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Feds Send Clear Message With Flurry Of Fintech Cases

By **Reenat Sinay**

Law360 (June 7, 2019, 6:08 PM EDT) -- The past 12 months have seen the SEC show leniency in its first-ever settlement over an unregistered initial coin offering, FinCEN determine that peer-to-peer cryptocurrency exchangers are money transmitters subject to banking laws, and prosecutors target a massive $4 billion crypto pyramid scheme.

As the SEC ramps up for its next battle over what constitutes a security in its suit against mobile messaging app Kik following a $100 million unregistered ICO, let's take a look at the most influential enforcement actions in the past year.

In the Matter of Gladius Network LLC

Cybersecurity startup Gladius Network LLC escaped a U.S. Securities and Exchange Commission enforcement action relatively unscathed in what was the agency's first-ever settlement involving a self-reported unregistered initial coin offering.

The February agreement required Gladius, which had raised $12.7 million through its unregistered ICO, to repay investors and properly register the tokens as securities, but the startup avoided having to pay any monetary penalties.

The comparatively lenient decision was seen as a signal to the industry that early cooperation with the SEC could result in a more favorable outcome in enforcement actions, according to Anne Termine of Covington & Burling LLP.

"From my perspective, having a no-fine case is a pretty big deal," she said. "And I think the SEC wanted to make pretty clear that it was a big deal that this was a self-report and that [the company was] recognizing the SEC jurisdiction, that they were taking immediate steps to comply."

The trail for unregistered ICOs to come clean was blazed by CarrierEQ Inc., known as Airfox, and Paragon Coin Inc., which both agreed to cooperate with the agency in November but didn't self-report and were fined $250,000 each.

All three ICOs followed the SEC's July 2017 issuance of The DAO Report, which determined digital tokens sold in initial coin offerings may be considered securities under U.S. law.

Gladius conducted its ICO in late 2017, raising about $12.7 million by offering GLA tokens to roughly 1,700 individuals, according to the SEC. The company self-reported its conduct the following August after becoming increasingly concerned about regulatory risks, it said.

The SEC chose not to fine the company because it took "significant steps" to remedy the issue, according to the settlement.

While the SEC's message is intended to be encouraging, whether more companies will come forward has yet to be seen, according to Termine.

"The SEC distinguished this case from two other similar matters that did result in monetary penalties," she said. "It's always a big risk to self-report, and it's always a big risk if you don't self-report and you get found out later. I think it's this balancing act that companies really struggle with and we have to figure out when making that decision."

The Gladius case also represented the first time that the commission formally acknowledged that a digital asset could change from a security to a non-security over time, according to Philip Moustakis of Seward & Kissel LLP.

"There have been statements made by various commissioners as well as by the head of the [SEC's] Division of Corporation Finance that a digital asset could be a security in its offering but, over time, if it becomes sufficiently decentralized or for other reasons, it could become a non-security," said Moustakis.

"But those are just the views of individuals," he added. "An enforcement order is a statement of the commission itself, so the Gladius order was actually the first official acknowledgement by the commission that the legal status of a digital asset could change over time."

SEC v. Blockvest LLC et al.

In an unusual defeat for the SEC, a California federal judge denied the agency's November request for a temporary restraining order to shut down an allegedly fraudulent initial coin offering set to be issued by cryptocurrency company Blockvest LLC. The court found that the regulator failed to definitively show that the digital tokens could be considered securities because there was no actual sale.

Then, in a turnaround in February, the judge reconsidered and reversed his earlier decision, ruling that the mere offer of digital tokens met the definition of securities under the Howey test, as established by the U.S. Supreme Court in 1946.

"This was a significant decision because it reemphasized the application of the Howey test to determine whether a token is a security," Shamoil T. Shipchandler of Jones Day told Law360. Shipchandler is the former director of the SEC's Fort Worth Regional Office in Texas.

"This reinforces the SEC's framework for digital assets that it published last month. Nothing about this says that every ICO is a security, but it does suggest that ICOs must perform a Howey analysis," he added.

Dan Nathan of Orrick Herrington & Sutcliffe LLP told Law360 that the case was a prime example of government agencies making a statement about cracking down on cryptocurrency fraud and convincing the courts to do the same.

"From a fintech perspective, there's nothing particularly novel or interesting about how the judge is interpreting whether something is a security or not, but it does say if there's fraud involved in connection with a crypto offering, the SEC can get a judge to take it seriously and shut it down," said Nathan.

In the Matter of Eric Powers

Eric Powers, a California man accused of buying and selling bitcoins for clients he met online, became the target of the Financial Crimes Enforcement Network's first-ever enforcement action against a peer-to-peer cryptocurrency exchanger in April.

In a case some attorneys said could show the agency is stepping up its profile as a regulator of virtual currencies, FinCEN argued Powers should be considered a "money transmitter" subject to the Bank Secrecy Act because he exchanged millions of dollars' worth of bitcoins for other people, yet he was not registered with the agency or adhering to anti-money laundering protocols.

"They're saying they're on the job, they want to be active in this space," Nathan said of FinCEN. "In the crypto world, they and SEC are viewed as the two big regulators, so they certainly need to be on the boards in this area, and this certainly puts them on the boards."

In addition to being unregistered and not establishing AML procedures, Powers failed to follow any and all of the cornerstone requirements of a money services business, such as designating a compliance officer or creating an internal review system, according to Nathan. He should also have filed a currency transaction report for any transaction of over $10,000 and suspicious activity reports documenting suspected money laundering, Nathan said.

"They do throw kind of throw the book at him; they do say he did all the important things that they regulate," said Nathan.

While FinCEN has said they could have pushed for huge penalties — conceivably for each transaction, which in Powers' case is over 200 — the bureau settled with Powers for just $35,350 and a ban from the money services business, citing his extensive cooperation.

The suit, which is the bureau's third cryptocurrency-related enforcement action overall, also came just ahead of FinCEN's updated guidelines regarding AML standards in the digital assets space, which were published in May.

U.S. v. Scott et al.

In what may be the largest-ever pyramid scheme involving a digital asset, two Bulgarian siblings are charged with defrauding investors out of $4 billion by convincing them to pour funds into a purported cryptocurrency called OneCoin.

Prosecutors cracked down on Ruja Ignatova, also known as Cryptoqueen, and her brother Konstantin Ignatov, in March, alleging the two laundered $400 million of that money through several countries with the help of an American attorney, former Locke Lord LLP lawyer Mark S. Scott.

Ignatov was arrested in California and charged with one count of conspiracy to commit wire fraud. His sister was charged with wire fraud, conspiracy to commit wire fraud, securities fraud, conspiracy to commit securities fraud and conspiracy to commit money laundering, but remains at large.

According to Shipchandler, the OneCoin case is an example of the government's increasing capability in bringing down global fraud schemes that threaten American investors.

"U.S. regulators are developing more significant relationships with international regulators to take concerted action," he said. "There will likely be many more instances of actions that are international in scope and rely on cooperation and coordination between foreign and domestic regulators."

Scott was arrested last September and charged with one count of conspiracy to commit money laundering, which prosecutors believe he carried out through a series of international financial institutions.

In the Matter of Crypto Asset Management LP and FINRA v. Ayre

Regulators showed they mean business when it comes to cracking down on any market participant who improperly interacts with cryptocurrency with two first-of-their-kind actions in September.

The SEC fined an unregistered private fund manager known as Crypto Asset Management LP and its founder, Timothy Enneking, $200,000 for touting its fund as the "first regulated cryptoasset fund in the United States," even though it was never registered as an investment company.

Crypto Asset had raised roughly $3.6 million from 44 investors between August and December 2017, according to the order.

"You can't go around saying, 'The SEC has blessed my investments,' and for it to be a total fiction and not get in a lot of trouble," said Moustakis.

Part of Crypto Asset's defense was that it had relied on the advice of its lawyers in how it operated the fund, which likely saved it from more serious charges or steeper fines, Moustakis added.

On the same day as the SEC's action, the Financial Industry Regulatory Authority targeted a former broker for allegedly selling unregistered tokens.

In its first cryptocurrency-related disciplinary action, FINRA accused Timothy Tilton Ayre of flouting registration requirements and fraudulently peddling a security called HempCoin.

Ayre allegedly sold 81 million HempCoins by telling investors that 10 coins were equivalent to one share of Rocky Mountain Ayre Inc., a publicly traded, Delaware-based shell company purporting to be a cannabis business.

FINRA said that Ayre purchased HempCoin from THC Farmaceuticals in June 2015 with the sole purpose of wielding the cryptocurrency to spark interest in his failing company, Rocky Mountain.

The decision to go after Ayre followed the independent regulator's stated 2018 goal of increased scrutiny of how broker-dealers handle initial coin offerings and cryptocurrency transactions.

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