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Securities Cops Wary Of Bitcoin Morphing Into Madoff

By **Dunstan Prial**

Law360 (February 7, 2018, 7:20 PM EST) -- The proactive approach U.S. securities regulators are taking toward the dangers posed by cryptocurrencies and their related technologies is exactly the right thing to do to educate and protect vulnerable retail investors from another Bernard Madoff-like debacle, according to legal experts.

A perceived global frenzy for cryptocurrencies such as Bitcoin has led to soaring and plunging valuations accompanied by intense media coverage, all of which has led to fears that digital currencies' value has been blown out of proportion and that the volatile markets could harm investors.

In response, market watchdogs such as the U.S. Securities and Exchange Commission and Commodities Futures Trading Commission are stepping up and warning investors of the potential pitfalls inherent to these new technologies — specifically the proliferation of fraudsters — and attorneys say it's because regulators are wary of missing another massive fraud like Madoff's Ponzi scheme.

"My hat's off to the SEC and the CFTC for being very proactive as opposed to sitting back and waiting until there's a lot of blood on the walls and then waking up," said David Chase, a former SEC prosecutor and now principal in his own Florida-based defense firm.

SEC Chairman Jay Clayton and his CFTC counterpart J. Christopher Giancarlo have regularly **touted** their agencies' unprecedented efforts geared toward protecting investors from getting burned by unscrupulous players in the cryptocurrency markets.

In an effort to add some perspective to the phenomenon, Giancarlo noted Tuesday during a Senate Banking Committee hearing on the need to tighten regulatory oversight of cryptocurrencies that the current market cap of Bitcoin, the most widely owned digital currency, stands at about $130 billion, about the same as the market cap of McDonald's, a single large U.S. company.

“Perspective is critically important,” Giancarlo said, adding, "Clearly, the column inches of press attention to virtual currency far surpass its size and magnitude in today's global economy.”

But despite the actual reach of cryptocurrencies remaining relatively limited, legal experts say getting out in front of the issue is the right way to go.

"This is where the SEC prior to Madoff had historically failed. They'd let other regulators, such as the CFTC or the state attorneys general, take the lead and be proactive,” said Chase. “This is a reflection, to the SEC's credit, of a more nimble and more proactive agency saying, 'Hey, this stuff is emerging, it's out there. Even though on a market-cap level it's less than McDonald's, we see this as a potential threat and we want to be on the front end of it.'"

Mitchell Littman, a partner at Littman Krooks LLP, said federal regulators are still “living in the legacy of things like Madoff. There's a lot of sensitivity, especially at the federal level, that, ‘Hey, we're not going to get a black eye again. We've got to be very focused on these things before they happen, not afterwards.’”

Littman said the high level of regulator focus is needed because unsophisticated investors often get swept up in high-profile trends, whether it be dotcom IPOs as in the late 1990s or the current cryptocurrency frenzy.

Since taking the helm at the SEC in May and making the protection of retail investors a primary focus of the agency, Clayton has taken particular aim at cryptocurrencies, releasing numerous **warnings** to investors through bulletins, public statements and a full-scale investigative report in July targeting issuers of so-called initial coin offerings.

Much of Clayton’s emphasis has been focused on ICOs, in which issuers offer blockchain-based digital tokens, often in exchange for digital currency or cash, to pay for projects. Clayton has vigorously argued that nearly all ICOs are securities offerings and as such should be subject to federal transparency and disclosure laws. When the SEC has determined issuers were flouting federal regulations, the agency has been quick to act by issuing enforcement actions.

Nick Morgan, a partner at Paul Hastings LLP, said the SEC could do a better job of clarifying the definition of a security and the scope of registration exemptions. One way to do that is by issuing no-action letters to issuers seeking guidance on ICOs, Morgan said.

“There are people who are acting in good faith issuing tokens who don’t know whether their token is a security or not, or whether their offering is exempt from registration or not. Those are the two questions we're seeing most,” Morgan said.

The SEC did not respond to a request for comment for this story.

“The advice for potential entrepreneurs who want to conduct virtual currency offerings is first and foremost to be really thoughtful about what it is that we’re offering here. What’s the business? How does it work? What are the fundamentals underlying it?” said Keir Gumbs, a partner in Covington & Burling LLP's Washington, D.C., office, who advises clients on SEC compliance with securities filing.

“And then making sure all of that is in the disclosure documents because to the extent that we don’t have those things in the disclosure documents and things go astray, I don’t think the SEC is going to be distinguishing between people who meant well with offerings that go badly and people who are genuine fraudsters,” Gumbs explained.

The CFTC has also been actively reaching out to investors, in particular retirees who, according to Giancarlo, may believe an investment in a cryptocurrency could be a quick way to supplement a fixed income.

Chase said federal regulators seem determined to warn retail investors that the current cryptocurrency landscape is tantamount to “the wild, wild West on steroids.”

“It’s not that huge of a market yet, but it’s rife with fraud and the potential for it. And you’ve got a vulnerable class of investors that really need the protection,” he said.

Clayton and Giancarlo agreed during Tuesday’s hearing that lack of a clear definition of what the digital currencies are and how they should be sold, traded and valued has contributed to the difficulty in regulating them, a factor the two regulators said may require Congress’ help in passing new legislation.

“The technology is ahead of where the law is so frankly the reaction to that is the correct one,” said Littman. “We have to bring the securities laws into the 21st century. The question really is, what are these things. Is it a security, in which case the SEC has jurisdiction? Is it a commodity, in which case the CFTC has jurisdiction? Is it a currency, which would give the Treasury jurisdiction?”

Digital currencies don’t “fall neatly into any of the boxes that have historically been created under securities laws,” Littman added. “It’s ahead of the curve. What they may have to do is create a brand new box just to address this.”

--Editing by Philip Shea and Kelly Duncan.