TransReflection

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ICOs: A Breeding Ground for Ponzi Schemes, Regulatory Action and Securities Law Class Actions

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In addition to adjudicating and settling customer claims, our Claim Department personnel keep up to date with major market developments. Originally developed for internal training and education purposes, they share their summaries and perspectives on topical issues.

In this paper, Renee Franklin, Senior Claims Examiner in New York, looks at Initial Coin Offerings, and their potential to generate Securities Class Action Claims

A. Will the Securities Exchange Commission regulate Initial Coin Offerings (ICOs)?

There has been substantial controversy over whether the SEC has regulatory authority over Initial Coin Offerings (ICOs). The SEC is charged with regulation of the securities industry, essentially to provide investor protection and maintain fair, orderly and efficient capital markets and to facilitate capital formation.[1]

Currently, those regulatory eyes are squarely fixed on the ICO market where an initial offering of a newly created "coin" or "token" of cryptocurrency is made available to investors. Like an Initial Public Offering (IPO) of stock, the ICO will operate to raise capital for the company producing the coin or token. The tokens may later be sold, much like stock, representing the underlying value to the token.

Jay Clayton, Chairman of the SEC, has taken the position that in most cases, depending on the facts and circumstances of each case, a coin or token offered in an ICO is a "security" as defined in the US Securities Laws and the ICO is thus a securities offering subject to regulation by the SEC. Thus, the company must register with the SEC and must register the ICO as a securities offering.[2] The initial SEC paper setting forth this position is The DAO Report[3] which analyzes in detail how the SEC viewed the Decentralized Autonomous Organization ("DAO") token, as a security. The report is now regularly referenced in discussing the SEC's position.

Since the creation of Bitcoin and the further development of blockchain technology, there have been hundreds of additional currencies generated, such as those from Ethereum and Ripple as well as many small start-ups. Blockchain technology ideally creates what is supposed to be a "tamper-proof" digital ledger across multiple computers, thereby assuring the safety of the coins created.[4] Digital tokens can eventually be sold or redeemed for goods and services. The market has been red hot, with firms raising about $8 billion, primarily within the last year, according to coin desk, which tracks the offerings.[5] Reports of the exact figure do vary.

This relatively new investment opportunity has seen wild fluctuations in the value of the coins or tokens involved in recent months. This burgeoning market is highly volatile and has been making many millionaires in the process. The huge profits that appear to be available are the perfect breeding ground for fraudulent conduct… and the good old Ponzi scheme… as well as other well-known fraudulent tactics.[6] In fact, money-laundering criminal conduct and prosecution appears to have been instrumental in bringing this market into focus.[7]

The SEC is worried that in many cases small investors are not adequately researching the risks involved. Risks can arise from inaccurate or non-existent disclosure, volatility, manipulation, fraud and theft, all earmarks of the typical securities fraud case.[8] Beyond a regulatory investigation, securities law class actions often occur simultaneously with or on the heels of an investigation into allegations of undisclosed, misleading or false information provided to public investors. Both regulatory actions and securities law class actions often become D&O claims. Consequently, the SEC is looking with intense scrutiny at ICOs.

The SEC says Yes It Can Regulate ICOs

The SEC considers an ICO in most instances to be a security offering under its jurisdiction, requiring registration as a security and providing investors with the protections of the Securities laws, at least in the US market (or where the ties to the US market are adequate for jurisdiction).[9] The SEC has set out to prove it.

In December 2017, Clayton issued an opinion statement. As of the December 2017 Clayton opinion paper, no ICOs had been registered with the SEC and the SEC had not approved any exchange-traded products holding cryptocurrencies or other assets related to cryptocurrencies. He posed several initial questions for consideration by investors and market professionals when considering these investments, including:

- Is the product legal? Is it subject to regulation, including rules designed to protect investors? Does the product comply with those rules?
- Is the offering legal? Are those offering the product licensed to do so?
- Are the trading markets fair? Can prices on those markets be manipulated? Can I sell when I want to?
- Are there substantial risks of theft or loss, including from hacking?

He continued to express both interest in the ICO market and concerns for investor protection.[10]

Subsequently, in February, 2018, Clayton and J. Christopher Giancarlo, Chairman of the Commodities Futures Trading Commission, testified before the Senate Committee on Banking, Housing and Urban Affairs. Clayton made it clear that the Chairmen of the two regulatory agencies will work together to appropriately determine which agency is responsible in particular situations.[11] Giancarlo also made the point they previously stated jointly that they will "work together to bring transparency and integrity to these markets and, importantly, to deter and prosecute fraud and abuse."[12]

Clayton advises that, while each situation must be evaluated on the individual facts and circumstances, many of the newer currencies bear the "hallmarks of a security under the U.S. law" by incorporating "features and marketing efforts that emphasize the potential of profits based on the entrepreneurial or managerial efforts of others." He notes that "simply calling something a "currency" or a currency-based product does not mean it is not a security... Many products labeled as cryptocurrencies or related assets are increasingly being promoted as investment opportunities that rely on the efforts of others, with their utility as an efficient medium for commercial exchange being a distinct secondary characteristic…." and thus should be considered securities subject to SEC regulation.[13]

Thus, the SEC has concluded that an ICO, which represents an investment of money in a "common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," usually falls within the ambit of the securities laws.[14]

That said, it has also been generally acknowledged that some cryptocurrency, such as Bitcoins and Ethers, are currencies rather than securities. [15] However, that would not necessarily prevent regulators from stepping in.

The Commodities Futures Trading Commission (CFTC) has taken jurisdiction over cryptocurrency in certain instances. In 2015, the CFTC defined Bitcoin and other virtual currencies as commodities. It will take jurisdiction where there is a derivatives contract or if there is fraud or manipulation involving trading of a virtual currency in interstate commerce.[16]

In my take on the Chairman's testimony, as well as in the industry trend, they want to encourage the development of this new capital market while providing the protections of the securities and commodities laws for the "main street investor" as well as justifying making these investments available to retail and institutional investors. The SEC appears to have brought the pending enforcement cases both to bring certain players to justice and to test the strength of the laws as they exist. The stance of the SEC is strongly that they have the power to regulate the ICOs; however, new rules are being contemplated to regulate the burgeoning market in cryptocurrencies.

The Nay-sayers

Of course, there are those who disagree with regulation. One of the initial reasons virtual currencies became popular was the decentralized nature of blockchain technology used to create a distributed ledger technology that arguably allows for verifiable transactions without the expense and time involved with traditional banking and trading transactions.

Market makers and sellers of the various tokens have also been enjoying a relatively unregulated market and argue that the compliance costs in a regulated environment could force some coin exchanges out of business. However, even those who prefer the unregulated marketplace have begun to see the need for a regulatory scheme that protects investors from the potential fraud and abuse in this highly volatile and complex market.[17]

The most viable argument currently is that the securities laws predate the cryptocurrency revolution and were not designed to apply in the age of digital currency.[18] The SEC in its efforts in regard to ICOs is challenging that argument.

B. Will SEC actions and class action lawsuits impact future ICOs?

The SEC has been cracking down on fraudulent ICOs, concerned that some ICOs raise money for businesses that do not even exist. The SEC has issued subpoenas to firms and individuals behind specific offerings that the SEC believes might be violating securities laws.[19]

1. On May 29, 2018, the SEC obtained an emergency order to halt an ongoing ICO marketing scheme by the self-described "blockchain evangelist" Michael Alan Stollery aka Michael Stollaire, President of Titanium Blockchain Infrastructure Services Inc. Stollaire allegedly fabricated business relationships with the Federal Reserve, PayPal, Verizon and other companies and fabricated testimonials from corporate clients, comparing investing in his ICO to investing in Intel or Google. The ICO scheme had raised as much as $21M from investors. The complaint filed in Federal Court in Los Angeles charges Stollaire and Titanium with violating the anti-fraud and registration provisions of the federal securities laws. Another Stollaire company is also charged.[20]

2. On April 2, 2018, the SEC announced it has charged two co-founders of CentraTech Inc. with orchestrating a fraudulent ICO that raised more than $32M from thousands of investors. The founders of the company, Sohrab "Sam" Sharma, Robert Farkas and Raymond Trapani, have been arrested. The ICO, an unregistered securities offering, occurred from July 30, 2017 through October 5, 2017.[21] The complaint points out that this activity occurred after the SEC had warned the industry via the DAO Report that digital securities are often securities requiring registration. The offering scheme is described in the complaint as offering 400 Centra Tokens for 1 Ether (an Ethereum cryptocurrency). The alleged purpose of the Centra ICO was to raise capital to enable Centra to complete and operate what it termed the "world's first Multi-Blockchain Debit Card and Smart and Insured Wallet" which purportedly would allow the holders to convert their Bitcoins and Ethers and other harder to spend cryptocurrencies into a Centra Card backed by Visa or MasterCard thereby converting their holdings into easily spendable legal tender. The promoters used social media to tout their offering. They also allegedly engaged in market manipulation tactics prior to the ICO. The complaint alleges that the relationships with Visa and MasterCard were non-existent.[22]

3. In another case filed by the SEC, the operators of an ICO, REcoin Group Foundation, LLC, DRC World Inc. aka Diamond Reserve Club and Maksim Zaslavskiy, are alleged to have engaged in ongoing fraudulent conduct and misstatements designed to deceive investors in an ICO allegedly backed by real estate and diamonds. The parties are charged with selling unregistered securities for digital tokens or coins that do not really exist. Zaslavskiy was arrested by the FBI and his assets frozen by the SEC.[23] The initial motion to dismiss was argued May 8th, 2018. Trial is set for January, 2019. [24]

Class Action Lawsuits for Securities Law violations involving ICOs are likely to become increasingly common. A case filed April 6, 2016 in the USDC for the Eastern District of New York, Alex Brola, individually, and on behalf of all others similarly situated v. NANO f/k/a RaiBlocks f/k/a HIEUSUS, LLC, et al. which includes the individual promoters and developers as defendants.[25] As described by Coinsight Financial, this case is unique because it is the first time a company was sued alleging that it was professionally negligent in listing their cryptocurrency on an unfit exchange. The Italian exchange BitGrail was allegedly hacked and lost 17M XRB coins which were worth about $180m. The lawsuit alleges BitGrail negligently represented Nano as safe and that the Nano development team withheld several million XRB for themselves. It is also alleged that Nano sold and distributed unregistered securities in XRB. [26]

Through these suits by the SEC and private citizens, investors are testing the strength of the regulator's power to intercede in the ICO market.

Questions for Underwriters

- If the SEC is right, ICOs will face tighter regulation, and the Directors/Officers will want to buy ICO covers. Are you ready?
- The regulatory environment is changing rapidly. How do you make sure the risk you write today will be the same you're 'on risk' for in six months' time?
- Will you offer standalone cover for regulatory investigations and/or defense costs?
- How will you distinguish 'good' ICOs from 'bad' ICOs? How do you gauge the likelihood of fraud? Can you amend your policy wording to address the fraud risk through severability and removal of final adjudication wording?
- Are you picking up exposure to ICOs in other lines of business? FI, E&O?
    - If you write investment bank D&O, do they issue ICOs and other cryptocurrency solutions?
    - If you write investment advisory D&O? Are you silently covering officers who channel investment funds into cryptocurrencies?
    - If you write tech/IT D&O, and a company's products are used to create a cryptocurrency, they may become secondarily liable for investor fraud if/when the SEC has jurisdiction?
    - If you write Professional Liability for tech consultants, who do you manage your aggregate exposure?

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