2017), https://www.sec.gov/fast-answers/answersnoactionhtm.html.

174. *See* Pocketful of Quarters, Inc., SEC No-Action Letter, WSB File No. (CCH) 0729201901 (July 25, 2019), https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1; Turnkey Jet, Inc., SEC No-Action Letter, WSB File No. (CCH) 0408201903 (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.

the securities will be established.[175] In August 2018, the SEC rejected requests by the Cboe BZX Exchange to list the GraniteShares Bitcoin ETF on the grounds that a national securities exchange's rule must "be designed to prevent fraudulent and manipulative acts and practices."[176] Moreover, the SEC's order noted that the Exchange "has offered no record evidence to demonstrate that Bitcoin futures markets are 'markets of significant size,'" so that efforts to prevent fraud and manipulation may not be sufficient.[177] Similarly, in March 2017, a request by Cameron and Tyler Winklevoss, made famous in the movie *The Social Network*, sought approval to list a Bitcoin ETF on the New York Stock Exchange called the Winklevoss Bitcoin Trust.[178] The SEC rejected the request, once again citing the need "to prevent fraudulent and manipulative acts and practices and to protect investors and the public interest."[179] In September 2018, the SEC entered a temporary trading suspension in Bitcoin Tracker One and Ether Tracker One.[180] By announcing the suspension, the SEC pointed out to brokers and dealers that they "should be alert to the fact that, pursuant to Rule 15c2-11 under the Exchange Act, at the termination of the trading suspension, no quotation may be entered unless and until they have strictly complied with all of the provisions of the rule."[181]

In August 2019, Coinbase[182] announced that a blockchain startup called Securitize was approved by the SEC to be a registered transfer agent.[183] This will allow Securitize to transfer digital assets between accounts and be

175. *See* Asjylyn Loder, *Bitcoin ETFs Keep Trying, Despite Regulators' Rejections*, WALL ST. J. (Sept. 23, 2018), https://www.wsj.com/articles/bitcoin-etfs-keep-trying-despite-regulators-rejections-1537754701 ("One central question concerns the basis of any SEC decision on cryptocurrency ETFs: Does the commission need to determine that cryptocurrencies are a worthwhile investment for individual investors, or should it be enough for fund firms to provide clear warnings about the risks?").

176. Self-Regulatory Organizations; Cboe BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change to List and Trade the Shares of the GraniteShares Bitcoin ETF and the GraniteShares Short Bitcoin ETF, Exchange Act Release No. 83913 (Aug. 22, 2018).

177. *Id.* at 3.

178. *See id.*

179. Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, To List and Trade Shares Issued by the Winklevoss Bitcoin Trust, Exchange Act Release No. 80206, 82 Fed. Reg. 14076 (Mar. 10, 2017).

180. Bitcoin Tracker One, Exchange Act Release No. 84063, 2018 WL 4293447 (Sept. 9, 2018).

181. *Id.*

182. Coinbase is a firm that allows users to buy and sell cryptocurrencies. According to its website, it is "the easiest place to buy, sell and manage your cryptocurrency portfolio." COINBASE, https://www.coinbase.com/ (last visited Feb. 20, 2020).

183. The SEC describes a transfer agent as a firm that records "changes of ownership, maintain the issuer's security holder records, cancel and issue certificates, and distribute dividends. Because transfer agents stand between issuing companies and security holders, efficient transfer agent operations are critical to the successful completion of secondary trades." *Transfer Agents*, U.S. SEC. & EXCH. COMM'N (Apr. 28, 2016), https://www.sec.gov/divisions/marketreg/mrtransfer.shtml.

compliant with rules for holding assets and protecting customer accounts.[184] This is a step towards regulating the transfer of digital assets and cryptocurrencies, and it is a means to enhance customer security.

Another challenge the cryptocurrency industry faces is complying with anti-money laundering provisions. *The Wall Street Journal* noted:

> The standards, adopted in June by the Financial Action Task Force [FATF], require cryptocurrency exchanges, some digital wallet providers and other firms to send customer data—including names and account numbers—to institutions receiving transfers of digital funds, similar to a wire transfer at a bank. The goal of the so-called travel rule is to help law enforcement track suspicious activity. The FATF is the global standard-setter for anti-money-laundering.[185]

Because one goal for using cryptocurrencies is to maintain anonymity, the money-laundering rules, along with "know your customer" requirements,[186] are likely to curtail how individuals can hide their transactions.

One way to keep the SEC away from regulating cryptocurrencies would be for Congress to remove its authority to regulate them under the *Howey* test. A bill introduced in the House of Representatives, H.R. 2144,[187] would amend Section 2(a)(1) of the Securities Act of 1933 to remove a "digital token" from the definition of a security. That would effectively bar the SEC from using the *Howey* test to require that ICOs and Bitcoin ETFs be registered with the SEC before being sold to investors. Whether that is a sound idea is certainly an open question because cryptocurrencies have shown themselves to be a handy means to engage in fraudulent action and even market manipulation. Without a so-called cop on the cryptocurrency

184. *See* Nicholas Marinoff, *Coinbase-backed Securitize gets SEC Approval to Record Digital Securities*, DECRYPT (Aug. 21, 2019), https://decrypt.co/8625/coinbase-backed-securitize-gets-sec-approval-record-digital-securities.

185. Kristin Broughton, *Crypto Firms Assess How to Comply with Anti-Money-Laundering Standards*, WALL ST. J. (Sept. 16, 2019), https://www.wsj.com/articles/crypto-firms-assess-how-to-comply-with-anti-money-laundering-standards-11568626200.

186. Under Rules issued by the Financial Crimes Enforcement Network, "know your customer" rules require the following four elements: (a) identifying and verifying the identity of customers, (b) identifying and verifying the identity of "beneficial owners" of customers that are legal entities, (c) understanding the nature and purpose of customer relationships, and (d) conducting ongoing monitoring to maintain and update customer information and identify suspicious transactions. *See Information on Complying with the Customer Due Diligence (CDD) Final Rule*, FIN. CRIMES ENFORCEMENT NETWORK (2020), https://www.fincen.gov/resources/statutes-and-regulations/cdd-final-rule. 31 U.S.C. § 5318(g)(1) provides, "[t]he Secretary may require any financial institution, and any director, officer, employee, or agent of any financial institution, to report any suspicious transaction relevant to a possible violation of law or regulation." 31 U.S.C. § 5318(g)(1) (2018).

187. Token Taxonomy Act of 2019, H.R. 2144, 116th Cong. (2019). The bill has seven co-sponsors—four Democrats and three Republicans—joining Republican Representative Warren Davidson in sponsoring the legislation. Whether it will get through the House Financial Services Committee, which has shown a rather distinct hostility toward Facebook's Libra proposal, is very much an open question. Broughton, *supra* note 185.

beat, investors may be exposed to a range of conduct that is designed to separate them from their money. Is that a good thing?

IV. CONCLUSION

Should the SEC continue to regulate cryptocurrencies? That question is not easy to answer. As seen above, there have been enough fraudulent offerings of cryptocurrencies that requires at least some federal presence in this area to prevent investors from being taken by scam artists. The SEC may not be equipped to deal with new developments in the use of blockchain. In a statement from the SEC's Division of Trading and Markets and the Financial Industry Regulatory Authority, Inc. (FINRA),[188] they take the position that:

> An entity that buys, sells, or otherwise transacts or is involved in effecting transactions in digital asset securities for customers or its own account is subject to the federal securities laws, and may be required to register with the Commission as a broker-dealer and become a member of and comply with the rules of a self-regulatory organization ("SRO"), which in most cases is FINRA.[189]

The registration requirement as broker-dealer and compliance with FINRA's rules makes it an expensive proposition to hold and administer digital wallets holding cryptocurrencies for those who deal with cryptocurrencies. This expense alone might be enough to discourage firms from trying to meet the regulatory requirements.

SEC Commissioner, Hester Peirce, noted that the agency should act more like a lifeguard on the beach, stating:

> On a beach, the lifeguard watches over what is happening, but she is not sitting with sandcastle builders monitoring their every design decision. From her perch on the lifeguard stand, she can spot dangerous activity and intervene with a blow of the whistle or, if necessary, a direct intervention. She always stands ready to answer questions about the rules of the beach. She puts up the red flag to warn of dangerous riptides or sharks.[190]

Should the SEC only act as a lifeguard, or is there a more proactive role the agency should take? Chairman Jay Clayton has taken a more activist

188. "FINRA is authorized by Congress to protect America's investors by making sure the broker-dealer industry operates fairly and honestly. [It] oversee[s] more than 634,000 brokers across the country—and analyze[s] billions of daily market events." *About FINRA*, https://www.finra.org/about (last visited Apr. 9, 2020).

189. Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, Div. of Trading and Mkts, U.S. Sec. & Exch. Comm'n, and Office of Gen. Counsel, Fin. Industry Regulatory Auth. (July 8, 2019), https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities.

190. Hester M. Peirce, Comm'r, U.S. Sec. & Exch. Comm'n, Beaches and Bitcoin: Remarks Before the Medici Conference (May 2, 2018), https://www.sec.gov/news/speech/speech-peirce-050218.

position. He noted in a policy statement that "[a] number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation."[191] In an appearance on CNBC on September 9, 2019, Mr. Clayton stated that a Bitcoin ETF is "[a]n even harder question given that they trade on largely unregulated exchanges is how can we be sure that those prices aren't subject to significant manipulation? . . . People needed to answer these hard questions for us to be comfortable that this was the appropriate kind of product."[192] If manipulation and false promises in ICOs are the problem, then there really are sharks in the water that the lifeguard has to warn investors to avoid.

There is no clear answer to who should regulate cryptocurrencies. They are a new form of investment that promises, perhaps, to provide benefits to those who do not have access to the banking system. But they are also a fertile field for scams when investors can be hoodwinked into putting money into a cryptocurrency that may never have any real value or exist at all. Designating them as securities has the benefit of allowing the SEC to play at least some role in policing the frauds and manipulations that are likely to arise in this field. Whether the SEC is equipped to oversee an area of more than 1,600 cryptocurrencies as of August 2018 raises an interesting question regarding its resources to adequately police this area. Cryptocurrencies were designed to avoid government oversight, but the hope that they will exist in a 'Wild West' in the future is dubious at best. It may be that resource constraints argue in favor of having a separate regulator for cryptocurrencies so that they can develop in a manner that both protects those who purchase them and prevents the types of frauds they seem to attract.

191. Statement of Chairman Clayton, *supra* note 104.

192. William Foxley, *SEC Chair Clayton: Would-Be Bitcoin ETFs Have 'Work Left to Be Done'*, COINDESK (Sept. 9, 2019), https://www.coindesk.com/sec-chair-clayton-would-be-bitcoin-etfs-have-work-left-to-be-done.