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DIGITAL CURRENCY AND ITS POSSIBLE FUTURE IN SECURITIES LITIGATION

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Let's start simple, or at least as simple as can be expected for a discussion on potential litigation related to money that for the most part you can't actually hold in your hand like a coin or bill. Virtual currencies are electronic money that some people will agree to accept and treat just like other forms of money. However, virtual currency has distinct differences from traditional currency such as the dollar. First and foremost, no virtual currency is issued or backed by the United States nor is anyone required to exchange them or accept them as payment. Indeed, the whole framework basically depends on a public ledger called the blockchain, digital wallets and a worldwide network of private computers mining information. (If that last sentence sounds confusing, well, hang in there.)

There are over 1,600 different digital currencies but the most well-known for general illustrative purposes is Bitcoin. In guidance published in early 2017, the Financial Industry Regulatory Authority (FINRA) provided a useful primer which attempted to demystify the digital currency and its related terminology. As a starter, FINRA explains that Bitcoin is a cryptocurrency. In other words, it is a digital currency secured by codes that can't be read without a key. The amount of Bitcoin in circulation is determined by an algorithm developed by its founder which determines how many Bitcoins are produced and added to the economy every year through Blockchain technology. Basically, it's a ledger of all Bitcoin transactions that anyone can download but is immutable. "You can only add to it, you can't edit it," explained Dr. Campbell Harvey of Duke University. (There are many technical reasons why that is so, but a discussion of cryptographic links is best reserved for a different author.)

Bitcoins are created by a process called mining which is very labor intensive. However, instead of using hardhats and going down into a mine, Bitcoin miners use software algorithms to add transaction records to the public ledger of past transactions and verify legitimate transactions where Bitcoins are traded or spent. For those efforts, miners receive transactions fees. In addition, if you find a new "block," the miner is awarded bitcoins. (In an oversimplified way, think of a "block" as the distinguishing digital information about a verified transaction which is stored in a public database called the "chain.") Adding to the potential desirability, only a finite number of bitcoins can be mined; 21 million based on the complex mathematics underlying Bitcoin mining.

As most people don't have a PhD level understanding of computer cryptography, there are other options than mining to obtain a virtual currency like Bitcoin. Crypto exchanges work similarly to a stock exchange. An exchange would act as a matchmaker and charge a fee for completed transactions. At present, only a handful of broker dealers have secured approvals to list digital assets and conduct some initial security token transactions. The firm operations section on BrokerCheck for these entities will typically describe the type of business as, "alternative trading system for secondary trading of private and unregistered securities, involving digital assets and securities" or similar such disclosure language. At present, there are supposedly as many as 40 pending applications with FINRA, so the landscape is certainly evolving.

With that evolution will certainly come increased litigation both from securities regulators and public customers. FINRA has repeatedly described virtual currency as volatile, risky, speculative and subject to hacking. The storm warnings are on the horizon. It's certainly easy to envision crypto currency fitting into the commonplace theories of liability in securities arbitrations such as suitability, selling away, Ponzi schemes and fraud. Indeed, recent regulatory actions and guidance have offered a potential framework for such claims by public customers.

A particular instructive example comes from New Jersey where the State recently filed a three-count lawsuit against a blockchain-driven online rental marketplace, and its president. The lawsuit alleges that Defendants offered and sold $410,000 of unregistered securities in the form of a cryptocurrency to 217 investors. The offering was advertised as a way to raise capital to develop an online marketplace using blockchain technology, where consumers would be able to use and spend tokens made available through an Initial Token Offering (ITO). The Defendant is a travel website which linked to the ITO website which advertised that the company was developing an "online community driven marketplace ecosystem [where users would be able to exchange goods and services], built around a decentralized blockchain oriented model." The website further included a link to a private placement memorandum which included a description of the business and tokens. In particular, investor funds were to be used for development and engineering with the tokens to be used for various transactions on the company ecosystem that was under construction.

The tokens were sold pursuant to an exemption from registration that requires all purchasers to be verified as accredited investors. It is alleged that Defendants failed to take reasonable steps to comply with the requirement to ensure that the investors were accredited. The company merely required investors to confirm their accredited status by checking a box during the online investment process. The website requested "income proof documents" but allegedly only 11 of the 217 investors actually provided them. Thus, the vast bulk of investors were approved allegedly without proper vetting of their accredited status. The matter is ongoing.

The SEC undertook recent administrative proceedings which are further instructive. In the Matter of Paragon Coin, SEC administrative proceeding 3-18897, an Order was issued on November 16, 2018 imposing penalties and a cease and desist order. Paragon is an online entity that was purportedly established to implement blockchain technology in the cannabis industry. It sold digital coins issued on a blockchain but did not register the offering nor attempt to qualify for a registration exemption. Digital tokens were sold to the general public via private agreements. A monetary sanction of $250,000 was imposed among other remedial measures.

The SEC also issued an Investor Alert cautioning about Ponzi schemes using virtual currency. The SEC's well-founded concerns are that fraudsters would entice investors into Ponzi schemes in which these currencies are used to facilitate fabricated investments or transactions. Like most Ponzi schemes, the promise of high returns for "getting in on the ground floor" remains a concern as well as the hallmarks of fraudulent Ponzi schemes such as overly consistent returns, unregistered investments, complex strategies and fee structures, and no minimum investor qualifications.

In fact, the SEC has obtained a $40 million judgment against the operator of a Bitcoin Ponzi scheme. In SEC v. Shavers, a federal district court entered final judgment against an online entity created and used to operate a Ponzi scheme through which investors were defrauded out of at least 764,000 bitcoins which, at the time, were worth more than $4.5 million. The defendant solicited investors in online chat rooms and an online forum dedicated to Bitcoin. The defendant promised returns of 7% per week (!) based on trading Bitcoin against the U.S. Dollar. He actually just used the new bitcoin received from investors to pay supposed returns and his personal use. This matter also resulted in the first U.S. criminal securities fraud case related to digital currency as the perpetrator was sentenced to 1 ½ years in prison.

Also of concern is that digital currency is potentially at greater risk for being stolen. Mt. Gox was a bitcoin exchange based out of Japan that, at its height, handled roughly 70% of all bitcoin transactions in the world. Bizarrely, the exchange website initially started as a place for fans of the card game "Magic: The Gathering" to trade cards online before morphing into a bitcoin exchange. In early 2014, it suspended trading and filed for bankruptcy protection. It later announced that approximately 850,000 bitcoins belonging to its customers were missing and probably stolen. That represented roughly 6% of all bitcoins in circulation! A significant portion of the bitcoins were eventually found, but ultimately hundreds of thousands of customer bitcoins were stolen directly from Mt. Gox.

This is merely a starting point for understanding where potential litigation could be headed. In ten years, litigation surrounding digital currency may become commonplace. Indeed, recent regulatory events suggest that it may just be a variation on existing risk management and best practice concerns. However, the backdrop of that history is being written now and may, like evolving technology tends to do, take us to places that we can't now imagine. It's a brave new world.

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