Three Notable Developments for Cryptocurrency Firms Portend Future Regulatory Enforcement Actions

The price of bitcoin is down nearly 80 percent since January 2018. Many other cryptocurrencies are down with it and investors are bearish about the future of digital assets. Atop such industry concerns, three recent regulatory developments portend more enforcement actions and litigation against cryptocurrency actors in the future. We discuss these developments briefly below.

The SEC Charged Its First Crypto Hedge Fund Manager for Failing to Register[1]

On Sept. 11, 2018, the Securities and Exchange Commission ("SEC") announced settled charges alleging that Crypto Asset Management, LP violated securities laws by engaging in an unregistered non-exempt public offering of securities and by operating as an unregistered investment company. The SEC also alleged that the entity and its founder, Timothy Enneking, violated securities laws by making negligent misrepresentations to investors.

Specifically, the SEC alleged that the respondents had illegal raised capital from investors by offering and selling interests in the fund through a website, social media and traditional media outlets without filing a registration statement with the SEC or complying with any applicable exemption from registration. The offer and sale of a security must be registered with the SEC under the Securities Act of 1933 or made under an exemption from the Securities Act's registration requirements (and applicable state law). For more background on the issue, click **here** and **here** to read our insights on LLC interests as securities, and **here** and **here** related to pooled investment entities and investments under the EB-5 program.

Interestingly, this is the SEC's first action against a cryptocurrency fund for failing to register as an investment company. The SEC's case relies on the position that the fund's investments in cryptocurrencies constituted securities. Generally speaking and subject to further conditions and exemptions, an issuer who is engaged in the business of investing, reinvesting, owning, holding or trading in securities is required to register as an investment company under the Investment Company Act of 1940. The fund had failed to register and did not meet any statutory exemption or exclusion.

The SEC's settled order also found that marketing materials used with investors negligently misrepresented "Crypto Asset Fund LLC" as the "first regulated cryptoasset fund in the United States" and that the fund had filed a registration statement with the SEC when it had not, which constituted violations of the Securities Act and the Investment Advisers Act of 1940. Notably, the SEC did not cite any specific allegations of intentional or reckless conduct and, therefore, shows the SEC's willingness in this space to bring enforcement actions based on allegations of negligence alone.

The SEC's settled order noted the respondents' cooperation and remedial acts. Among other actions, the respondents immediately halted the unregistered securities offering when contacted by the SEC's staff, made a rescission offering under a valid exemption from the Securities Act's registration requirement to each investor and corrected misrepresentations. In addition to being ordered to cease and desist from committing future violations, the respondents were censured and agreed, jointly and severally, to pay a $200,000 civil fine.

This case is not only a warning sign to funds looking to offer clients investment opportunities in cryptos, it is also a broader warning to all cryptocurrency firms to be mindful of the broad definition of "security" and whether their business or conduct complies with applicable securities laws.

The SEC Charged Crypto Exchange for Failing to Register[2]

On the same day as the Crypto Asset Management order, the SEC also announced settled charges against TokenLot LLC and its founders Lenny Kugel and Eli L. Lewitt for acting as unregistered broker-dealers. The SEC alleged that Kugel and Lewitt marketed TokenLot as an "ICO superstore" for over 200 digital tokens and promoted and sold digital tokens that included securities in exchange for compensation and, therefore, respondents should have registered as broker-dealers with the SEC.

The SEC alleged that the respondents violated Section 15(a) of the Securities Exchange Act of 1934, which generally requires any broker or dealer effecting transactions in, or inducing or attempting to induce the purchase or sale of, any security to be registered with the SEC. The Exchange Act generally defines a "broker" to mean any person engaged in the business of effecting transactions in securities for the account of others, and generally defines a "dealer" to mean any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. The SEC also alleged that the respondents violated the registration provisions of the Securities Act.

Similar to the respondents in the Crypto Asset Management case, discussed above, the SEC's settled order notes the respondents' cooperation and remedial acts. Among other actions, the respondent voluntarily stopped accepting purchase orders, stopped selling digital tokens and took steps to winding down the business.

In addition to being ordered to cease and desist from committing future violations, the respondents, jointly and severally, agreed to disgorge $471,000 in profits and to pay $7,929 in interest, and Kugel and Lewitt each agreed to pay a $45,000 civil fine. Kugel and Lewitt also agreed to certain industry bars and from participating in penny stock offerings for three years. The respondents also agreed to retain an intermediary, among other things, to destroy all digital tokens in TokenLot's inventory.

The case is notable in that it did not involve any direct allegations of fraud or misrepresentation. Generally speaking, it has been relatively uncommon for the SEC to bring enforcement actions based solely on the alleged failure to register as a broker or dealer in the absence of fraud or some other significant violation. This enforcement action stands as a warning sign to those involved with promoting, selling, trading or providing a market for selling or trading cryptocurrencies, such as exchanges, that they must consult legal counsel to determine if they must register or can operate under an appropriate exemption.

Judge Allows the Government's Case Against Crypto Trader Zaslavskiy to Proceed Finding that a Reasonable Jury Could Find ICO Tokens Are Securities[3]

Many in the crypto space have been following the government's criminal case against Maksim Zaslavskiy alleging that he duped investors into purchasing tokens in two separate initial coin offerings ("ICO") backed by scam enterprises. Zaslavskiy's counsel moved to dismiss the government's indictment arguing that the tokens at issue did not constitute securities and that the securities laws are unconstitutionally vague as applied. The court

disagreed, upholding the indictment and holding that whether the tokens sold in the ICOs constitute securities is an issue for the jury.

This decision could signal that more enforcement actions and criminal cases may have to go to trial rather than be resolved on a dispositive motion. This adds more risk for industry players who have sought to avoid registering cryptocurrencies as securities by trying to distinguish tokens from securities.

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