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The Year Of The Crypto Investigation

By **Daniel Payne** (August 23, 2018, 2:44 PM EDT)

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In January 2017, digital assets and initial coin offerings were limited to a narrow, niche market. But then 2017 became “the year of the ICO.” By December of that year, ICOs were rapidly raising large amounts of money and introducing new digital assets — and significant excitement — to the market.

The crypto market had rapidly accelerated and achieved mainstream appeal based on several factors: the number of tokens and coins issued and their increasing values, the amount of money raised by ICOs, and the number of individuals opening new digital wallets.[1] The explosive run-up in value of bitcoin in the fourth quarter of 2017 exemplified the mania: Bitcoin increased more than 350 percent between Oct. 1 and mid-December, when it hit its all-time high against the dollar.

Even as this transformational phenomenon took hold, the prevailing belief in the crypto community was that digital assets were neither securities nor commodities. Thus, ICO issuers generally made no attempt to comply with securities or commodities laws.

But financial regulators have had a much different view. Although they have yet to issue any new rules or regulations, the main regulatory bodies have offered public comments that serve as informal guidance to the market.

From the U.S. Securities and Exchange Commission’s DAO report in July 2017 and SEC Chairman Jay Clayton’s remarks to Congress in February (“I believe every ICO I’ve seen is a security”[2]), to the U.S. Commodity Futures Trading Commission’s "advisory with respect to virtual currency derivative product listings" issued in May,[3] it is clear that federal regulators strongly believe that many digital assets and exchanges are subject to their oversight and regulation.

Meanwhile, even with the ongoing volatility of cryptocurrency prices, the crypto mania of 2017 has not subsided. In fact, 2018 has surpassed 2017 in terms of money raised in ICOs.[4]

Perhaps the more important development is the steady stream of newly announced investigations into cryptocurrency trading and ICOs paired with the first wave of crypto enforcement actions.[5] With the flurry of subpoenas and investigations into companies in the blockchain space that has erupted in the first eight months of this year, 2018 is on track to be “the year of the crypto investigation.”

Investigations, on the rise, are coming from both state and federal regulators. Moreover, even though their investigations are not backed by the force of law, the media have joined the fray with in-depth reporting on irregularities in the market. And these numerous investigations raise questions about what might come next.

Federal Investigations

Federal regulators have announced several investigations focused on different parts of the crypto community. In February, the SEC began subpoenaing companies and ICO advisers in a coordinated effort looking for fraud in the ICO market.[6] The Wall Street Journal reported that the probe was examining, in part, the use of SAFTs, or simple agreements for future tokens. Some in the crypto community viewed SAFTs as a contractual means of avoiding application of the securities laws, though that view is now being re-examined.

Then in August, public reports identified a new investigation by the SEC's Office of Compliance Inspections and Examinations, focusing on how brokers are serving clients interested in digital assets.[7] This investigation is a natural extension of OCIE's priorities, which were announced earlier this year. OCIE identified "cryptocurrencies, Initial Coin Offerings (ICOs), secondary market trading, and blockchain" as areas of focus.[8] By widening its focus beyond ICOs, though, the SEC has signaled that it is seeking a comprehensive understanding of all the many players involved in the crypto sphere.

Meanwhile, the CFTC has been conducting its own investigations. In May, the CFTC partnered with the U.S. Department of Justice on a criminal investigation into potential market manipulation by cryptocurrency traders.[9] The alleged wrongdoing includes spoofing and wash trading, which are types of manipulation found in traditional, noncrypto equities markets. The CFTC followed up in June with subpoenas to four cryptocurrency exchanges for trading data.[10]

Other government agencies are conducting investigations as well. The IRS is investigating potential tax evasion in cryptocurrency, in an investigation that began at the end of 2017.[11] A U.S. congressman asked the U.S. Department of the Treasury's Financial Crimes Enforcement Network to conduct a cryptocurrency investigation in the wake of the July 13 indictments of Russian operatives who purportedly used bitcoin to fund their alleged interference in the 2016 U.S. presidential election.[12]

State Investigations

States have had a significant presence in both enforcement and investigations in 2018, as well. Alabama, Massachusetts, Texas, North Carolina and many more states have issued cease-and-desist orders to operators of unregistered ICOs in 2018.[13] New York then made headlines with its Virtual Markets Integrity Initiative, announced in April.[14] Former Attorney General Eric Schneiderman sent a public letter to 13 cryptocurrency exchanges seeking the voluntary disclosure of policies, business practices, fees and security practices, among other requests. The initiative hopes to bring transparency to the market and, hopefully, protect investors, but at least some of the cryptocurrency exchanges felt that the information requests sought sensitive trade secrets. It is unclear how much support the initiative will have in the aftermath of Schneiderman's resignation.

Meanwhile, in May, the North American Securities Administrators Association announced "Operation Cryptosweep," an effort to crack down on ICOs and crypto-related investment products.[15] NASAA announced it had opened 70 inquiries or investigations and 35 enforcement matters in a matter of weeks throughout North America. This appears to be the largest enforcement sweep to date, and NASAA said that it was the result of a task force that combined resources from many of its member organizations.

Notably, state and federal regulators are also combining their efforts. In May, the CFTC and NASAA entered into a memorandum of understanding designed to increase coordination on cryptocurrency derivatives.[16]

Investigative Journalism Focused on the Crypto Community

Due to the potential for civil and criminal liability, most of the results of the ongoing government investigations will not come to light until the next wave of enforcement actions are filed. In the meantime, media outlets are conducting their own investigations and publishing the results. The Wall Street Journal has written two major pieces on its two investigations to date: ICOs[17] and crypto pump-and-dumps.[18] In the ICO report released in May, the Journal identified 1,450 ICOs, finding hundreds of red flags for fraud among the offerings. Although it researched ICOs as far back as 2014, the Journal reported that most ICOs, including most of the ICOs with red flags, were launched in 2017 or 2018. The Journal found ICO white papers that copied text verbatim from other white papers regarding marketing plans, security issues and technical features. The Journal also found ICOs with fake team members, no website and guaranteed returns in the promotional materials. It is unclear how many, if any, of the ICOs had registered with the SEC or claimed an exemption from registration.

In its crypto pump and dump report from August, the Journal found "175 pump and dump schemes involving 121 different digital coins, which show a sudden rise in price and an equally sudden fall minutes later." Although the report suggests that "manipulations of cryptocurrencies are no different" than alleged pump and dump schemes in publicly traded stocks, this type of investigation is much easier in the cryptocurrency market than it ever was previously in the publicly traded equities markets.

The cryptocurrency market communicates in large part through Telegram and Discord, which are crypto-centric social media platforms. The Journal relied heavily on communications from those platforms to corroborate apparent pumps because pump organizers, relying on anonymity and the unsettled regulatory regime for crypto trading, will sometimes execute their plans publicly. Those or other platforms have yet to be used in an analogous fashion for publicly traded stocks, possibly because of the more robust regulatory regime surrounding traditional exchanges and possibly because of the mania surrounding cryptocurrencies. Thus, the Journal was able to find the kind of pre-litigation corroboration for a crypto pump that generally has not existed for publicly traded stocks.

The Journal's report followed a similar November 2017 report in Business Insider that also alleged to have easily identified multiple pump and dump plans in lightly traded cryptocurrencies.[19] Business Insider also relied on Telegram and exchange data to highlight the apparent manipulation.

What Comes Next?

The ongoing investigations raise several questions for the crypto community:

- If widespread noncompliance is found by the SEC in the ICO market, how hard will the SEC come down? While the SEC may want to ensure compliance with the securities laws going forward through harsh enforcement, some have suggested that an amnesty program may be a better way forward.[20]

- How will regulators and prosecutors prioritize new cases? Given the number of investigations and the significant resources behind each investigation, regulators and prosecutors may ultimately need to prioritize which cases they bring. Indeed, the ICO-related enforcement actions, thus far, have generally involved claims more serious than a failure to register.[21] Suspected fraud may be one driver of priority for these cases, and other characteristics could merit priority as well: unsophisticated investor victims, especially large losses or connections to alleged criminal activity.

- How will rulings in ongoing cases affect the scope of these investigations? A magistrate judge in Florida has ruled that tokens issued in an ICO constituted investment contracts that must comply with federal securities laws.[22] A similar issue is under consideration in other jurisdictions around the country, and it remains to be seen what, if any, consensus trial courts may develop on the question.[23] Similarly, the question of whether cryptocurrencies are commodities has been ruled on in favor of the CFTC's position in one case,[24] though the question remains pending in other jurisdictions.[25]

- When will the next wave of enforcement actions and prosecutions begin? While NASAA announced its members had already brought 35 enforcement matters arising out of its investigation, it appears that the SEC and CFTC investigations are taking longer to bear fruit.

Time will tell what the answers will be to these questions. Once thing is virtually certain — these new investigations are likely to lead to a second, bigger wave of prosecutions and enforcement matters as they progress.

If 2017 was "the year of the ICO," and 2018 is "the year of the crypto investigation," then 2019 may be forecasted as "the year of crypto enforcement actions."

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Disclosure: Murphy & McGonigle represents an individual defendant in CFTC v. My Big Coin Pay Inc., which is referenced in this article as an example of a pending case that presents the question of whether cryptocurrencies are commodities.

[1] See, e.g. https://www.icodata.io/stats/2017.

[2] https://www.coindesk.com/sec-chief-clayton-every-ico-ive-seen-security/

[3] https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-05/18-14_0.pdf

[4] https://www.icodata.io/stats/2018

[5] To be sure, the first wave of enforcement actions began in late 2017. See, e.g., In re Munchee, 3-18304 (SEC Dec. 11, 2017) and SEC v. REcoin Group Foundation, 17-cv-05725 (E.D.N.Y. Sept. 29, 2017).

[6] https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266

[7] https://www.bloomberg.com/news/articles/2018-08-02/brokers-cryptocurrency-deals-are-said-to-be-focus-of-sec-review

[8] https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf

[9] https://www.businessinsider.com/us-justice-department-bitcoin-crypto-market-manipulation-probe-2018-5

[10] https://www.ethnews.com/cftc-subpoenas-cryptocurrency-exchanges-in-bitcoin-futures-investigation

[11] https://www.bloomberg.com/news/articles/2018-02-08/irs-cops-scouring-crypto-accounts-to-build-tax-evasion-cases. The IRS also identified virtual currency as one of its large business and international compliance campaigns. https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns.

[12] http://thehill.com/policy/technology/397632-democratic-lawmaker-presses-treasury-to-scrutinize-cryptocurrency-after

[13] E.g., In the Matter of Platinum Coin, CD-2018-0007 (Ala.); In re Pink Ribbon ICO, E-2018-0028 (Mass.); In re DavorCoin, ENF-18-CDO-1757 (Tex.); In the Matter of Adosia, 18 ADM 007(N.C.)

[14] https://ag.ny.gov/press-release/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges

[15] http://www.nasaa.org/45121/state-and-provincial-securities-regulators-conduct-coordinated-international-crypto-crackdown-2/

[16] http://www.nasaa.org/45123/cftc-nasaa-sign-agreement-for-greater-information-sharing-between-federal-commodities-and-state-securities-regulators/

[17] https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115

[18] https://www.wsj.com/graphics/cryptocurrency-schemes-generate-big-coin/

[19] https://www.businessinsider.com/ico-cryptocurrency-pump-and-dump-telegram-2017-11?IR=T

[20] https://www.coindesk.com/sec-give-amnesty-illegal-icos/

[21] See, e.g., SEC v. Sharma, 18-cv-1582 (S.D.N.Y.) (alleging fraudulent ICO); SEC v. Titanium Blockchain Infrastructure Services Inc., 18-cv-4315 (C.D. Cal.) (same)

[22] Rensel v. Centra Tech Inc. et al., 17-cv-24500, Dkt. No. 79 (S.D. Fla. Jun. 25, 2018)

[23] E.g., U.S. v. Zaslavskiy, 17-cr-647 (E.D.N.Y.)

[24] CFTC v. McDonnell, Civil Action No.18-cv-361, Dkt. No. 29 at *4 (E.D.N.Y. Mar. 6, 2018)

[25] CFTC v. My Big Coin Pay Inc., Civil Action No. 18-cv-10077 (D. Mass.)