Blockchain Litigation Year In Review (Part 2): Lessons From 2019 And What's Ahead For 2020

It began as an obscure experiment in unregulated virtual currency. Initially undistinguished from Bitcoin, blockchain evolved to become one of the pillars of web 3.0, enabling new means of trust, transparency, security and tokenization. Since its introduction more than a decade ago, Blockchain has shown promise across industries. Cryptocurrency is now but one of blockchain's many applications, albeit, the application that still draws the most attention. 2017 was a breakout year. Bitcoin soared to a record high of $20k USD and total investment in blockchain ballooned. 2018 ushered in a bear market and brief period of "crypto-winter": Bitcoin and other cryptocurrencies tumbled in value and Initial Coin Offerings (ICOs) dipped. Yet, 2018 exceeded 2017 in total blockchain investment and saw more than one ICO break past the billion dollar mark. Amidst the uncertainty of many altcoins and ICOs, 2019 saw a decline in blockchain investment but roughly the same number of enforcement actions as the prior year. With Bitcoin and other cryptocurrencies on the rise, 2020 may see bullish investment in blockchain again (particularly with the third Bitcoin "halving" slated for Q2), but along with it, increased scrutiny by regulators.

As we saw in first part of this piece, Federal District Courts were asked in 2019 to decide novel issues of law as the number and nature of blockchain disputes increased. In part two we look at the lessons learned from 2019 administrative actions by the Securities And Exchange Commission (SEC), orders by the Commodity Futures Trading Commission (CFTC), revenue rulings by the Internal Revenue Service (IRS) and advisory opinions by the Federal Election Commission (FEC) to glean what may be ahead for 2020.

16. Failing To Verify Investors Are Accredited Forgoes Securities Exemption For SAFT Sale. (*In the Matter of Simply Vital Health, Inc., Respondent.*, Release No. 10671 (Aug. 12, 2019)).

Raising capital from accredited investors affords exemption from some federal securities regulations. But failing to ensure investors are accredited can cause forfeiture of such protections.

Blockchain-based healthcare company SimplyVital Health, Inc. ("SimplyVital") set out to raise funds for its "Health Nexus" platform, a blockchain protocol through which healthcare providers could securely share patient data with audit trails. In late 2017, SimplyVital announced plans to conduct a token sale. The company would sell a token a called "Health Cash" ("HLTH") to be used as the currency in the Health Nexus blockchain platform. SimplyVital planned to offer tokens in two phases: a presale and a crowdsale.

To qualify for the securities registration exemption provided under Section 4(A)(2) of the Securities Exchange Act and Regulation D , the company's presale required a minimum purchase of $10,000 from accredited investors. Investors provided personal information through SimplyVital's website and entered into a Simple Agreement for Future Tokens ("SAFT")—a form agreement modeled after a Simple Agreement for Future Equity ("SAFE") commonly used by angel and venture investors. Under the SAFT agreement, investors in SimplyVital's presale would receive HLTH tokens when launched. Yet, despite the SimplyVital's efforts to abide by the securities exemption, the company failed to take reasonable steps to verify that its investors were accredited. Though the company was aware some investors were pooling funds to meet the minimum investment requirement, it did not try to determine whether the participants in the pool were also accredited.

When the SEC began an administrative action against SimplyVital, the Commission determined that $5.2 million of the $6.3 million raised through the token presale had come from purchasers whom SimplyVital had not reasonably vetted. Consequently, SimplyVital's token sale did not qualify for exemption – violating Sections 5(a) and 5(c) of the Securities Exchange Act. The company cancelled its scheduled crowdsale (which was to follow presale) and returned the funds it had raised in the presale. Because SimplyVital accepted the SEC's offer and undertook remedial acts, no civil penalties were imposed, however, the company was ordered to cease from future violations.

It's worth noting that the SEC is looking to update the definition of an "accredited investor". The current definition based on income and wealth and has remained unchanged for nearly four decades. While the requirement to verify prospective investors won't change anytime soon, more Americans would qualify under the expanded definition, which may allow accreditation for professional knowledge, experience or certification. The SEC's proposal is open for comments through mid-February 2020 and could be voted in this year.

17. Free Tokens Not Tax-free: "Airdropped" Tokens Are Taxable Income. (Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (2019)).

In a recent revenue ruling, the IRS held that "airdropped" tokens from a "hard fork" are taxable income. An airdrop is a way of distributing cryptocurrency for no consideration. Tokens are "dropped" into a recipient digital wallet. A hard fork happens when a blockchain undergoes a protocol change resulting in a permanent deviation from the existing chain of transactions. As described in the revenue ruling, "[a] hard fork may result in the creation on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger."

An airdrop and a hard fork are not contingent on one another: an airdrop does not require a hard fork and a hard fork is not always followed by an air drop. But when a hard fork is followed by an airdrop, it is taxable income under Section 61 of the Internal Revenue Code. In the hypothetical given in the revenue ruling, if an taxpayer receives an airdrop of cryptocurrency "S" by virtue of holding cryptocurrency "R"—which experiences a hard fork—the taxpayer has taxable income as of the date and time cryptocurrency "S" is recorded in the taxpayer's wallet address. That income is the fair market value of cryptocurrency "S" at the date and time of receipt.

One noteworthy detail in the IRS's hypothetical is that the taxpayer must have custody and control of the airdropped tokens to trigger the taxable event (e.g., tokens are recorded to taxpayer's wallet address). Presumably then, if custody and control is differed, so too is the taxable event.

18. Incentivizing Campaign Volunteers and Supporters With Tokens Permitted Under Federal Election Laws…Sort Of. (AO 2019-08 (F.E.C.) Omar Reyes, 2019 WL 3219131, at *1 (July 11, 2019)).

A candidate in a federal election can distribute blockchain tokens to incentivize his campaign volunteers and supporters without violating federal election laws. That was determination by the Federal Election Commission in an advisory opinion.

Omar Reyes, an independent candidate from the 22nd Congressional District of Florida running for election to the U.S. House of Representatives in the 2020 general election, sought guidance from the Commission regarding his campaigns plan to distributed digital tokens to volunteers. The Reyes campaign committee created 10,000,000 unique "OMR Tokens" on the Ethereum blockchain to distribute to volunteers and supporters as an incentive to host events, register to vote and engage in other activities to support the campaign. But the tokens would be subject to some strictures. The tokens would have no monetary value and would not be usable to purchase goods or services. Instead, the three volunteers amassing the most OMR tokens would receive prizes.

Based on the proposed use and distribution of OMR Tokens, the Commission determined it was permissible for the Reyes campaign to distributed OMR Tokens to volunteers and supporters to engage participation. The issue decided by the Commission was whether OMR tokens constituted compensation or merely souvenirs. If compensation, then volunteers must be compensated at the normal rate for such services, or treat the difference between the normal rate and compensated rate as an in-kind contribution. But if merely a souvenir, like a campaign cap or pin, then compensation rules would be exempt.

The Commission determined that the "provisions of OMR Tokens to volunteers would not constitute compensation for their services" because the tokens "have not monetary value, are not a type of cryptocurrency, and cannot be used to purchases goods or services." The Committee likened the disbursement of OMR Tokens "to more traditional types of campaign souvenirs, such as a bumper stickers, yard signs or buttons – all of which are regularly distributed by campaigns to volunteers and supporters at no cost to the volunteer or supporter, and without implicating federal campaign finance laws." Looking ahead, the Committee found that the display and distribution of free campaign souvenirs "through a digital, rather than physical, medium is immaterial for purposes of the [Federal Elections Campaign] Act and Commission regulations" – opening the door for future campaigns to similarly adopt digital souvenirs.

19. Unregistered Bitcoin Swaps Subject to Double Scrutiny and Sanction. (*In the Matter of: XBT Corp. SARL d/b/a First Global Credit, Respondent*, CFTC Docket No. 20-04 (Oct. 31, 2019); *In the Matter of: XBT Corp. SARL d/b/a First Global Credit, Respondent*, Release No. 10723 (Oct. 31, 2019)).

Navigating the world of derivatives regulation, especially when digital assets are involved, can be a challenge. Both the SEC and CFTC's regulation of derivatives is perpetually evolving, and, when combined with the uncertainty around the regulation of digital assets, can create a difficult space to navigate for issuers. Unfortunately for XBT Corp. SARL d/b/a First Global Credit ("XBT"), the SEC and CFTC both found XBT violated swap regulatory frameworks.

On October 31, 2019, XBT settled with both the SEC and CFTC for alleged violations regarding solicitations and acceptances of futures orders from twenty-four U.S. customers, including accepting Bitcoin for margin trades. At the time, XBT was not registered with CFTC as a futures commission merchant ("FCM") or with SEC on a registered national securities exchange. According to the SEC's order, From 2014 until 2019, XBT had at least ninety investors who conducted more than 18,000 security-based swaps representing more than $100 million in transactions "based on U.S.-listed securities". Of those transactions, $43.8 million in trades were made by U.S. residents. The SEC ordered XBT to pay over $130,000, including disgorgement and a civil penalty, while the CFTC ordered XBT to pay an additional $100,000. The civil penalty levied by the CFTC could have been much greater but "was substantially reduced in light of [XBT]'s cooperation and remediation."

When XBT initially offered the financial products in question, it marketed them as "contracts for difference" ("CFDs"), allowing customers to deposit Bitcoin to receive credits that represented shares in US-listed securities, including Apple stock. CFDs are a commonly traded derivative throughout Asia and Europe, but are less commonly traded on U.S. markets. CFDs fit within the CTFC and SEC definitions of "swaps", and therefore, must comply with applicable regulatory structures. In the case of CFDs that reference commodities, they must be offered by an FCM, and in the case of CFDs that reference securities, they must be offered on a registered national securities exchange. The latter is a high bar that often prevents security-based swaps from being offered in the United States.

20. Solicitation of U.S. Investors From Offshore Does Not Deter Regulators' Reach.
(*CFTC v. 1POOL LTD. and PATRICK BRUNNER, No. 1:18-cv-2243-TNM*, Consent Order (Mar. 4, 2019); *Sec. & Exch. Comm'n v. 1Pool Ltd. a.k.a. 1Broker and Patrick Brunner*, No. 1:18-cv-02244-TNM (D.D.C.)).

U.S. regulators keep a watchful eye on foreign companies soliciting investments from U.S. customers. That included 1pool Ltd. ("1pool"), a company based in the Marshall Islands, and its CEO Patrick Brunner, a resident of Austria. In a Consent Order entered into between 1pool, Brunner, and the CFTC, the CFTC found that Brunner, through 1pool, illegally offered retail commodity transactions—a regulated type of transaction under federal commodities laws—that were margined in Bitcoin. According the Order, the offer and sales were improper because 1pool failed to register as an FCM and further failed to put anti-money laundering (AML) procedures in place. Similarly the SEC found that 1pool and Brunner solicited investors from the United States to buy and sell security-based swaps. The SEC stated that 1pool improperly transacted in these swaps on a registered national securities exchange, failed to register as a dealer and lacked anti-money laundering procedures.

The SEC and CFTC's jurisdiction over transactions facilitated outside of the United States is limited when there are no U.S. persons involved in the relevant transactions. However, if a foreign entity solicits U.S. investors or executed a regulated transaction, such as a retail commodity transaction or security-based swap, with a U.S. investor, the CFTC and SEC's jurisdiction is triggered. In recent years, especially in the digital asset space, the CFTC and SEC have been quick to assert their jurisdiction both against foreign issuers and foreign instituted transactions. Often under financial pressure to settle, firms sometimes agree to jurisdiction when the CFTC and SEC's arguments of such may be tenuous. Recently, famed mobile-message-app Telegram has pushed back regarding the SEC's overseas jurisdiction in a response to the SEC in its ongoing litigation. It is yet to be seen whether this argument will gain traction but will be watched with much interest in 2020.

21. Self-Reporting Unregistered ICO Saves From Civil Penalties. (*In the Matter of Gladius Network LLC, Respondent.*, Release No. 10608 (Feb. 20, 2019)).

Sometimes it is better to self-report than to see if you get caught. Gladius Network LLC ("Gladius") was established to provide blockchain-enabled cybersecurity services. In July 2017, Gladius began developing a network in which participants could rent spare bandwidth and storage space on their computers and servers to others for use in defense against certain types of cyberattacks and to enhance content delivery speed. Gladius created "GLA Tokens" to be issued on a blockchain and used as the sole "currency" for services within the Gladius Network. The Gladius Network was to be a decentralized, peer-to-peer network that offered internet content providers faced with a DDoS attack or increased traffic the ability to access spare bandwidth and storage space belonging others in the network. Participating content providers would purchase excess bandwidth and storage with GLA Tokens.

To raise capital for development of the Gladius Network, Gladius conducted an ICO where sold GLA Tokens for Ether. GLA Tokens could be acquired directly from Gladius or purchased in secondary markets. The company raised $12.7 million worth of Ether during its ICO (based on the exchange rate of Ether to USD at the time of the offering) but it did not register the offering with the SEC, nor did it qualify for an exemption to the registration requirements.

Gladius, perhaps realizing afterwards that it was at risk of an enforcement action (and investor lawsuits), notified the SEC of its unregistered coin offering. The SEC determined that GLA Tokens were securities and that Gladius had violated Section 5(a) of the Securitas Exchange Act, yet, the Commission imposed no penalty against Gladius. The Commission reasoned that, despite the illegal activity, penalties were unwarranted because Gladius had (1) self-reported to the Commission to take prompt remedial steps; (2) cooperated with the Commission's investigation and (3) voluntarily agreed to the remedial steps in the Commission's order.

As part of the deal, Gladius had to inform all purchasers of the GLA Token of the right to file claim under Section 12(a) of the Securities Exchange Act, including the right to sue "to recover the consideration paid for such security with interest thereon, less the amount of any income received".

22. Then Again, The Penalty For A Billion Dollar ICO Is Pennies On The Dollar. (*In the Matter of Block.one,* Respondent., Release No. 10714 (Sept. 30, 2019)).

While self-reporting may stave off civil penalties, when an ICO is so large it raises funds in the billions from individuals around the world, the penalties for not complying with U.S. securities laws may be outweighed by the sheer upside of crowdfunding through a coin offering.

Block.one's ICO for the EOS blockchain made headlines in 2018 as one of the largest crowdfunded projects of all time. Block.one offered and sold 900 million "ERC-20" tokens in exchange for Ether, to raise capital for development of the EOS blockchain and EOS.IO software.[1] The ICO raised several billion dollars, including from residents in the U.S. After Block.one failed to register its coin offering with the SEC and qualify for a registration exemption, the SEC investigated the company for offering and selling unregistered securities.

Foreseeing the risk associated with running an unregistered, non-exempt coin offering in the U.S., Block.one tried to discourage purchase of tokens by persons within the United States. Though Block.one sold ERC-20 Tokens direction through the EOS.IO website, it blocked U.S. IP addresses from accessing the website's token sale page. In addition, Block.one required all customers to agree to the Token Purchase Agreement, which included provisions that U.S. persons were prohibited from purchasing tokens. But despite these measures to prevent U.S. purchases, Block.one did not verify that purchasers *were not* U.S.-based persons. Nor did Block.one try to prevent resale of tokens to U.S. purchasers in secondary markets.

In an administrative action by the SEC, the Commission determined that purchases had occurred in the U.S. though the EOS.IO website. The Commission further determined that the ERC-20 tokens offered and sold by Block.one were non-exempt, unregistered securities in violation of Section 5(a) of the Securities Act. For this offense, Block.one was fined $24 million—a penalty of pennies on the dollar compared to billions raised by its ICO. Perhaps more potent than the pecuniary penalty, however, Block.one was and ordered not to commit future securities violations, which could have hamstrung future fundraising efforts. But Block.one sought and was granted a waiver from the SEC, allowing the company to rely on Regulation A and D exemptions for future projects. In the end, Block.one's censure was relatively insignificant considering the scale of the company's sale of unregistered securities.

The SEC took firmer steps against Telegram Group Inc. (Telegram), maker of the popular "Telegram" mobile messaging app., and its affiliate company TON Issuer Inc. (together "Telegram"). (*Sec. & Exch. Comm'n v. Telegram Group Inc. et al.*, 1:19-cv-09439-PKC (S.D.N.Y.).) After raising $1.7 billion in proceeds, the SEC sought a temporary restraining order (TRO) enjoining Telegram from proceeding with plans to offer tokens called "Grams". The SEC alleged that Grams are securities because investors expect profits from implementation of a new blockchain platform called the "TON Blockchain" and the tokens are not redeemable for products or services.

Telegram refuted these allegations, contending that it lawfully raised proceeds through exempt SAFT-like sales to sophisticated investor and not from the public sale of Grams. The agreement provides for payment in Grams upon completion of the TON Blockchain. At bottom, Telegram contends that the Grams, which will be the currency within the TON blockchain, are separate and distinct from the agreements providing for future tokens. Still, the company stipulated to the TRO and to delay the sale of Grams until the court resolves the issue of whether Grams are securities. The case is currently undergoing expedited discovery and scheduled for further hearing on February 18, 2020.

[1] ERC-20 is a standardized smart contract on the Etherium blockchain for creating a tradeable token. The standard allows entities to create and issue tokens.

23. Outsourcing ICO Sales Does Not Offload Liability For Unregistered Securities. (*In the Matter of Blockchain of Things, Inc.*, Release No. 10736, December 18, 2019)

Blockchain of Things Inc. ("BCOT"), maker of blockchain development tools, raised nearly $13 million through an initial coin offering. BCOT intended to use the funds to develop its blockchain-based technology and platform that, according to BCOT, would facilitate third-party secure messaging, digital asset generation and digital asset transfer over blockchain. To sell its token, BCOT engaged resellers in South Korea, Vietnam, Japan and the UAE. BCOT's reseller agreements provided that each foreign reseller would have exclusive sales rights within its respective geographic territory (i.e., South Korea, Vietnam, Japan, and the UAE). However, the agreements did not require resellers to ensure potential purchaser were in fact residents of the respective geographic territory. In other words, resellers were not required verify whether purchasers were individuals outside U.S. Because direct contact with purchases was through the foreign resellers, BCOT had no visibility into the resellers' token sales or as to the identity of the potential purchases. BCOT's resellers succeeded in selling more than $12 million in tokens to more than 1,380 individuals. When the SEC began looking into whether BCOT had broken federal securities laws through the offer and sale of its token, BCOT accepted a settlement with the SEC.

While the SEC Order does not clarify whether any of 1,380 purchasers were U.S. individuals, it included sales to these individuals in its assessment of unregistered and non-exempt sales. Moreover, though BCOT itself sold tokens to 69 U.S. investors (accounting for less than 5% of the total coin sales), the SEC did not limit remedial measure to just U.S. customers. Rather, all customers of BCOT's coins could request a refund. In addition to returning funds to investors, BCOT agreed to register its tokens as securities, to cease and desist from violating federal securities laws in the future, and further agreed to pay a $250,000 penalty.

24. The SEC Sternly Advises Against Misrepresenting Advisors. (*In the Matter of Nextblock Glob. Ltd. & Alex Tapscott*, Respondents., Release No. 10638 (May 14, 2019))

As NextBlock Global Ltd.'s (NextBlock) CEO learned the hard-way, telling misrepresenting who your advisors are can have adverse consequences. NextBlock solicited investment through a private placement of convertible debentures in digital assets, such as tokens and coin offerings. A convertible debenture is a type of long-term debt, like an unsecured bond or loan, which can be converted into equity after a specified period. In its pitch deck to prospective investors, NextBlock falsely represented that four prominent, well-known figures in blockchain were serving as advisors for the company. This misrepresentation was part of the selling point of NextBlock's fundraising effort: that NextBlock had access to and relationships with high profile figures, opinion-makers, and entrepreneurs in blockchain. NextBlock went on to raise approximately $16 million.

Besides a court-imposed remedial measure requiring NextBlock to return investor money plus profits and pay a penalty, the SEC required NextBlock's CEO to personally pay a fine of $25,000. In a cease and desist proceeding, the Commission found the company and its CEO in violation of Section 17(a)(2) of the Securities Act for false and misleading statements for the sale of securities.

25. Inexperience Does Not Excuse Offense But Inability To Pay Limit Penalty. (*In the Matter* of *Mutual Coin Fund LLC and Usman Majeed*, Release No. 10624, April 1, 2019)

There is no substitute for experience, as first-time fund manager Usman Majeed of found out. Mr. Majeed, a 27 year-old resident of Saginaw, Michigan, had no prior experience in the securities industry or managing a fund. Yet that did not deter him from setting up a private fund for investing in cryptocurrency. Mr. Majeed consulted with an attorney before the funds formation and filed a Form D notice of exempt securities offerings. But missteps were still made nonetheless. Mr. Majeed misrepresented the amount of money raised by the fund and the size of the fund investments. In addition, at least one non-accredited investor was allowed participate in the fund. Mr. Majeed succeeded in raising $567,000.00 from fifteen individuals, but faired significantly worse in growing the investment, as the fund quickly dwindled to approximately $223,000, a loss of 62%.

Mr. Majeed promptly settled with the SEC and accepted the alleged violations for offering and selling unregistered securities and for making untrue statements in connection with the offer and sale of securities. However, while Mr. Majeed's inexperience did not excuse his offense, his apparent inability to pay limited his liability. Other than requiring Mr. Majeed to notify the investors of the SEC Order, the SEC did not levy a penalty on him, and only required him to turn over the $10,000 in management fees he had "earned" from losing his investors' money.

26. Undisclosed Paid Promotion of ICOs Doesn't Pay. (*In the Matter of ICO Rating*, Respondent, Release No. 10673 (Aug. 20, 2019)).

While penalties for offering and selling unregistered or non-exempt tokens can be substantial, the penalty for noncompliant promotion of tokens can be just as stern, if not more. Operating under the trade name "ICO Rating", the Russian website www.icorating.com reviewed and rated ICOs. The website published its reports and ratings in social media posts. The website promoted itself as "a rating agency that issued independent analytical research, evaluation ICO projects and assigning them ratings." ICO Rating generated significant web traffic from the United States and even contracted with a state-side provider to host its website in the United States. Research and ratings were published in English, imperial figures fashioned in U.S. Dollars.

But unbeknownst to the website's readers, ICO Rating received a fee to rate, produce and publish research reports on ICO projects on its website and social media networks. For its failed disclosure, ICO Rating was found in violation of Section 17(b) of the Securities Act by the SEC. The Russian website was discouraged of its $100,000 in profits and ordered to pay prejudgment interest and civil penalties of for more than $165,000.

As we saw from lesson number 9 in part 1, the same penalties were levied against Floyd Mayweather and DJ Khaled for the same infraction – failing to disclose payment for promotion of an ICO. Both celebrities were disgorged and fined, incurring a net loss from their promotional efforts. On the whole, taking payment for promoting a coin or token without complying with federal securities laws is a losing endeavor. And while the Supreme Court has agreed to review the SEC's pursuit of disgorgement in civil actions, the decision will not impact the SEC's ability to levy disgorgement in administrative actions—a difference that could prompt fewer parties to submit to SEC settlement offers.

Administrative Action Trends For 2020

With 2020 in full swing, blockchain enterprises can expect ongoing scrutiny by U.S. regulators. Already in 2020, the SEC has charged an enterprise with violating antifraud and securities registration provisions of the federal securities laws for scheme involving blockchain software for managing hedge funds. Further action by the SEC and CFTC can be expected when investor protections and anti-money laundering rules are not properly observed. Similarly, as cryptocurrencies continue to rise in value and cryptocurrency trading, options, and swaps continue in popularity, increased interest and scrutiny can be expected by the IRS. Lastly, as an election year, time will tell whether other candidates embrace tokens as means to incentivize participation by campaign supporters and volunteers.