# Initial Coin Offerings – Complying with U.S. Securities Laws

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## The Legal / Regulatory Landscape

- Blockchain technology is generally not subject to regulation
  - It is the *applications* built on top of the blockchain platform that are regulated
  - In some cases, laws and regulations are not sufficiently "technology-neutral" and may need to be updated to account for blockchain (inadvertent regulation)
- Bitcoin and other digital currencies are receiving the most attention
- Different approaches to Bitcoin/Digital Currency regulation:
  - Is it a commodity? CFTC has jurisdiction.
  - Is it a security? SEC has jurisdiction.
  - Is it money? FinCEN / state regulators have jurisdiction.
  - Is it an asset or an investment? IRS tax treatment may vary.



## Introduction To Cryptocurrencies & Blockchain

- See Our Webinar on February 28, 2018 Introduction to Cryptocurrencies, Blockchain & Smart Contracts: https://blockchainplusthelaw.com/2018/03/01/missed-our-webinar/
- See Our Website: https://www.michaelbest.com/Practices/Banking-Financial-Services/Blockchain-Digital-Currencies-Smart-Contracts
- Read our Blogs: https://blockchainplusthelaw.com/
  - Believe The Hype: Distributed Ledger Technologies Are Here To Stay
  - Better To Ask Forgiveness Than Permission? Not When It Comes To ICOs…
  - Tell Your Friends To Buy Their Own Cryptocurrencies – Money Transmitter Issues In Private Sales Of Cryptocurrencies For Legal Tender Currencies
  - SEC Shoots With A Spiritual Blunderbuss –Why Your ICO Is Most Likely A Securities Offering
  - Free! Does not mean Freedom from Compliance with U.S. Securities Laws - Do ICOs through the Use of AirDrops violate U.S. Securities Laws?
  - Lost Your Investment In Cryptocurrency? There is a Remedy for That!
  - SEC Provides Guidance on the Applicability of Securities Laws to ICOs and Sales of Digital Tokens – The Beginning of a "Safe Harbor"

## Definition of Security – Section 2(1) of Securities Act

- **"Security"** means any: [Note: the below is only an excerpt]
  - Note
  - Stock
  - Treasury Stock,
  - Security Future
  - Bond
  - Debenture
  - Evidence Of Indebtedness
  - Transferable Share
  - **Investment Contract**
  - Voting-trust Certificate
  - Fractional Undivided Interest In Oil, Gas, Or Other Mineral Rights
  - Any Put, Call, Straddle, Option, Or Privilege On Any Security,
  - Or, In General, Any Interest Or Instrument Commonly Known As A "Security"



## Definition of Investment Contract


- **"Investment contract"** includes:
  - any investment in a **common enterprise** with the expectation of profit to be derived through the **essential managerial efforts of someone other than the investor;** or
  - any investment by which:
  - an offeree furnishes initial value to an offeror;
  - a portion of this initial value is subjected to the risks of the enterprise;
  - expectation of a profit; and
  - **passivity**.
- **Howey Test – 1946 Supreme Court Opinion**
  - In 1946, the U.S. Supreme Court stated in Howey that the test of an investment contract involving ORANGE GROVES is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."
  - **HOT TOPIC** – ICOs, Cryptocurrencies – SEC constantly referring to "Howey Test" in multiple recent actions



## Security Broadly Defined

- **Reves v. Ernst & Young, U.S. Supreme Court 1990**
  - **Applying Howey to Promissory Notes "Family Resemblance Test"**
- **Edwards – U.S. Supreme Court 2003**
  - "Encompass virtually any instrument that might be sold as an investment"
    - Pay Phones
    - Orange Groves
    - Live Beavers
    - Bitcoins (ICOs)
- **Short Answer:**
  - If you are asking the question, it probably is a security
  - Now is not the time to push the envelope. Going to prison for 20 years for knowingly violating securities laws versus accidentally violating the "spirit of the law" is a scary scenario.

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### SEC Taking a Strong Position

- Citing the Howey Test in mid-December, 2017, SEC Chair, Jay Clayton, warned that the SEC would be specifically scrutinizing cryptocurrencies and initial coin offerings (ICOs) under applicable securities laws that apply to the offer and sale of securities. [Bitcoin loses $7,000 in value in following 2 weeks]
- Chairman Clayton, in a statement in January, 2018, made it clear that the SEC's approach to compliance with securities laws will be to apply the law broadly with respect to ICOs and other cryptocurrency offerings that are "contrary to the ***spirit* of**…securities laws" (emphasis added).
- Constantly Changing – Until June, it appeared that the SEC may view "all digital tokens" as securities.



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### SEC Provides Guidance on June 14 – Safe Harbor?

- William Hinman, Director, Division of Corporate Finance
  - Reminded the community that The Howey Test was still the main analysis
  - Factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security:
    - Role of promoter
    - Efforts of others
    - Flow of Funds
    - Are purchasers "investing," that is seeking a return?
    - Does application of the Securities Act protections make sense?
  - How a Digital Token can be more like a consumer item and less like a security:
    - Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?
    - Are independent actors setting the price?
    - Is the primary motivation for purchasing the digital asset is for personal use or investment?
    - Are the tokens distributed in ways to meet users' needs?
    - Is the asset marketed and distributed to potential users or the general public?
    - Are the assets dispersed across a diverse user base or concentrated in the hands of a few?
    - Is the application fully functioning or in early stages of development?"

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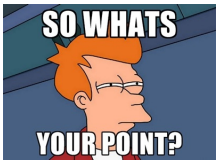
### Give Them Away – Air Drops – Can't be illegal?

- The distribution [Via AirDrops] of TOM … constituted sales under Section 2(a)(3) of the Securities Act, which applies to "every disposition of a security or interest in a security, for value." The lack of monetary consideration for "free" shares does not mean there was not a sale or offer for sale for purposes of Section 5 of the Securities Act.
- a "gift" of a security is a "sale" within the meaning of the Securities Act when the donor receives some real benefit. See SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp. 2d 923, 940–43 (S.D. Ohio 2009), aff'd, 712 F.3d 321 (6th Cir. 2013).
- Everything Old Is New Again - Dot.Com Bubble - SimplyStock.com asked for "No-Action Letter" from the SEC that issuing shares for "free" wouldn't be deemed a "sale" of securities. The SEC responded, however, that "the issuance of securities in consideration of a person's registration on or visit to an issuer's [I]nternet site would be an event of sale within the meaning of section 2(a)(3) of the Securities Act of 1933." Therefore, the stock offerings would trigger the Securities Act of 1933's registration provisions unless an exemption was available.




## All very interesting, but so what?!

- Civil Liability – No Corporate Veil Protection
- Criminal Liability – Jail and Fines



**"It's the SEC. How do you plead?"**


*"It's the S.E.C. How do you plead?"*

**The Basics – Securities Act of 1933**

Prior to offering or selling a security, the security or transaction must be:

- Registered; or
- Exempt from registration.

# Private Offering Exemptions



## Reg. D/Rule 506(b) & (c) Exemptions

- Safe Harbor for compliance with §4(a)(2)
  - Noncompliance with Rule 506 does not mean §4(a)(2) exemption is unavailable. Rule 506(b) – Old Rule; 506(c) – JOBs Act
- No dollar limit on size of offering
- Issuer must make available to prospective offerees at a reasonable time prior to the sale the opportunity to ask questions and receive answers concerning terms and conditions of offering




## Rule 506(b) or 506(c) – Which Rule to Use

| | 506(b) Offering | 506(c) Offering |
|---|---|---|
| **Communications with Investors** | Companies may not advertise their security offering. Generally, companies may approach potential investors if there is a substantive, pre-existing relationship. | General advertising permitted. Companies may advertise via social media, email, or offline. No substantive, pre-existing relationship with potential investors required. |
| **Filing Requirements** | Companies must file a Form D. | Companies must file a Form D. |
| **Intermediaries** | Not required. If used, the intermediary must be a registered broker-dealer or exempt from broker-dealer registration. | Not required. If used, the intermediary must be a registered broker-dealer or exempt from broker-dealer registration. |

### Rule 506(b) or 506(c) – Which Rule to Use (Cont.)

| | | |
|---|---|---|
| **Eligible Investors** | Accredited investors and up to 35 non-accredited investors who meet sophistication requirements. | Only accredited investors. |
| **Accreditation Process** | Self-certification via a questionnaire is the general standard. | Companies must take reasonable efforts to verify accredited investor status. Self-certification via a questionnaire is not permissible. The SEC issued examples of reasonable steps for verification. |




## Verification of Accredited Investor Status under 506(c)



### Rule 506(b) or 506(c) – Which Rule to Use (Cont.)

| | | |
|---|---|---|
| **Disclosure** | Companies must decide on what information to provide to accredited investors, but that information must not violate antifraud prohibitions. If non-accredited investors are included, companies must provide those investors with disclosure documents that are generally the same as those used in small registered offerings. If a company provides information to accredited investors, it must make that information available to non-accredited investors as well. Companies must be available to answer questions from potential investors. | Companies must decide on what information to provide to accredited investors, but that information must not violate antifraud prohibitions. Companies must be available to answer questions from potential investors. |

MICHAEL BEST & FRIEDRICH LLP

## Exemptions Are Complicated, Seek Advice!


Do you need an attorney, little boy?

My fees are quite high, and yet you say you have little money. I think I'm seeing a conflict of interest here.

## Complying with Securities Regulations – Public Sales

**Prepared by:**
**Betsy T. Voter**



**Sale of Cryptocurrency in a Public Offering**

a. Fundamentals of Public Offerings
b. Types of Public Offerings
c. Example of a public offering of a cryptocurrency - The Praetorian Group, SEC File no 333-223459 (filed March 6, 2018)

**Fundamentals of a Public Offering**
***Accurate and complete disclosures***

a. Description of the investment
b. Manner of sale and who is selling, including broker-dealer
c. Management analysis of the business
d. Current and past financials
e. Current and anticipated plan of operation including use of proceeds
f. Current and anticipated risks
g. Compensation of involved parties
h. Related party transactions

Bottom line: *What would an unsophisticated investor need to know to make a rational and informed decision to buy or sell?*



**Fundamentals of a Public Offering**
***SEC review process***

a. Don't expect "no review"
b. "Bed bugging" an offering: SEC may request that the disclosure statement be withdrawn because of its extreme level of deficiency in meeting the disclosure requirements
c. SEC regular review:
   i. Comment usually provided within 30 days after filing, with an expected deadline for response (e.g., 20 days).
   ii. Successive comments and responses.
   iii. Cannot proceed with sales until comments resolved
d. Offerings, but not sales, after filing—i.e., the marketing effort can begin. "Test the waters"
e. State process is similar



**Types of Public Offerings**

a. Traditional IPO – Form S-1
b. Regulation A+
c. Regulation S – Offshore Sales

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**Regulation A +**

- Tier 1 Offerings – raise up to $20 million dollars in a twelve month period
- Tier 2 Offerings – raise up to $50 million dollars in a twelve month period



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**Tier 1 Offerings**

- Anyone can invest
- No investment limits
- General solicitation permitted
- Reviewed financials but not necessarily audited financials
- Not state exempt [Compliance with 50 State Blue Sky Laws]
- No ongoing reporting requirements (after the exit report)



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**Tier 2 Offerings**

- Anyone can invest
- Investor limits
  - Unaccredited investors are limited to less than 10% of their income or net worth
  - Entities are limited to less than 10% of net revenues or assets
- State preempt [Blue Sky laws preempted]
- Audited financials required
- Annual and semi-annual reporting requirements (but these can be terminated if the company has fewer than 300 shareholders)

**Regulation S**

- "For the purposes only of section 5 of the Act the terms offer, offer to sell, sell, sale, and offer to buy shall be deemed to include offers and sales that occur within the United States and shall be deemed not to include offers and sales that occur outside the United States."
- Rule 903 covers sales by issuers

**Example of a Public ICO: Praetorian Group**

- Likely the first Initial Coin Offering
- Filed under S-1
- $75M offering, 15M "PAX tokens" at $5 per token.
- 200M PAX tokens in existence. "Market value" of $1B.
- *Cryptocurrency Real Estate Investment Vehicle* ("CREIV")
- All tokens listed exclusively on the Praetorian website.
- PAX token holders entitled to the net profit of real property rents accumulated based on token holdings relative to total float of PAX tokens.
- Prospectus and financial statements filed with the SEC in March 2018, amended in August, and not yet declared effective

# Cryptocurrency Litigation & Enforcement Actions

**Evan S. Strassberg**



## Quick Review – Who's Regulating Crypto and ICOs?

- SEC
- CFTC
- FinCEN
- IRS
- State Regulators
- Private Parties/Attorneys

…and now…

- FINRA



## United States Securities and Exchange Commission (SEC)

- The billion dollar question: When is a cryptocurrency a security?
- SEC has broadly stated its position that initial coin offerings are sales of securities subject to all relevant securities laws and regulations
- Chairman Clayton recently confirmed it will treat coin issuances like any other securities offering:
  - "If you have an ICO or a stock, and you want to sell it in a private placement, follow the private placement rules. If you want to do any IPO with a token, come see us."
- He also emphasized the difference between "cryptocurrencies" and tokens or coins issued through ICOs:
  - Cryptocurrencies, which "are replacements for sovereign currencies, replace the dollar, the euro, the yen with bitcoin – that type of currency is not a security. A token, a digital asset, where I give you my money and you go off and make a venture, and in return for giving you my money I say 'you can get a return' that is a security and we regulate that. We regulate the offering of that security and regulate the trading of that security."
    - https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html

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## U.S. Commodity Futures Trading Commission (CFTC)

- The CFTC effectively regulates commodities trading much the same way the SEC regulates securities trading
  - The Commodity Exchange Act has an antifraud provision (7 USC 9 (1)) that is virtually identical to that found in the Securities Act
    - Bars the use, "in connection with any swap, or a contract of sale of any commodity in interstate commerce . . . any manipulative or deceptive device or contrivance…"
- In 2014 the CFTC declared virtual currencies to be a "commodity" subject to CFTC oversight under the Commodity Exchange Act
  - Largely fills the void for true "cryptocurrencies" like Bitcoin
    - So even if a coin is not a security, its issuers are not off the hook
- Initially took action against unauthorized crypto futures exchange
- On December 1, 2017 the CFTC did not act to stay the self-certification of the Chicago Mercantile Exchange and the CBOE Futures Exchange for bitcoin futures products
  - Bitcoin futures could lawfully be traded on these exchanges
  - And that allowed the CFTC to regulate and watch for signs of potential manipulation in trading



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## Financial Crimes Enforcement Network (FinCEN) (Department of the Treasury)

- The Bank Secrecy Act ("BSA") requires any "money services business" ("MSB") to register with FinCEN
- "MSB" includes any person doing business that operates as a money transmitter
- A "money transmitter" includes anyone who accepts currency, funds, or other value that substitutes for currency from one person and transmits currency or funds to another person or location by any means
- FinCEN has taken the position that anyone who buys or sells virtual currency in exchange for legal tender or another virtual currency is a money transmitter
- That means any such person must, among other things:
  - Register as an MSB with FinCEN
  - Assess its money laundering risk exposure and implement an AML program



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## Internal Revenue Service

- The primary issues with the IRS are:
  - When is crypto considered a "capital asset"
    - The answer here is the same as any other asset—when it is held for more than a year and then sold
  - Does mining crypto create a taxable event?
    - Yes. Generally the fair market value of the crypto as of the date it is mined is considered as gross income
      - Consider someone who mined Bitcoin in November and December 2017 when it traded around $20,000
      - As far as the IRS is concerned that was $20,000 per coin mined in income in 2017
  - When is there a taxable sale of crypto?
    - When crypto is used to pay for goods or services, or satisfy any liability
    - When a crypto is exchanged for another form of crypto
    - Fair market value of the crypto as of that date is the sale price; basis is the value at the time it was acquired

### State Regulations

- More and more states are regulating blockchain and cryptocurrencies
- The vacuum caused by the lack of definitive federal legislation is leading states to fill the void
- Some smaller states, such as Wyoming, are clearly trying to drive their economies and industries by passing crypto-friendly legislation
  - Recently passed legislation designed to, among other things, provide exemptions from money transmitter laws for virtual currency dealers and exchange operators
- State banking regulations are the most common source of crypto regulation
- Consult counsel regarding laws and regulations in your state



## SEC Actions

- **Lawsuits Filed by the SEC**
- **Criminal Proceedings**
- **Administrative Actions**

### Lawsuits Filed by the SEC

- ***SEC v. AriseBank***
  - In January 2018 the SEC sued AriseBank and its two founders in Texas for securities violations relating to its then-ongoing ICO.
  - Looking to raise $1 billion in working capital for a "decentralized bank," and claimed to have raised $600 million when the SEC sued.
  - SEC sought and obtained an immediate TRO and seizure of assets
    - Assets were seized at gunpoint
  - The AriseBank situation presented several very bad facts:
    - The complaint filed by the SEC alleges that AriseBank made numerous false statements of material fact in connection with its ICO, including, most significantly, that AriseBank had purchased two FDIC-insured banks. In fact, according to the complaint, AriseBank had not purchased such banks, and the FDIC reported it had no pending applications from AriseBank.
    - Also didn't help that AriseBank had made public statements last October that it would not "shiver in fear" and had "geared up for the coming fight with the SEC."

## Lawsuits Filed by the SEC

- ***SEC v. CentraTech***
  - Civil action filed April 2, 2018 in SDNY against the two principals
  - Criminal action also filed – both defendants arrested
  - Conducted ICO "touting nonexistent relationships between Centra and well-known financial institutions, including Visa, Mastercard and the Bancorp."
    - Claimed a technology that would allow users to easily convert crypto to cash
  - Defendants raised $32 million selling "CTR Tokens"
  - Claims include unregistered sale of securities and fraud under 10(b)
  - The complaint was later amended to add civil and criminal claims against two other co-founders for their roles in the scheme
    - The amendment was based in part on text messages between the defendants, including one sent while they were trying to get the token listed on an exchange using bogus credentials, asking a co-defendant to "cook me up" a false document; the response: "don't text me that s**t lol."



## Lawsuits Filed by the SEC

- ***SEC v. PlexCorps***
  - Filed Dec 1, 2017 in the Eastern District of New York
  - Claims arose from an ICO for "PlexCoin Tokens" that the defendants claimed raised more than $15 million
  - The defendants allegedly represented that early investors could earn a return of 1,354% in less than 30 days
  - In fact, the SEC alleged that the proceeds from the token sale went to pay the founders' personal expenses
  - Three days after the case was filed court entered an order freezing defendants' assets



## Lawsuits Filed by the SEC

- *SEC v. Titanium Blockchain Infrastructure Services, Inc.*
  - Filed May 22, 2018 in the Central District of California
  - Suit against two companies and their principal Michael Stollery
  - Alleges they conducted an ICO for a digital asset called "BAR"
  - Alleges the defendants "employed a 'create and inflate' scheme" through false and misleading claims
    - Defendants claimed they offered IT services (network construction using Blockchain) that were being used or would be used by major corporations including Apple, ebay, Boeing, Disney and GE
    - In fact, the defendants had no relationships with any of these companies
    - **"Create and Inflate"** seems to be the crypto derivative of **"pump and dump"**
  - Raised $21 million in cash, Bitcoin and Ether based on a $1 per BAR sale price
    - As of May 21, 2018, the value of one BAR was $0.004253.
  - After companies demanded the defendants stop using their names, defendants allegedly made up new lies to tell investors to prop up the value of BAR
  - Claims filed under 10b and 10b-5 and for sale of unregistered securities
- The scheme here is prevalent: entice investors with two hot words: "ICO" and "blockchain," but the product/service actually being offered is vague

### SEC Criminal Proceedings

- United States v. Zaslavskiy (E.D.N.Y., Sep. 11 2018)
  - Defendants promised that REcoin "was backed by domestic and international real estate investments" and "had some of the highest potential returns"
    - Also claimed "investors could change their money into a more stable and secure investment: real estate, which grows in value."
  - In fact, no real estate was purchased and no coin was ever developed
  - Defendants moved to dismiss the indictment, arguing that the scheme "did not involve securities and are beyond the reach of the federal securities laws."
  - The court did not resolve the question of "whether the conspirators *in fact* offered a security, currency, or another financial instrument altogether," noting that was "undoubtedly a factual one" that the jury would have to answer.
  - But the court found that "a reasonable jury could conclude that the facts alleged in the indictment satisfy the Howey test."
  - "Stripped of the 21st-century jargon…the challenged Indictment charges a straightforward scam, replete with the common characteristics of many financial frauds."

### SEC Administrative Actions

- In re TokenLot, LLC (Sep. 11, 2018)
  - Cease and desist proceeding/offer of settlement to resolve claims that Respondents "promoted and sold digital tokens that included securities"
  - Respondents "advertised and sold securities, in the form of digital tokens, to retail investors using TokenLot's website platform"
  - However, Respondents never held any securities licenses and were never registered with the SEC in any capacity
  - The SEC alleged that Respondents were acting as unregistered brokers or dealers in handling investor purchase orders, and facilitating the sale of digital tokens as part of ICOs
  - Respondents stopped their activities after the SEC began investigating, so sanctions were less onerous than they otherwise might have been
    - Still ordered to disgorge all proceeds of their activities ($471,000) and barred from associating with any broker-dealers for at least three years



## CFTC Actions

- **Lawsuits Filed by the CFTC**

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## Lawsuits Filed by the CFTC

- *CFTC v. Cabbagtech* (aka "Coin Drop")
  - Filed Jan. 18, 2018 in the Eastern District of New York
  - Alleges fraud in connection with Cabbagetech's solicitation of money and virtual currencies in exchange for "virtual currency trading advice" and purchases
  - After taking money and crypto from customers, no services were provided
  - McDonnell, an individual defendant representing himself *pro se*, filed a motion to dismiss claiming that virtual currencies are not commodities and thus the CFTC lacked standing to sue
  - CFTC had taken the position in actions dating back to 2015 that "bitcoin and other virtual currencies are commodities subject to the Commodities Exchange Act and CFTC regulations."
    - This was the first case in which that issue was actually considered by a court.



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## Lawsuits Filed by the CFTC

- *CFTC v. Cabbagtech* (aka "Coin Drop") Continued…
  - Judge Weinstein (287 F.Supp. 3d 213) rejected the defendant's argument, finding that crypto met the statutory definition of a commodity ("all … goods and articles … and all services, rights, and interests … in which contracts for future delivery are presently on the future dealt in.").
  - What kinds of things have historically been viewed as commodities?
    - Wheat, cotton, rice, corn, oats, all fats and oils, peanuts, livestock, "frozen concentrated orange juice"
  - How is the term generally understood and applied?
    - "Commodities are generally defined as 'goods sold in the market with a quality and value uniform throughout the world."
    - Using that definition, it begins to make more sense to characterize virtual currency as a commodity—the quality and value of Bitcoin doesn't vary depending on where you are in the world
- This one District Court Judge's opinion
  - No appellate decisions yet
  - No other cases yet following, distinguishing, or rejecting the analysis



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## Lawsuits Filed by the CFTC

- *CFTC v. Gelfman Blueprint, Inc.*
  - Complaint filed 9/21/17 in the Southern District of New York
  - Alleges that the defendant and its CEO "obtained more than approximately $600,000 from at least 80 customers" for a "pooled fund" using an "algorithmic trading strategy" to buy and sell Bitcoin
  - Obtained investor money with false statements of performance, including that customers averaged a 7-9% monthly increase in Bitcoin balances
  - The only payouts made came from other investors, not trading profits
  - Defendants "staged a fake computer 'hack' that supposedly caused the loss of nearly all" customer funds; in fact, CFTC alleges the CEO stole all the money
  - Claim filed for violations of 7 USC 9(1) and 17 CFR 180.1(a) (fraud by deceptive device or contrivance in the same of a commodity)
  - Criminal charges were also filed in New York state court

# IRS Actions

## The CoinBase "John Doe" Summons

- A "John Doe" summons is used to gather information about possible violations of the law by people whose identities is unknown
  - The IRS has statutory authority (26 USC 7602(a)) to issue a summons for "ascertaining the correctness of any return" or "determining the liability of any person for any internal revenue tax"
- In 2016 the IRS requested and received an order from the USDC for the Northern District of California requiring Coinbase (a large crypto exchange) to disclose identifying information on U.S. customers who used the service between 2013 and 2015.
  - During that time period, the IRS represented that less than 1000 U.S. taxpayers reported Bitcoin gains, while 14,000 Coinbase users transacted at least $20,000 worth of Bitcoin in that same time period
  - Gave the IRS reasonable suspicion that many Coinbase users were not properly reporting income or paying taxes
  - IRS sought complete user profiles, "know-your-customer due diligence," account or invoice statements, etc.



## The CoinBase "John Doe" Summons (Cont.)

- After the initial summons was issued, Coinbase refused to comply
- The IRS narrowed the scope to persons with $20,000 in transactions
  - Still covered more than 14,000 account holders
  - Coinbase still refused to comply, and the IRS filed a motion to enforce
- The court granted the motion to enforce, but did not allow the IRS to obtain a significant amount of identity information (such as images of passports and driver's licenses)—at least not yet
  - First the IRS needs to determine if persons had taxable gains that were not reported; can come back later to request more information if needed
  - Allowed the IRS to get taxpayer ID number, name, date of birth, and addres
- To a certain extent this can be seen as a warning shot to taxpayers who trade in crypto
  - IRS Commissioner John Koskinen confirmed this: "Tools like the John Doe summons authorized today send the clear message to U.S. taxpayers that whatever form of currency they use—bitcoin or traditional dollars and cents—we will work to ensure they are fully reporting their income and paying their fair share of taxes."

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# Private Litigation

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## Private Litigation

- Putative Class Actions Based on Securities Violations
  - *Hodges v. Monkey Capital, LLC*
    - Filed December 19, 2017 in the Southern District of Florida
    - Putative class action filed by six individuals who collectively invested using cryptocurrency that was, at the time of the investment, worth more than $3.8mm
      - With the rising price of cryptocurrencies, the value of the "investment" grew to $15,000,000 by the time the lawsuit was filed
      - **This marks an interesting issue that will arise more and more—where investments are made using crypto, and the remedy is rescission, how will the wide swings in cryptocurrency prices come into play?**
        - **If an investor paid in Bitcoin, should his or her remedy be return of the Bitcoin?**
    - The plaintiffs did not buy coins in an ICO, but instead traded crypto for "cryptocurrency options" tokens which would entitle plaintiffs to 10,000 "Monkey Coins" when a future ICO took place
    - Defendants were allegedly promoting Monkey Capital with paid news stories
    - After the initial options purchases, the defendants "released to Daniel Harrison and Monkey Coin insiders one billion (1,000,000,000) Monkey Coins—800,000,000 of which went to Harrison
    - No ICO was conducted
    - Plaintiff suing for unregistered sale of securities and securities fraud
    - Default entered against Monkey Capital on March 27, 2018
    - No appearance by Daniel Harrison



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## Private Litigation

- Putative Class Actions Based on Securities Violations
  - *In Re Tezos Securities Litigation (Case No. 17-cv-06779-RS)*
    - Filed in 2017 in the Northern District of California
    - The Breitmans, husband and wife from North Carolina, touted Tezos as "the last cryptocurrency"
    - Although they were careful not to call their offering an "ICO," they promoted "a process by which Tezos 'tokens' would be allocated in exchange for 'initial investments.'"
    - The coin offering began in July 2017 and raised $232 million in Bitcoin and Ethereum in 14 days
    - The lead plaintiff in the case claimed he saw no promotional materials, and thus claimed only that he was a victim of an unregistered securities sale, seeking rescission
      - This makes this a unique fact pattern in the cases filed to date—no claims of fraud

## Private Litigation

- Putative Class Actions Based on Securities Violations
  - *In Re Tezos Securities Litigation (Continued)*
    - In a memorandum decision issued August 7, 2018, Judge Richard Seeborg addresed a very interesting discussion about personal jurisdiction, where the court asks: "where does an unregistered security, purchased on the internet, and recorded 'on the blockchain,' actually take place?
    - Court concludes a number of facts "support an inference that [the] alleged securities purchase occurred inside the United States":
      - The plaintiff participated in the offering in the U.S.
      - He did do using an interactive website hosted on a server in Arizona and run by a California resident
      - He learned about the ICO and participated in response to marketing targeting U.S. residents
      - "[H]is contribution of Ethereum to the ICO became irrevocable only after it was validates by a network of global "nodes' cluttered more densely in the Unites States than in any other country."
    - Cited *SEC v. Traffic Monsoon, LLC*, 245 F.Supp.3d 1275 (D. Utah 2017) for the proposition that "where non-exchange listed securities are offered and sold over the internet, the sale takes place in both the location of the seller and the location of the buyer")



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- Putative Class Actions Based on Securities Violations
  - *Morris v. Overstock.com*
    - Filed March 29, 2018 in the District of Utah
      - NOT a claim based on a coin offering
      - Claim that Overstock.com stock was artificially inflated by statements regarding a planned $500mm ICO
        - Allege statements regarding the coin offering "are false and misleading because they concealed and/or failed to disclose that: (1) Overstock's coin offering was highly problematic and potentially illegal . . . ."
        - On March 1, 2018, Overstock announced that "the SEC had requested information about its initial coin offering," and the stock price fell
        - Overstock received only a "request" for information—not even a subpoena
    - So here is a case involving only statements about a possible ICO and the would-be issuer STILL GOT SUED
      - Regardless of the merits, this illustrates the precarious position those who are planning ICOs can occupy
      - The Plaintiff's bar is watching…
    - Utah case was dismissed without prejudice on August 7



## FINRA

- Department of Enforcement v. Ayre (filed Sep. 11, 2018)
- FINRA filed its first ever disciplinary proceeding against a broker/dealer in the cryptocurrency/blockchain arena
- Complaint alleges that "Ayre attempted to attract public investment in his worthless public company, Rocky Mountain Ayre, Inc. (RMNT), by making material misstatements in its public filings and by creating, offering, and selling unregistered cryptocurrency securities to the public that touted as 'the first minable coin backed by marketable securities."
- Ayre marketed "HempCoin as the world's first currency to represent equity ownership in a publicly-traded company," but no registration statement for HempCoin securities was ever filed
  - The HempCoins were supposedly backed by 500 million shares of RMNT, and "Ayre understood he created a structure that transformed HempCoin into a security tied to RMNT stock"
- Alleges violations of 10b-5 and FINRA Rule 2020 because Ayre claimed in quarterly filings that RMNT had business operations, when it didn't, and because Ayre made unlawful sales of unregistered securities (HempCoin)

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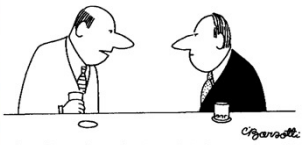

I consider myself a passionate man, but, of course, a lawyer first.