

# US Blockchain Enforcement and Litigation Update

Government enforcement and private litigation drive important developments in cryptocurrencies, initial coin offerings and blockchain-related digital assets

June 2018

Dechert  
LLP





## Overview

With soaring cryptocurrency prices attracting significant new investment in late 2017, U.S. regulators sought to fill the statutory void by exercising jurisdiction over a variety of digital assets. That trend continued in the first half of 2018, as both the federal government and state agencies have increased regulatory oversight for the rapidly-expanding digital asset industry. This has resulted in a distinct uptick in both enforcement actions and private litigation in the cryptocurrency space.

At the federal level, both the U.S. Securities and Exchange Commission (“SEC”) and Commodities and Futures Trading Commission (“CFTC”) have asserted jurisdiction over various elements of cryptocurrency products. The first half of 2018 saw the SEC continue to focus on initial coin offerings (“ICOs”), which often function as public offerings of new digital assets falling within the statutory definition of “securities” under the Securities Act of 1933. As the SEC has staked out its territory in cryptocurrency regulation, ongoing enforcement actions are likely to have significant implications for regulation under the federal securities laws. Meanwhile, the CFTC secured a key court ruling that certain cryptocurrency products should be regulated as commodities. In an effort to crack down on cryptocurrency price manipulation, the CFTC is also reportedly working on an investigation alongside the U.S. Department of Justice (“DOJ”), which is similarly engaged in several cryptocurrency-related enforcement actions.

The first half of 2018 also featured a substantial increase in regulatory activity at the state level, as regulators in Texas, New Jersey and North Carolina, among others, have become active in digital asset regulation. An increase in private litigation related to cryptocurrency products, meanwhile, will require courts across the country determine the boundaries of the federal securities laws in this space.

# Background on cryptocurrencies and initial coin offerings

The terms “virtual currency” and “cryptocurrency” can bring to mind images of dollars and cents, but they are distinct from traditional legal tender in ways that have important implications for government regulation.

Virtual currency is an umbrella category of digitally represented value without legal tender status. It can be either convertible (with equivalent value in real currency) or non-convertible (with value only in a specific virtual world). Similarly, it can be either centralized (with a single administrator) or decentralized (distributed across peer-to-peer networks with no central administrator).

---

Importantly, the categories of commodities and securities are not mutually exclusive, meaning that the SEC and CFTC may wield overlapping jurisdiction in this field — at least in the absence of contrary federal legislation.

---

The term “cryptocurrency” refers to convertible, decentralized virtual currency that uses cryptography to facilitate transactions over a “distributed ledger.” This process allows for the transfer of value among a network of individual actors conducting encrypted but publicly recorded transactions. Bitcoin is just one example of a cryptocurrency that has gained widespread usage and acceptance. Cryptocurrency developers can create new types of coins either on existing cryptocurrency protocols (like Litecoin, which was built on the Bitcoin protocol) or on new protocols (like Ether, which uses its own protocol). A valuable feature of some, though not all, cryptocurrencies is the possibility of constructing self-executing (“smart”) contracts embodied in actual computer code to certain transactions.

During 2017, an increasing number of entrepreneurs and start-up companies began conducting ICOs for so-called “tokens,” which enable buyers to use platforms or other blockchain-based resources that they plan to construct. The industry quickly began to describe these tokens as either “utility tokens” (credits for a new product or service) or “equity tokens” (conferring rights to own real assets or company shares). The term “digital assets” refers to both virtual currencies and utility and equity tokens.

These various functions of digital assets cross regulators’ jurisdictional boundaries, creating challenges for government agencies seeking a proper regulatory approach. The CFTC has treated cryptocurrencies as commodities under the broad definition in the Commodity Exchange Act (“CEA”), enabling the agency to regulate cryptocurrency derivatives contracts and target cases of fraud involving underlying cryptocurrencies. The SEC has also exercised jurisdiction in this area, though its focus has turned mostly to tokens (often marketed as investment opportunities) rather than to cryptocurrencies whose function is solely as a store of value. Importantly, the categories of commodities and securities are not mutually exclusive, meaning that the SEC and CFTC may wield overlapping jurisdiction in this field — at least in the absence of contrary federal legislation.



## SEC cryptocurrency enforcement

The SEC's approach to digital asset regulation in the first half of 2018 largely focused on ICOs. In a June 2018 speech, SEC Division of Corporation Finance head William Hinman clarified that the SEC does not view Bitcoin or Ether, two of the most prominent cryptocurrencies, as "securities" for the purposes of the federal securities laws. ICOs, on the other hand, have remained well within the SEC's sights. As ICOs are increasingly viewed as a more flexible alternative to attracting venture capital for startups—as evidenced by the more than US\$5 billion raised through ICOs in 2017 — the SEC has expressed concern that this fundraising mechanism creates considerable risk for unsuspecting consumers. In a December 2017 release, SEC Chairman Jay Clayton stated, "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."<sup>1</sup>

Among its efforts to address these concerns, the SEC has sought to require registration of ICOs under Sections 5(a) and 5(c) of the Securities Act of 1933. The SEC has also prosecuted ICO-related fraud under Sections 10(b) and 32 of the Securities Exchange Act of 1934. This assertion of authority turns on whether ICOs involve "investment contracts." To make this determination, the SEC and the courts turn to the framework set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), which requires a fact-specific analysis of four factors: (1) whether there is an investment of money (2) into a common enterprise (3) with an expectation of profit (4) based solely on the efforts of a third party.

Among the cases likely to have the most immediate impact on the SEC's jurisdiction is a DOJ criminal case that is proceeding alongside parallel civil charges in New York. In September 2017, the SEC filed a complaint in the Eastern District of New York against businessman Maksim Zaslavskiy, alleging violations of the securities laws' registration and anti-fraud provisions. The SEC's civil case has been stayed pending the outcome of the DOJ criminal case, and Zaslavskiy has moved

---

<sup>1</sup> U.S. Securities and Exchange Commission, *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017).

to dismiss the criminal charges, arguing that the federal securities laws do not govern the ICOs at the center of the case. The DOJ and SEC have both filed responses that characterize Zaslavskiy's tokens as "investment contracts," according to the *Howey* factors. The court held oral argument in early May, and a decision is pending.

Over the first five months of 2018, the SEC initiated four additional cryptocurrency-related enforcement actions that are likely to clarify when the sale of cryptocurrency products meets the *Howey* factors.

- In January, the SEC secured a court order in the Northern District of Texas halting an ICO conducted by AriseBank, which marketed itself as a "decentralized bank" that would enable users to store hundreds of types of cryptocurrencies in FDIC-insured accounts. The company's co-founders face charges for the unregistered sale of securities (in the form of "AriseCoins") and also for fraud in the sale of securities related to claims that AriseBank would offer branded debit cards that could be used to spend various cryptocurrencies.
- The next month, the SEC charged a cryptocurrency platform, BitFunder, and its founder, Jon Montroll, for operating an unregistered securities exchange and defrauding users. According to the SEC's complaint, filed in the Southern District of New York, the platform operator commingled users' Bitcoins in his own virtual currency wallet and later made false statements regarding the sale of another investment product. The defendant also faces related criminal charges for perjury and obstruction of justice.
- In April, the SEC brought charges in the Southern District of New York against Sohrab Sharma, Robert Farkas, and Raymond Trapani, the founders of Centra Tech., Inc., for conducting an allegedly unregistered and fraudulent ICO for "CTR Tokens," which would be used for a variety of financial products. The defendants allegedly fabricated executive biographies for marketing materials and paid celebrities to promote the ICO on social media, while making false claims about the tokens' functionality. Later that month, the DOJ followed suit with parallel criminal charges.
- The SEC filed suit in the Central District of California against Titanium Blockchain Infrastructure Services, Inc., and its operator for the allegedly fraudulent and unregistered sale of a token called "BAR," which would be used for blockchain-based IT development. The SEC claimed that the defendant promoted the ICO by falsely claiming relationships with various prominent companies in order to stoke interest in the new token.

Commentary by SEC officials has also had a significant impact on cryptocurrency prices in recent months. In March, for example, Bitcoin prices tumbled more than 10% after the Divisions of Enforcement and Trading and Markets released a statement indicating their view that cryptocurrency exchanges must register with the SEC.<sup>2</sup> While the SEC is aggressively pursuing cryptocurrency-related fraud cases, SEC officials have also repeatedly emphasized the need to consider each product based on its substance. In early May, SEC Commissioner Hester Peirce highlighted the need for regulators to grant entrepreneurs space to innovate in this field. And, most recently, Director Hinman offered the SEC's first clear statement that it does not consider Bitcoin or Ether to be "securities" that fall within the SEC's jurisdiction. These public statements may highlight an understanding that cryptocurrency enforcement should avoid a heavy-handed approach that could impede technological innovation and economic growth.

---

<sup>2</sup> U.S. Securities and Exchange Commission, *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (March 7, 2018).

# CFTC cryptocurrency enforcement

The CFTC has taken an active role in regulating cryptocurrency products dating back to September 2015, when the agency first penalized a cryptocurrency operator (Coinflip Inc.) for violations of the CEA in a settled enforcement action.

A recent decision in the Eastern District of New York was the first court order recognizing CFTC authority in this area. In *CFTC v. McDonnell, et al.*, 287 F. Supp. 3d 213 (E.D.N.Y. 2018), U.S. District Judge Jack Weinstein affirmed the CFTC's jurisdiction over fraud involving cryptocurrencies that underlie futures and derivatives contracts (and not just the futures and derivatives themselves). In denying a motion to dismiss, the court recognized the CFTC's enforcement authority in this area. Citing the CEA's broad definition of "commodities," Judge Weinstein wrote, "CFTC may exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce."

So far this year, the CFTC has brought three additional enforcement actions involving cryptocurrency:

- On January 16, the CFTC initiated an enforcement action against My Big Coin Inc. and its operators, who allegedly engaged in fraud in the sale of a new cryptocurrency, "My Big Coin" (MBC), and other products. The agency's complaint, filed in the District of Massachusetts and amended in April, alleges that the defendants raised approximately US\$6 million by falsely characterizing MBC trading markets and prices, along with the coin's functionality.
- Two days later, the CFTC announced charges against Dillon Michael Dean and his company, The Entrepreneurs Headquarters Limited, for allegedly soliciting Bitcoin from the public based on fraudulent statements and failing to register with the CFTC as a commodity pool operator. Filing charges in the Eastern District of New York, the CFTC asserted that Dean falsely stated that the Bitcoin would be pooled and invested in various products and that he instead made Ponzi-style payments to investors and otherwise misappropriated investors' funds.
- On April 16, the agency filed a complaint in the Eastern District of New York alleging that Blake Harrison Kantor and several affiliated companies engaged in a fraudulent scheme involving binary options and a sham cryptocurrency called "ATM Coin." According to the CFTC, Kantor and his companies operated an illegal binary options trading scam that used software that skewed the likelihood of profit against the customer. He then allegedly converted customers' funds into ATM Coin to cover up the binary options fraud. The DOJ also announced parallel criminal charges against Kantor.

# DOJ investigation and enforcement

The DOJ has also played a key role in complementing the enforcement efforts of both the SEC and the CFTC. May 2018 public reports suggested that the DOJ and CFTC had begun a broad investigation into price manipulation in cryptocurrency markets.<sup>3</sup> The probe, which relates to the cryptocurrencies Bitcoin and Ether, is reportedly considering allegations that traders are using tactics such as "spoofing" and wash trading to artificially inflate and deflate the value of the digital commodities. "Spoofing" describes fraudulent transactions in which a trader submits a volume of trading orders large enough to trigger a market ripple effect and then cancels those orders once the desired result has been achieved. Similarly, wash trades are those in which only one trader is on both sides of a transaction, in order to simulate demand that does not actually exist.

---

<sup>3</sup> See, e.g., Matt Robinson, *U.S. Launches Criminal Probe into Bitcoin Price Manipulation* Bloomberg (May 24, 2018).



The DOJ has also brought four criminal cases against the operators of cryptocurrency companies so far in 2018. Each of these criminal cases accompanied civil enforcement actions by either the SEC or the CFTC. As discussed above, alleged violations include conducting an unregistered and fraudulent ICO (Sharma, Farkas and Trapani), engaging in a fraudulent binary options scheme (Kantor), and perjury in an SEC investigation into cryptocurrency-related misconduct (Montroll). In addition, on February 15, 2018 the DOJ announced charges against Joseph Kim, a trader for Consolidated Trading LLC, for allegedly misappropriating US\$2 million of the firm’s Bitcoin and Litecoin for his own use.

## State regulatory efforts

While federal law generally precludes state regulators from taking an active role in regulating investment products, the lack of federal legislation on cryptocurrency opened the door for state agencies to bring a variety of enforcement actions in the first half of 2018. On May 21, the North American Securities Administrators Association (“NASAA”), a coalition of U.S. state and Canadian provincial agencies, announced a broad effort to crack down on cryptocurrency-related misconduct. A release by the NASAA stated that “Operation Cryptosweep” had resulted in “nearly 70 inquiries and investigations and 35 pending

---

<sup>4</sup> See, Texas State Securities Board, *Enforcement Actions: Administrative* (last visited June 6, 2018) (listing eight enforcement actions against cryptocurrency companies in 2018).

<sup>5</sup> See, New Jersey Division of Consumer Affairs, Bureau of Securities, *Cryptocurrency* (last visited June 6, 2018) (listing five enforcement actions against cryptocurrency companies in 2018).

<sup>6</sup> See, Alabama Securities Commission, *Alabama Securities Commission Participates in Coordinated International Crypto Crackdown* (May 21, 2018) (listing five enforcement actions against cryptocurrency companies).

<sup>7</sup> See, North Carolina Secretary of State, *Cryptocurrencies and Investing* (last visited June 6, 2018) (listing seven enforcement actions against cryptocurrency companies in 2018).

<sup>8</sup> See, New York Office of the Attorney General, *A.G. Schneiderman Launches Inquiry Into Cryptocurrency “Exchanges”* (June 8, 2018).

or completed enforcement actions related to ICOs and cryptocurrencies since the beginning of May.” Among the states with the most cryptocurrency-related regulatory activity are Texas,<sup>4</sup> New Jersey,<sup>5</sup> Alabama<sup>6</sup> and North Carolina<sup>7</sup>.

In New York, meanwhile, regulators continue to grapple with the proper approach to cryptocurrency. On April 17, then-Attorney General Eric Schneiderman initiated the “Virtual Markets Integrity Initiative,” described in a release as “a fact-finding inquiry into the policies and practices of platforms used by consumers to trade virtual or ‘crypto’ currencies like bitcoin and ether.”<sup>8</sup> The announcement was accompanied by disclosure requests made to 13 cryptocurrency exchanges, with questions focused on the companies’ ownership, operations, trading policies and procedures, internal controls and other matters. Since 2015, New York has required companies to obtain “BitLicenses” in order to conduct cryptocurrency-related activities occurring in New York or involving New York residents, and licensees are required to adhere to a variety of internal controls, books-and-records, and other provisions.

## Private litigation

As federal agencies continue to bring actions for cryptocurrency-related misconduct, private litigation will also shape the regulatory landscape. In the first half of 2018, at least 23 private lawsuits pertaining to cryptocurrencies were filed. While a majority of these lawsuits allege causes of action rooted in the federal securities laws, plaintiffs have also brought claims under state securities and consumer protection laws, the Truth in Lending Act, and common law principles of fraud and unjust enrichment.

Among the private lawsuits with significant implications for federal cryptocurrency regulation is *Coffey v. Ripple Labs Inc.*, filed in California state court in May and subsequently transferred to the Northern District of California. Plaintiff Ryan Coffey alleged in his complaint that Ripple Labs Inc. (“Ripple”) has conducted an unregistered ICO in violation of the federal securities laws through its issuance of 100 billion Ripple tokens (“XRP”). The complaint highlights Ripple’s allegedly optimistic price predictions and portrayals of XRP as an investment opportunity as evidence that the tokens are securities, in addition to alleging that Ripple offered bribes to cryptocurrency exchanges to list XRP in order to boost its value. While the case remains in its early stages, it made news in early June when Ripple added former SEC officials Mary Jo White and Andrew Ceresney, now in private practice, to its legal team.

---

---

In the first half of 2018, at least 23 private lawsuits pertaining to cryptocurrencies were filed.

---

---

Another case proceeding in the Northern District of California, *Davy v. Paragon Coin Inc.*, may also have important consequences for cryptocurrency regulation under the federal securities laws. That suit pertains to alleged securities fraud on the part of Paragon Coin, Inc. (“Paragon”) for the company’s ICO in the fall of 2017. Complainant Astley Davy has alleged on behalf of a putative class that Paragon’s ICO resulted in at least US\$70 million in sales of ParagonCoins (or “PRG Tokens”), a cryptocurrency created to facilitate transactions in the cannabis industry. The plaintiff also argued that Paragon and its controlling parties are strictly liable for the sale of unregistered securities. A key issue in this litigation (as in other private cryptocurrency litigation) will be whether PRG Tokens should be classified as “investment contracts” under *Howey*.



# Looking ahead

The rise in enforcement actions and private litigation related to cryptocurrencies and other digital assets is likely to grow significantly (along with cryptocurrency economic activity itself) in the second half of 2018. Forthcoming rulings in pending cryptocurrency enforcement cases will provide important insight as to the scope of SEC and DOJ jurisdiction over these products. The courts will need to assess the metrics that the DOJ and SEC have used in identifying “investment contracts,” including the importance of statements on profit projects, the likely existence of secondary trading markets, and the roles of expert management teams in the success of certain coins. While ICOs with marketing materials that include these claims most likely come under the purview of the federal securities laws, court rulings over the next several months have the potential to confirm the relevance of these factors.

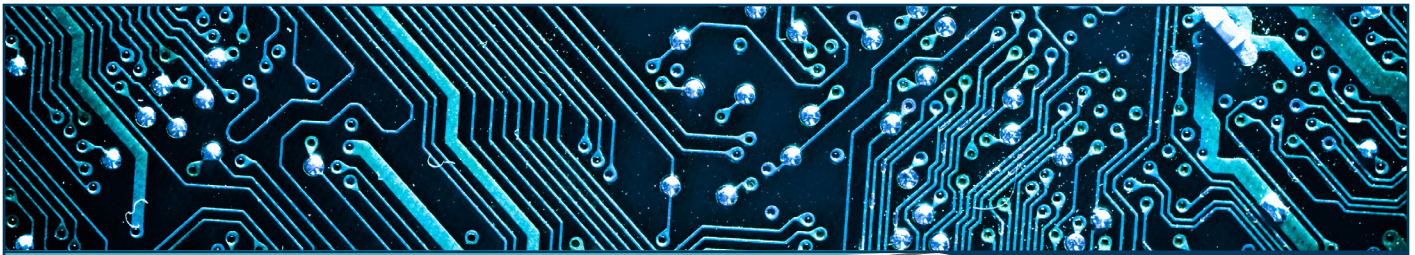
Companies operating in this space should also be cognizant of potential Congressional action. In May 2018, Rep. Warren Davidson (R-Ohio) pledged to draft a cryptocurrency bill by the fall. “I intend to lead legislation for initial coin offerings to clarify the role of regulators, protect consumers, address national security concerns, and facilitate a pro-growth environment for businesses to raise capital,” said Rep. Davidson. Such a bill would allow Congress to determine the SEC’s and CFTC’s roles in this evolving industry, rather than allowing the agencies to carve out their own authority through the courts. Others in Congress, including members of the Congressional Blockchain Caucus (“CBC”), have also cautioned against over-regulation by federal agencies.

## How Dechert can assist

The increasing use of cryptocurrencies and other digital assets has given rise to complex legal issues relating to compliance, securities transactions, litigation and regulatory enforcement. Dechert remains locked onto advances in the industry and will provide updates on critical cases and regulatory actions as they arise.

Dechert offers sophisticated and knowledgeable legal counsel to clients navigating this rapidly evolving space. At the heart of Dechert’s cryptocurrency and blockchain practice is a deep understanding of the technologies that drive blockchain and related developments in distributive computing networks. In addition, Dechert is distinctive among leading law firms in this area by bridging the financial service regulation and new financial technology to find solutions for our clients.

Dechert’s Investigations and White Collar Defense practice has extensive experience in navigating enforcement actions by the DOJ, SEC, CFTC and other agencies in the United States and throughout the world. In addition, our Financial Services Group is one of the leaders today in advising firms on the regulatory consequences of various cryptocurrency and blockchain-based transactions. As cryptocurrency enforcement policies continues to evolve, we will work with clients to anticipate compliance trends, defend against enforcement actions, and react to any issues that may arise.



## Dechert's Cryptocurrency and Blockchain Resources Center

**Providing the latest news, updates and analysis.**

Since the launch of bitcoin in 2009, cryptocurrencies and the encrypted, decentralized blockchain protocol that underpins them have grown from abstract theories to a transformational force that is disrupting the way many industries will operate for decades to come.

Dechert's cryptocurrency and blockchain technology website brings together a selection of resources on this subject, including legal updates and event recordings.



**[dechert.com/cryptocurrency](https://dechert.com/cryptocurrency)**

Attorney advertising. Prior results do not guarantee a similar outcome.

# Contact us



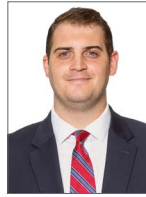
**Joseph A. Fazioli**

Partner

Silicon Valley: +1 650 813 4836

San Francisco: +1 415 262 4529

joseph.fazioli@dechert.com



**Rory Gledhill**

Associate

+1 215 994 4000

rory.gledhill@dechert.com



**Michael J. Gilbert**

Partner

+1 212 698 3886

michael.gilbert@dechert.com



**Hrishikesh N. Hari**

Associate

+1 202 261 3347

hrishikesh.hari@dechert.com



**Timothy Spangler**

Partner

Orange County: +1 949 442 6044

Silicon Valley: +1 650 813 4803

timothy.spangler@dechert.com



**Jacob Grubman**

Associate

+1 202 261 3445

jacob.grubman@dechert.com

© 2018 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 31/F Jardine House, One Connaught Place, Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000). Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Georgia, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at [dechert.com](http://dechert.com) on our Legal Notices page.