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Virtual Currency Exchanges Face Possible SEC Regulation

Virtual currency exchanges are creating new cryptocurrency tokens to raise funds through initial coin offerings (ICOs); a concept similar to initial public offerings. Companies issuing ICOs raised more than \$4 billion in 2017. Because of the potential economic impact in financial and investor markets, federal agencies are implementing regulations, issuing guidelines and starting enforcement actions. The U.S. Securities and Exchange Commission (SEC) in particular has been active in attempting to regulate ICOs as “securities” but with mixed results.

On November 16, 2018, the SEC announced it reached agreement to settle charges against Airfox and Paragon, two companies that sold digital tokens through ICOs. According to the SEC, the companies failed to register their ICOs under federal securities laws. As part of the settlement, both companies agreed to return funds to investors, register their tokens as securities, and pay fines.

On November 27, 2018, however the U.S. District Court for the Southern District of California in *SEC v. Blockvest LLC et al.*, case number 3:18-cv-02287, denied the SEC’s Motion for Preliminary Injunction that sought to enjoin Blockvest’s ICO because its pre-ICO capital raise was a securities law violation. The court held the SEC had failed to make an initial showing that tokens sold by a company pre-ICO were “securities.” At the core of this decision was the Court’s finding that “plaintiffs and defendants provided starkly different facts as to what the investors relied on before they purchased the [test] tokens.”

In addition to the SEC, the Commodity Futures Trading Commission (CFTC) has also brought enforcement actions. One such case was against Patrick K. McDonell and his company, Coin Drop Markets that was alleged to have operated a deceptive and fraudulent virtual currency scheme and misappropriated investor funds. Defendants advertised their services through two websites and social media. Investors transferred virtual currency to the defendants

paying for a membership or day trading opportunities, with promised profits of up to 300 percent per week. After receiving membership payments or virtual currency investments, the defendants deleted the social media accounts and websites and discontinued communication with customers. The defendants were ordered to pay over \$1.1 million in penalties and restitution.

The CFTC created a Customer Advisory: Understanding the Risks of Virtual Currency Trading addressing the risks of investing in virtual currencies. The lack of specific regulation and specific guidance from other government agencies however create confusion and allow for competing or even conflicting legal obligations and remedies for issuers and investors alike. Considering the potential consequences to regulatory non-compliance, competent advice from legal counsel or a qualified investment advisor is more important now than ever in the developing area of the financial markets.

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