Recent Developments in the War on Cryptocurrency Fraud[1]

KEVIN B. DUFF, *Rachlis Duff Adler Peel & Kaplan, LLC*
S. GREGORY HAYS, CIRA, *Hays Financial Consulting LLC*

Fanaticism over cryptocurrencies may have reached a crescendo in January 2018 as Bitcoin's price spiked to nearly $20,000 per bitcoin. While Bitcoin's current price is now less than half what it was only a few months ago, interest in the esoteric currency has not faded. In fact, some reports have suggested an appetite in the marketplace for Bitcoin to replace gold as an investors' choice.[2]

However, while some see cryptocurrencies as a burgeoning area for investment and financial utility,[3] many virtual currencies remain stippled by fraud. In a recent decision involving alleged cryptocurrency fraud, the court observed that "[t]he rise in users and value of virtual currencies has been accompanied by increased fraud and criminal activity."[4] One estimate pegged the *daily* loss from cryptocurrency fraud at $9 million.[5] A recent study by Satis Group suggested most digital coin offerings are scams,[6] finding that as many as 81% of recent ICOs were scams.[7] But the news may be even worse for investors: following an analysis of the ICO industry, Satis Group reported only 3.7% of ICOs over $50 million were considered to be either successful or promising.[8]

Regulatory Enforcement Is Rising

Although the regulatory regime for cryptocurrencies remains nascent[9] and uniformity is lacking as to the nature of cryptocurrencies for regulatory purposes,[10] regulators have become increasingly active in enforcement actions. Last fall, the Securities and Exchange Commission (SEC) created a Cyber Unit to target cyber-related misconduct and fraud.[11] The SEC also issued trading suspensions on the common stock of a handful of issuers (including First Bitcoin Capital Corp., CIAO Group, Strategic Global, and Sunshine Capital) who publicized their investments in ICOs or actions they had undertaken with respect to cryptocurrencies.[12]

In January 2018, the respective enforcement directors of the SEC and the Commodity Futures Trading Commission (CFTC) issued a joint statement about their enforcement efforts in cryptocurrency markets:

> When market participants engage in fraud under the guise of offering digital instruments – whether characterized as virtual currencies, coins, tokens, or the like – the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws. The Divisions of Enforcement for the SEC and CFTC will continue to address violations and bring actions to stop and prevent fraud in the offer and sale of digital instruments.[13]

Shortly thereafter, the Chairmen of the SEC and CFTC co-authored an op-ed, published in *The Wall Street Journal*, which made clear that both regulators are "looking at cryptocurrencies."[14]

In February 2018, in a move seen as a harbinger of future enforcement efforts, the SEC issued subpoenas to about 80 cryptocurrency companies.[15] Eaglesham and Vigna reported "[t]he sweeping probe significantly ratchets up the regulatory pressure on the multibillion-dollar U.S. market for raising funds in cryptocurrencies."[16] This activity is being coordinated with the SEC Enforcement Division's Cyber Unit, created in 2017, and the investigation is expected to continue throughout 2018.[17,18] Recent reports that the SEC is working on dozens of crypto cases continue to confirm that, as many industry pundits have predicted, 2018 will be a busy year for enforcement actions.[19]

The following are among enforcement actions seen thus far in 2018.

SEC v. AriseBank

In January 2018, the SEC filed an enforcement action against AriseBank and its principals, Jared Rice and Stanley Ford, alleging that AriseBank undertook a fraudulent and unregistered ICO that claimed to have raised $600 million from investors in just two months.[20] AriseBank purportedly sought to become the world's first 'decentralized' bank, from which its customers could receive traditional banking products and services in connection with more than 700 cryptocurrencies. AriseBank planned to raise $1 billion in capital through sales of its AriseCoin.[21] The SEC called it, "an outright scam."[22]

The court appointed Mark Rasmussen as the federal equity receiver, representing the first time SEC has requested appointment of receiver in an ICO case. After appointment, the receiver announced recovery of virtual currencies held by AriseBank, including Bitcoin, Litecoin, Bitshares, Dogecoin and BitUSD, as well as a plan to hold those cryptocurrencies within the receivership estate pending a recommendation to the court as part of the receiver's liquidation plan.[23]

CFTC v. My Big Coin Pay

Also in January 2018, the CFTC brought an action for fraud and misappropriation of $6 million related to a solicitation for a cryptocurrency known as "My Big Coin."[24] The action named as defendants Randall Crater, Mark Gillespie, and My Big Coin Pay, Inc.[25] The CFTC's Director of Enforcement, James McDonald, stated this action shows:CFTC is actively policing the virtual currency markets and will vigorously enforce the anti-fraud provisions of the Commodity Exchange Act. In addition to harming customers, fraud in connection with virtual currencies inhibits potentially market-enhancing developments in this area. We caution potential virtual currency customers, once again, that they should engage in appropriate diligence before purchasing virtual currencies.[26]

SEC v. Sharma

In April 2018, the SEC filed an action alleging co-founders of Centra Tech perpetrated a fraudulent ICO that raised over $32 million from investors in its "CTR Tokens," on the premise that Centra planned to create a cryptocurrency debit card that would have relationships with major credit card issuers.[27] Centra's ICO was backed by several celebrity endorsers including boxer Floyd Mayweather and DJ Khaled.[28] Centra's "white paper" also included fictitious executives with impressive biographies.[29] On April 20, 2018, it was reported that another co-founder of Centra, Ray Trapani, has been charged with securities fraud, wire fraud, and conspiracy.[30] The SEC's amended complaint describes Trapani as a mastermind of Centra's fraudulent ICO.[31] On May 14, 2018, a federal grand jury returned indictments for Trapani and co-founders Sohrab Sharma, and Robert Farkas.[32]

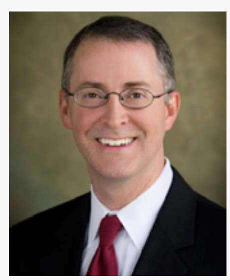
SEC v. Longfin

In April 2018, in *SEC v. Longfin Corp.*, the SEC successfully obtained a court order freezing $27 million in trading proceeds from allegedly illegal distributions and sale of restricted company shares.33 Shortly after it became registered on NASDAQ, Longfin announced its acquisition of a cryptocurrency business after which its stock price soared and its market cap surpassed $3 billion.34 Some have observed that the SEC's action in *Longfin* is indicative of "the SEC's heightened and aggressive focus in this area."35 Most recently, however, the court lifted the temporary restraining order against the company and its principal, but the case remains pending.36

CFTC v. Kantor

On April 16, 2018, the CFTC filed an action in the U.S. District Court for the Eastern District of New York charging Defendants Blake Harrison Kantor (aka Bill Gordon), Nathan Mullins, Blue Bit Banc (UK-based), Blue Bit Analytics, Ltd. (Turks and Caicos-based), Mercury Cove, Inc., and G. Thomas Client Services with running a fraudulent binary options scheme involving a cryptocurrency, "ATM Coin."37 The Complaint alleges that over a four-year period, the Defendants defrauded over 700 investors into purchasing illegal off-exchange binary options. It also alleges they attempted to conceal their scheme by inviting customers to transfer account balances into ATM Coin,38 and misled customers into believing their digital coin holdings had substantial value.39 The U.S. Attorney has filed a parallel criminal action (*United States v. Kantor*, Case No. 18 CR

ABOUT THE AUTHORS



Kevin Duff

Kevin is a member of Rachlis Duff Adler Peel & Kaplan, LLC in Chicago, Illinois. He is a trial lawyer who also has significant appellate experience in complex commercial litigation and receivership matters. Mr. Duff serves as a federal equity receiver and represents receivers as counsel in actions brought by the SEC, CFTC, and private litigants. He is President-Elect of the National Association of Federal Equity Receivers (NAFER) and serves on NAFER's Executive Board.

Greg Hays, CIRA

Greg, is Managing Principal of Hays Financial Consulting in Atlanta, Georgia. Mr. Hays serves as a court appointed fiduciary and forensic accountant that specializes in recovering funds from insolvent companies and investment offerings. He is routinely appointed by federal and state courts as a receiver or bankruptcy trustee to maximize recoveries for creditors. He is the current President of NAFER and serves on the Board of the Association of Insolvency & Restructuring Advisors.

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177 (E.D.N.Y.)) charging Kantor with fraudulent conduct, including the conduct that is the subject of the CFTC's action.40

The CFTC's Director of Enforcement, James McDonald, described the *Kantor* action as an indication that "the CFTC is continuing its efforts to root out fraud in our markets," including fraudulent schemes stretched across multiple markets and including virtual currencies.41

FTC v. Dluca

In an enforcement action of its own, the Federal Trade Commission recently took action to shut down and freeze the assets of My7Network and Bitcoin Funding Team, along with their individual defendants, as promoters of referral investment schemes in Florida.[42] The defendants, including Thomas Dluca, Louis Gatto, and Eric Pinkston, allegedly promoted deceptive chain referral schemes involving cryptocurrencies.[43] These schemes falsely promised that participants could earn large returns by paying cryptocurrency such as bitcoin or Litecoin to enroll in the schemes.[44] By its structure, the defendants' fraud took the form of a classic pyramid scheme. Tom Pahl, Acting Director of the FTC's Bureau of Consumer Protection, stated, "[t]his case shows that scammers always find new ways to market old schemes, which is why the FTC will remain vigilant regardless of the platform – or currency used. … The schemes the defendants promoted were designed to enrich those at the top at the expense of everyone else."[45]

SEC's Section 21(a) Report on The DAO

In July 2017, the SEC issued guidance on its view of ICOs as securities in a Section 21(a) Report of Investigation regarding the digital token sale by The DAO (an acronym for Decentralized Autonomous Organization).[46] In short the Report makes clear the SEC views ICOs as securities offerings, irrespective of whether the issuer's stock is promoted as a digital token.[47] SEC Chairman Jay Clayton has repeatedly stated that "merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security."[48]

CFTC v. McDonnell

A recent ruling in *CFTC v. McDonnell* has buttressed the CFTC's efforts to bring enforcement actions relating to cryptocurrencies.[49] Hon. Jack Weinstein of the U.S. District Court for the Eastern District of New York found that the "CFTC has standing to exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce."[50] In reaching this conclusion – consistent with the CFTC's administrative order from the administrative proceeding, *In the Matter of: Coinflip, Inc.*, CFTC Docket No. 15-29 ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.") – the *McDonnell* court found that "[a] 'commodity' encompasses virtual currency both in economic function and in the language of the statute."[51] The court also found that the "CFTC's broad authority extends to fraud or manipulation in derivatives markets and underlying spot markets."[52]

SEC v. Zaslavskiy

Relatedly, in *SEC v. Zaslavskiy*, an action initiated in 2017 by the SEC and also pending in the Eastern District of New York, Hon. Raymond J. Dearie is (at the time this article went to press) considering whether an allegedly fraudulent ICO involving "REcoin" – touted by defendant Maksim Zaslavskiy as "The First Ever Cryptocurrency Backed by Real Estate" – is a security subject to SEC regulation.[53]

Consumer Financial Protection Bureau – Consumer Advisories

Although not presently active in the area of enforcement, the Consumer Financial Protection Bureau long ago weighed in on the risks to consumers about Bitcoin. In 2014, CFPB Director Richard Cordray warned consumers to be cautious in relation to virtual currencies: "Virtual currencies are not backed by any government or central bank, and at this point consumers are stepping into the Wild West when they engage the market."[54]

Chief among potential issues with virtual currencies, the CFPB identified, "unclear costs, volatile exchange rates, the threat of hacking and scams, and that companies may not offer help or refunds for lost or stolen funds."[55] More information is available to consumers in the CFPB's August 2014 Consumer Advisory, "Risks to consumers posed by virtual currencies."[56] The CFPB allows "consumers who encounter a problem with virtual currency products and services – including exchange services or online digital wallets – [to] submit a complaint with the CFPB."[57]

Internal Revenue Service – Investigations and Tax Matters

The IRS is actively investigating and pursuing possible income taxes and penalties against certain cryptocurrency investors.[58] Gains in cryptocurrencies are taxable events and the IRS has indicated that very few investors have reported any Bitcoin profits. The IRS has subpoenaed trading accounts from one exchange and is pursuing capital gains taxes. As Baldwin summarizes in a recent Forbes article, "The IRS wants a share of the billions made last year. This is going to get ugly."[59]

Furthermore, the Tax Cuts and Jobs Act eliminated an exemption for like-kind exchanges, meaning all crypto transactions are now a taxable event and investors could have thousands more transactions to report. It is notable that a 2017 IRS report indicated only 802 customers of Coinbase (an exchange) reported Bitcoin-related activity in 2015; and in February 2018, Credit Karma found only 100 reports of cryptocurrency transactions in a sample of 250,000 returns.[60] While some investors may believe they can remain "anonymous" and have no need to report such transactions, the IRS is likely to pursue taxes and assess penalties that can range from 20% to 50% of any income generated from cryptocurrency transactions. Last year, the IRS subpoenaed records for transactions from 2013 to 2015 for 14,000 customers with more than $20,000 in virtual currencies.[61] At today's prices, this suggests the IRS is pursuing investors who have only about 2.5 Bitcoins.

San Francisco tax attorney Robert W. Wood recently suggested that Bitcoin owners who want to clear up past transgressions should report foreign Bitcoin accounts, using the IRS's amnesty program for foreign bank accounts. Wood asserts, "With extensive data swapping deals between the IRS, foreign governments and foreign banks, almost no offshore account is secret anymore."[62] There are signs the IRS is likely to take more aggressive action in 2018 on taxable income associated with cryptocurrencies. Investors who used Bitcoins to invest in ICOs might be in for a rude awakening if their transaction is taxed at the Bitcoin price as of the time of the exchange. If this occurs, investors may be taxed at the conversion price, and even if the ICO tanks may still owe capital gains taxes on the price of Bitcoin at conversion. In this scenario, capital losses may only be carried forward but the investor may owe taxes now.

On February 8, 2018, the IRS announced formation of a new task force of international crime investigators; in addition, the IRS is also deploying new software to identify crypto tax cheats. Given so much extra attention from the IRS, investors may realize they need to properly report dealings in virtual currencies.[63] With all crypto transactions stored on digital ledgers, the transaction data exists – the IRS just needs to determine which taxpayer owns the digital keys.

International Regulation and Enforcement Actions

It is noteworthy that other countries are also wrestling with cryptocurrencies and how to regulate them.[64] The Managing Director of the International Monetary Fund, Christine Lagarde, has stated that international regulation of cryptocurrencies is "inevitable."[65] Below are a few examples of international developments in this area.

Canada

Like its neighbor to the South, Canadian authorities are stepping up their actions against virtual currency fraud.[66] During recent parliamentary hearings, the Canadian government has been "looking at updating its laws around cryptocurrencies, money laundering, and terrorist financing."[67] But cryptocurrency fraud is having an effect even at the local level. For example, in Vancouver, British Columbia, from 2016 to 2017 there was "a 350% increase in filings related to cryptocurrency "and as of January 2018 the responsible agency projects "a potential for 800 cases by the end of year — a 300% increase over 2017."[68] While enforcement against fraud may be increasing, regulation may not be keeping pace. Some concern has been expressed, however, that over-regulating virtual currencies may stifle innovation.[69]

China

According to a February 2018 article by Andrew Nelson:

> China has been taking ever-increasing actions to clamp down on all things cryptocurrency. Starting off by banning ICOs, China ordered a bank account freeze associated with exchanges, kicked out bitcoin miners, and instituted a nationwide ban on internet and mobile access to all things related to cryptocurrency trading. The People's Republic of China appears to be the most stringent cryptocurrency regulator of the major economies regarding cryptocurrencies. This is an odd about-face given that, in 2017, Chinese bitcoin miners made up over 50 percent of the worldwide mining population and that cryptocurrency adoption in China increased at a rate higher than any other country.[70]

Recently, China's Central Bank signaled that China may follow global cryptocurrency regulations. It offered support for a global regulatory framework, suggesting that a lack of a coordinated international regulatory environment "leads to a regulatory vacuum."[71] Chinese authorities also recently shut down a crypto-based Ponzi scheme valued around $13 million from 13,000 investors.[72]

India

With regard to the crypto landscape in India, Nelson states:

> India, once viewed as a burgeoning, friendly environment for cryptocurrencies, has been clamping down on cryptocurrencies in 2018. India's tough stance stems from similar concerns that other, more stringent regulatory regimes have cited: money laundering, illegal activity proliferation, sponsorship of terrorism, tax evasion, etc. While the cash-reliant country is facing stern regulations, participants of the local cryptocurrency industry do not believe India can "ban" cryptocurrencies through regulations in the same way China has.[73]

Russia

Russia has in the past been critical of cryptocurrencies, but more recently announced plans to launch its own "CryptoRuble" in an effort to dodge economic sanctions from the West.[74] Unsurprisingly, this plan is not without its detractors.[75]

Small Countries with Noteworthy Developments

Located at the crossroads of Eastern Europe and Western Asia, Georgia has positioned itself as the world's second most prolific miner of cryptocurrencies behind China.[76]

Vietnamese Prime Minister Nguyen Xuan Phuc recently issued a directive calling for his country's government and financial bodies to strengthen "management of activities related to Bitcoin and other cryptocurrencies." This action followed allegations that Vietnam-based Modern Tech

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defrauded 32,000 investors in a scam estimated to be the equivalent of USD $658 million in an ICO involving sales of Ifan and Pincoin, two ECR-20 tokens.[77]

The smallest EU member is making big waves with this news: "[t]wo of the world's largest cryptocurrency exchanges plan to make the tiny European nation of Malta a central hub of their operations, and analysts say others are sure to follow."[78]

Conclusion

Recent enforcement actions reflect increasingly active regulatory scrutiny surrounding cryptocurrencies. Such scrutiny should reduce fraud, result in greater market confidence, and lend legitimacy to cryptocurrency transactions. There is a long road ahead to achieve those important goals and along the way, there will continue to be fraud and enforcement actions striving to reveal fraud and punish wrongdoers. But the extraordinary market capitalization of cryptocurrencies, even considering the downturn of the past few months, signals that cryptocurrencies are here to stay.

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55. Id.

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