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Curb Your Enthusiasm: The Rise of Enforcement Actions and Securities Litigation Involving Digital Currencies and Blockchain

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Although the price of Bitcoin is down nearly 80 percent since January, there continues to be tremendous interest in digital currencies and assets (sometimes referred to as “cryptocurrencies”), and in the potential benefits of the underlying blockchain technology. Indeed, according to [one estimate](#), through August 2018, there have been 706 initial coin offerings (“ICOs”) for blockchain startups in 2018 alone, raising over \$18 billion from a mix of institutional investors and individuals; this compares with 221 ICOs raising \$3.7 billion in 2017. This new-found enthusiasm in ICOs stems from the purported ease in which a company can obtain equity-like financing via issuing digital tokens or cryptocurrency in lieu of the more formal and traditional route of raising funds by issuing equity interests in such a company in accordance with applicable securities laws.

Two recent, first-of-their-kind enforcement actions, and the surge in securities lawsuits over the past year, may temper that enthusiasm. For over a year, the Securities and Exchange Commission (“SEC”) has cautioned businesses who invest in, offer, or trade digital assets that federal securities laws apply to their activities and that they have a responsibility to comply with those laws. On September 11, 2018, the SEC reinforced this warning by announcing the settlement of two enforcement actions against companies and individuals in the digital currency and blockchain space who failed to do just that, resulting in disgorgement of profits, monetary penalties, and bars from further trading.

Digital Asset Fund Manager Charged With Misrepresentations and Registration Failures

In *In the Matter of Crypto Asset Management, LP and Timothy Enneking*, the SEC found that Crypto Asset Management LP (“CAM”), a California-based hedge fund manager and its sole principal, Timothy Enneking, falsely represented to actual and prospective investors that its fund was “the first regulated crypto asset fund in the United States” and had filed a registration statement with the SEC. From August-December 2017, CAM and Mr. Enneking raised over \$3.6 million from investors while falsely claiming in marketing materials that the fund was regulated by the SEC and that a registration statement had been filed.

The SEC also found that CAM violated federal securities laws by failing to register the fund as an investment company. By engaging in an unregistered, non-exempt public offering and investing more than 40 percent of the fund's assets in digital asset securities, CAM caused the fund to operate as an unregistered investment company. As a result, the SEC ordered CAM and Mr. Enneking to cease-and-desist its activities and

pay a \$200,000 penalty.

The order against CAM marks the SEC's first-ever enforcement action finding a violation by a hedge fund manager based on its investments in cryptocurrencies and other digital assets.

Digital Token Traders Improperly Operating as Unregistered Broker-Dealers

In *In the Matter of TokenLot, LLC, et al.*, the SEC charged a digital token trading company and its owners with acting as unregistered broker-dealers. This enforcement action is the first charging unregistered broker-dealers for selling digital tokens since the SEC issued what has become known as “the DAO Report” – a [July 2017 investigative report](#) warning those who offer and sell digital assets using blockchain technology, including ICOs and “token sales,” that they must comply with federal securities laws.

Michigan-based TokenLot LLC (“TokenLot”) – a self-proclaimed “ICO Superstore” – and its owners Lenny Kugel and Eli Lewitt operated a website platform through which the company marketed and sold digital tokens to investors in connection with ICOs offered by other entities. The website platform also facilitated TokenLot's trading of digital tokens in the secondary market. TokenLot received orders from more than 6,100 retail investors and handled more than 200 different digital tokens.

Because the digital tokens issued in connection with the ICOs and traded by TokenLot, Mr. Kugel, and Mr. Lewitt were securities, their activities required them to be registered with the SEC as broker-dealers, which they failed to do. By effectuating unregistered securities transactions as unregistered broker-dealers, TokenLot, Mr. Kugel, and Mr. Lewitt were charged with violating federal securities laws. As a consequence, they were ordered to disgorge over \$471,000 received in compensation for these activities. Mr. Kugel and Mr. Lewitt agreed to pay penalties of \$45,000 each and submit to industry bars for a period of three years. In its [press release](#) announcing this enforcement action, the SEC was careful to point out that TokenLot's activities occurred after the DAO Report was issued, suggesting that they, and others who purport to trade digital tokens, are on notice of the applicability of United States securities laws to digital assets.

Rise in Securities Litigation Related to Blockchain and Digital Currencies

In addition to this increase in enforcement actions, securities lawsuits filed over cryptocurrencies or blockchain-based ICOs are on the rise, having tripled over the past year. According to a [new report](#) released by legal analytics firm Lex Machina, 45 cases have been filed so far this year that mention “blockchain,” “cryptocurrency” or “bitcoin” in their filings, as compared to only 15 filings in 2017. The SEC is responsible for 30 percent of those cases filed in 2018. Other cases include securities class actions asserting allegedly false and misleading statements related to ICOs.

Key Takeaways

The rise in enforcement actions over the past year makes clear that those seeking to ride the digital asset wave must comply with United States federal securities laws. The SEC's DAO Report put businesses on notice of the applicability of securities laws to digital assets. Investment advisers, fund managers, broker-dealers, and others involved in trading such assets who fail to ensure that their activities and offerings adhere to applicable registration obligations and provide accurate representations of those offerings do so at their peril. Those companies wading into the digital currencies and blockchain space must also weigh the increased risks of litigation arising from such activities.