Legal Ethics and Cryptocurrency

September 15, 2018

Panelists

David Hirsch
Securities & Exchange Commission, Fort Worth, TX

Prof. Donna Nagy
Maurer School of Law, Indiana University, Bloomington

Stephen D. Palley
Anderson Kill, Washington, DC

Moderator

Stephen T. Middlebrook
Womble Bond Dickinson, Atlanta

Nebraska Ethics Opinion

- Nebraska Ethics Advisory Opinion No. 17-03 (09-11-17)
- The opinion concludes that an attorney may accept virtual currency as payment for legal services in certain circumstances

- An attorney is prohibited from charging an unreasonable fee. Neb. Ct. R. Prof. Conduct §3-501.5(a)
- Given the volatility of virtual currency exchange rates, in order to avoid accepting an unreasonable fee, an attorney must
  - Notify client that attorney will immediately convert virtual currency to dollars
  - Immediately convert virtual currency to dollars at market rates
  - Credit client's account with amount of converted virtual currency

Nebraska Ethics Opinion

- An attorney may accept payment from a third party only if doing so does not interfere with attorney's independence, relationship with client or client confidentiality. Neb. Ct. R. Prof. Conduct § § 3-501.7(a), 3-501.8(f), 3-501.6.
- Given the pseudonymous nature of many virtual currencies, an attorney should comply with "Know Your Customer" standards when receiving payments from third parties.
- An attorney should request sufficient information about the third party payer to verify its identity.
- An attorney should use a virtual currency payment processor that requires participants to complete a KYC process.

Nebraska Ethics Opinion

- An attorney may hold property, including bitcoin and other virtual currencies, in escrow or trust for clients or third parties. Neb. Ct. R. Prof. Conduct § § 3-501.15(a).
- Property held in escrow should be segregated from attorney's property, be properly safeguarded, and appropriate accounting records maintained.
- Client should be notified that virtual currency held in escrow will not be converted to dollars and may fluctuate in value.
- Reasonable safeguards could include encryption, multi-sig wallets or offline storage of private keys

OGE Ethics Opinion

- Office of Government Ethics, Legal Advisory LA-18-06 (06-18-18)
- Provides guidance on reporting virtual currency on financial disclosure reports under Ethics in Government Act (EIGA)

- EIGA requires federal employees to report any interest in property held for investment or production of income, subject to thresholds
- OGE concludes virtual currency is property held for investment or production of income
- Filers must report holdings in virtual currency if they exceed $1000 or produce more than $200 in income during the reporting period.

OGE Ethics Opinion

- The EIGA requires public filers to report transactions above $1,000 in “stocks, bonds, commodity futures, and other forms of securities” no later than 45 days after the transaction.
- Transactions involving a virtual currency that is deemed to be a security would be reportable
- OGE notes that CFTC has concluded that Bitcoin is a commodity and transactions of commodities do not need to be reported

- Investments in virtual currencies, like investments in other assets, could create conflicts of interest
- OGE warns agency ethics officials to be alert to potential conflicts of interest posed by ownership of virtual currency

House Ethics Committee Guidance

- House Ethics Committee Memo – Cryptocurrencies: Financial Disclosure Requirements and Other Ethics Ramifications (06-18-18)
- For purposes of the Ethics in Government Act (EIGA), cryptocurrencies are considered “assets held for investment or production of income” that must be reported in annual filings if they exceed $1000 or produce more than $200 in income during the reporting period.

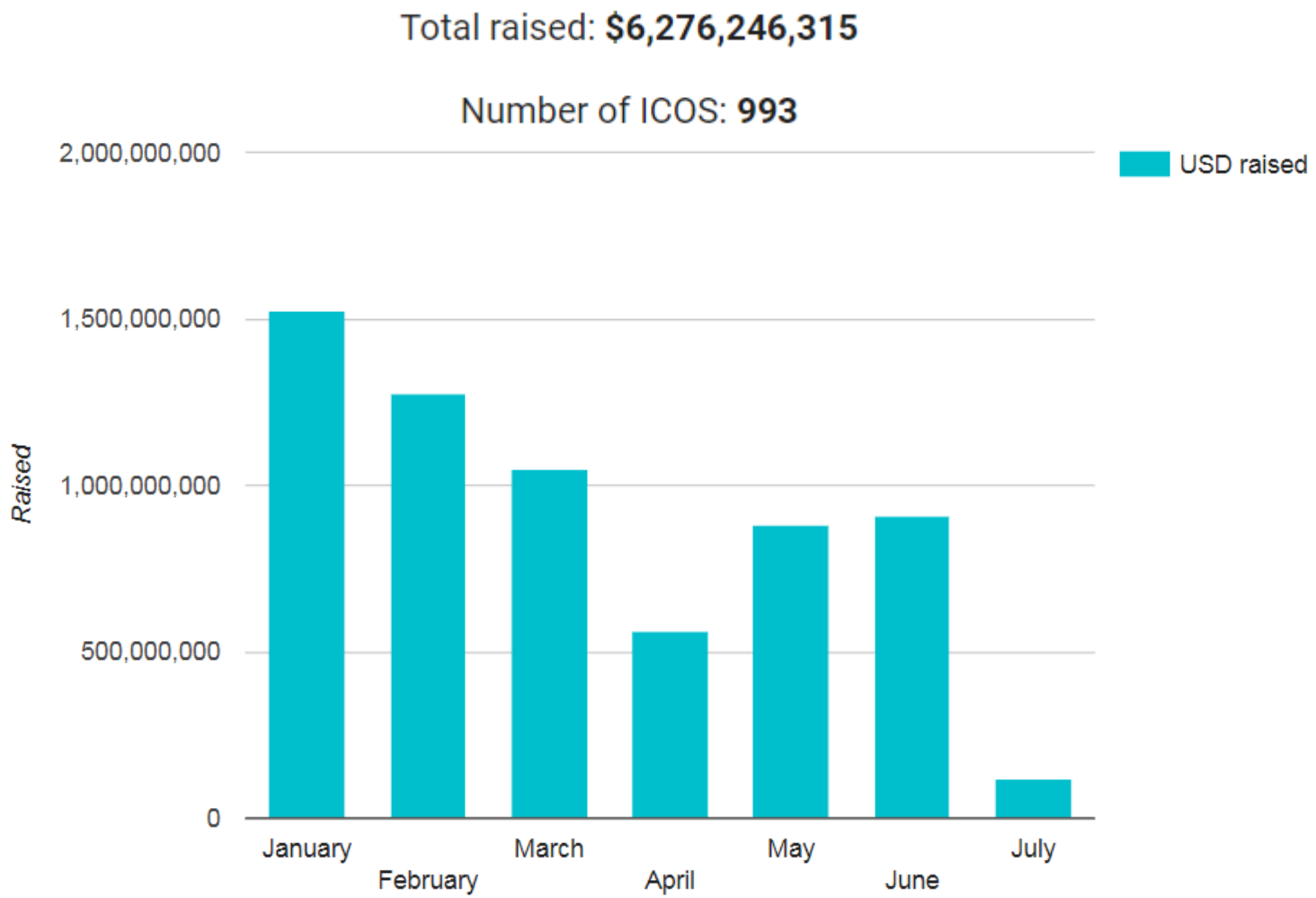
- Under Stop Trading on Congressional Knowledge (STOCK) Act, Members and senior staff must report transactions of “other forms of securities,” including cryptocurrencies, that exceed $1000 within 45 days of transaction.

House Ethics Committee Guidance

- Also under the STOCK Act, Members and employees are prohibited from purchasing securities that are the subject of an Initial Public Offering (IPO) in a manner "other than is available to members of the public generally."
- While Initial Coin Offerings (ICOs) are similar to IPOs, it is unclear if an ICO is covered by the IPO prohibition
- "Strongly encourages" House employees considering participation in an ICO to contact the Committee for guidance before doing so

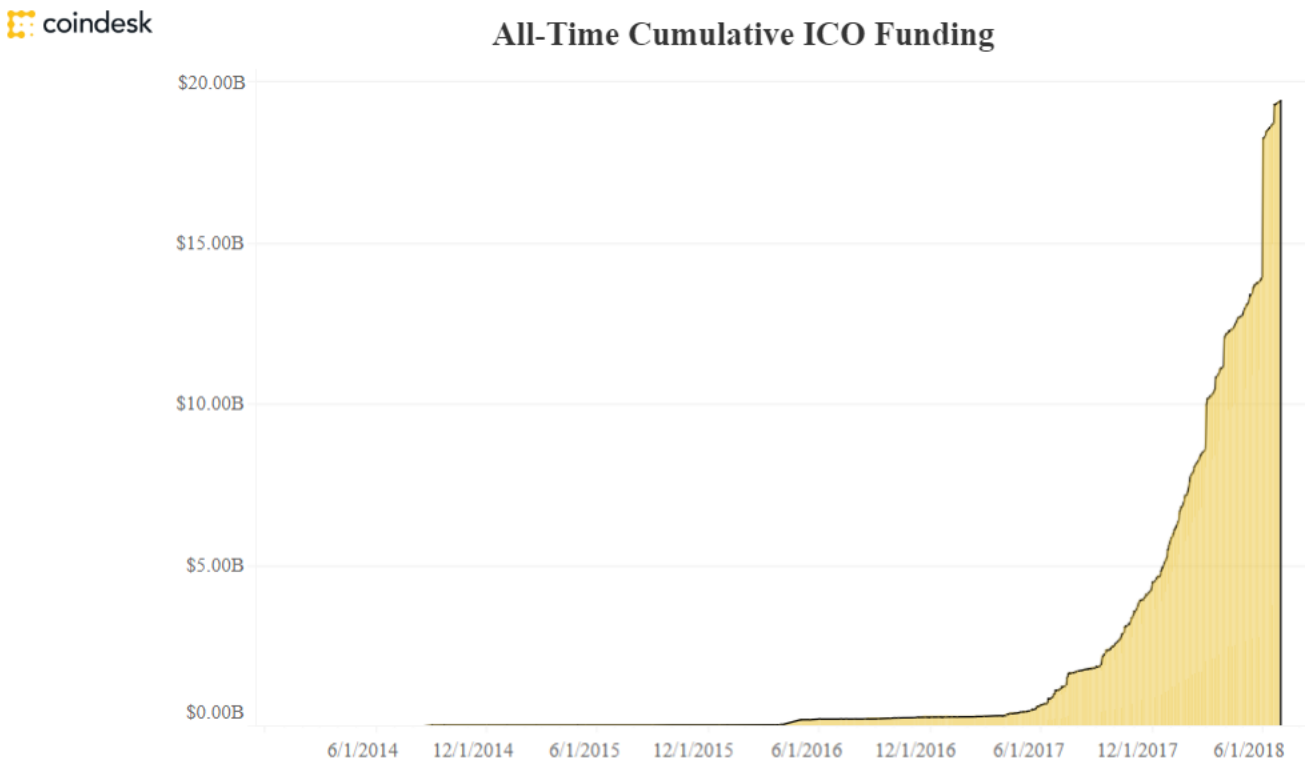
- Rules that prohibit trading on nonpublic information obtained in the course of official duties also apply to trading in cryptocurrencies
- Restrictions on "outside earned income" would apply to compensation earned from mining cryptocurrency

Initial Coin Offerings Raised $6.3 Billion in First Seven Months of 2018



https://www.icodata.io/stats/2018

$20 Billion in Cumulative ICO Funding



https://www.coindesk.com/ico-tracker/

ICOs Have a Poor Track Record

https://www.bloomberg.com/news/articles/2018-06-28/crypto-coin-graveyard-fills-up-fast-as-icos-meet-their-demise

So many ICOs have failed, there is now a website that just tracks Dead Coins.

Regulators Are Investigating Many ICOs

- “Operation Cryptosweep” – state and provincial regulators looked at ICOs and cryptocurrency investment schemes in Summer 2018
  - 70+ ICO investigations
  - 35+ ICO enforcement actions
  - http://www.nasaa.org/45121/state-and-provincial-securities-regulators-conduct-coordinated-international-crypto-crackdown-2/
- SEC has issued dozens of subpoenas and information requests and has taken a number of enforcement actions
- WSJ investigation of 1450 ICOs found hundreds of examples of:
  - Plagiarized investor documents
  - Promises of guaranteed returns
  - Missing or fake executive teams
- The SEC and other regulators are concerned about the role lawyers are playing in some of these projects

SEC Chairman Jay Clayton Raises Professionalism Concerns About ICOs

In a speech given January 22, 2018, SEC Chairman Jay Clayton raised concerns about the levels of professionalism is some of the advice being given to companies engaged in ICOs:

“My first message is simple and a bit stern. Market professionals, especially gatekeepers, need to act responsibly and hold themselves to high standards. To be blunt, from what I have seen recently, particularly in the initial coin offering ("ICO") space, they can do better. ”

SEC Chairman Jay Clayton Raises Professionalism Concerns About ICOs

“Legal advice (or in the cases I will cite, the lack thereof) surrounding ICOs helps illustrate this point. Let me posit a few scenarios. First, and most disturbing to me, there are ICOs where the lawyers involved appear to be, on the one hand, assisting promoters in structuring offerings of products that have many of the key features of a securities offering, but call it an "ICO," which sounds pretty close to an "IPO." On the other hand, those lawyers claim the products are not securities, and the promoters proceed without compliance with the securities laws, which deprives investors of the substantive and procedural investor protection requirements of our securities laws.”

SEC Chairman Jay Clayton Raises Professionalism Concerns About ICOs

“Second are ICOs where the lawyers appear to have taken a step back from the key issues – including whether the "coin" is a security and whether the offering qualifies for an exemption from registration – even in circumstances where registration would likely be warranted. These lawyers appear to provide the "it depends" equivocal advice, rather than counseling their clients that the product they are promoting likely is a security. Their clients then proceed with the ICO without complying with the securities laws because those clients are willing to take the risk.

With respect to these two scenarios, I have instructed the SEC staff to be on high alert for approaches to ICOs that may be contrary to the spirit of our securities laws and the professional obligations of the U.S. securities bar.”

Dave Hirsch

SEC Division of Enforcement

Recent SEC Activity Regarding ICOs

DISCLAIMER

- The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

The DAO

- April 2016 through May 2016
- Raised $150 Million From 12 Million Ether
- Decentralized Autonomous Organization
- DAO Tokenholders Expected to Receive Profits

The DAO

- The SEC Issued the DAO Report in July 2017
- Essentially, the SEC Investigated but Determined Not To Pursue an Enforcement Action
- Explained Why Tokens May Be Securities
- Put Token Promoters and Exchanges on Notice

The DAO

- The SEC Regulates Investment Contracts

- An Investment Contract Is an Investment of Money in a Common Enterprise with a Reasonable Expectation of Profits To Be Derived from the Entrepreneurial or Managerial Efforts of Others.

Subsequent ICO Enforcement

- ReCoin – Alleged Fraud and Registration Violations
- PlexCoin – Alleged Fraud and Registration Violations
- Munchee – Registration Violations Only

AriseBank – Public Claims

- ICO (Initial Coin Offering) Announced October 2017
- Claimed to be the World's First "Decentralized" Bank
- Their Relationships Allowed Them to Offer a VISA Debit Card Allowing Investors to Spend 700 Different Digital Tokens
- Purportedly Raised $600 Million Through Their ICO

AriseBank

- The SEC Pursued an Investigation in Parallel with the FBI
- Quickly Established Numerous Alleged Misleading Statements in the ICO Whitepaper and AriseBank Promotional Materials
- Investigators Encountered Significant Obstacles to Verifying Amounts Raised or Where Funds Were Held

AriseBank

- The SEC Sought and Obtained a TRO By Alleging That:
  - The AriseCoin Token Was a Security, in Part Because it Promised a Return on Investment Based on the Efforts of the AriseBank Promoters
  - AriseBank Lied About Its Relationships and Could Not Offer a VISA Card for Spending Digital Tokens
  - AriseBank Falsely Claimed to Have Acquired an FDIC Insured Bank
  - AriseBank Failed to Disclose that Its CEO Had a Criminal History, Including a Recent Guilty Plea for Tampering with Government Records

AriseBank

- The SEC Sought and Was Granted the Appointment of a Receiver
- On Day One the Receiver Recovered Almost $2 Million, Mostly in the Form of Digital Tokens, Which the Receiver Transferred to Wallets in His Control
- The Receiver Tracked Digital Tokens that Were Taken from an AriseBank Wallet, Liquidated by Unknown Persons, Then Used to Retain Counsel for AriseBank
- Based on a Sworn Accounting the CEO of AriseBank Submitted to the Receiver, the ICO Raised Approximately $4 Million, not $600 Million

Ethics Lessons Gleaned from Recent ICO Enforcement Actions

- Regulators are actively looking at lawyers' involvement in ICOs
- Evaluate public claims:
  - KYC – are the clients who they say they are?
  - Are financial claims supportable?
  - Is there evidence of claimed business relationships
- Be cautious about when advice turns into promotion
- Make sure you have sufficient technical expertise to evaluate your client's marketing claims