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WHITE PAPER

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Texas Enforcement Sweep Finds Widespread Fraud in Cryptocurrency Offerings

The surge in cryptocurrency activity has led to an increase in attention from enforcement authorities at both the state and national levels. The Texas State Securities Board launched an investigation into cryptocurrency offerings made available to the state's residents late last year, resulting in nine enforcement actions in less than six months.

This Jones Day *White Paper* describes the investigation and the enforcement sweep that followed.

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As the price of bitcoin rose to unprecedented levels in 2017, regulators began focusing more enforcement resources on cryptocurrency offerings, both at the federal and state levels. At the state level, the Texas State Securities Board (“TSSB”) has led the way. In late 2017, the TSSB quietly launched an investigation into cryptocurrency offerings being made to Texas investors. The TSSB announced the results of that investigation last month, indicating that it had found widespread fraud in cryptocurrency offerings. As a result of that investigation, the TSSB has brought nine enforcement actions over a span of less than six months. Given the growing investment in cryptocurrencies, we expect to see continued use of enforcement actions by the TSSB and other state regulators as one of the principal tools to regulate this growing market.

THE TEXAS STATE SECURITIES BOARD

The TSSB is comprised of five members who are appointed by the governor of Texas for staggered terms of six years. The TSSB appoints a Securities Commissioner (“Commissioner”), who is charged with administering and enforcing the Texas Securities Act (“Act”). Broadly speaking, the Act requires the registration of securities and the individuals and firms that sell securities or offer investment advice in Texas. It also authorizes periodic examinations of registered individuals and firms, as well as enforcement actions against alleged violators of the Act.

When the Commissioner suspects that someone has violated the Act, the Commissioner notifies the person of the alleged violation and, within 30 days of the notice, holds a hearing to determine whether a violation has occurred. If the Commissioner finds evidence of a violation, the Commissioner issues a cease-and-desist (“C&D”) order to prohibit the violation from continuing. If the Commissioner determines that conduct threatens immediate and irreparable public harm, the Commissioner has the authority to issue an emergency C&D order. Such orders become final and nonappealable unless the recipient requests a hearing within 31 days.

In addition, the Commissioner may deny, revoke, or suspend dealer, agent, and investment adviser registrations; impose administrative fines; deny or revoke the registration of securities;

revoke exemptions from registration; and issue cease-publication orders. When the Commissioner has evidence of criminal conduct prohibited by the Act, the Commissioner refers it to district attorneys or United States attorneys for prosecution.

THE CRYPTOCURRENCY OFFERINGS INVESTIGATION

Starting December 18, 2017, the TSSB initiated 32 investigations of securities offerings tied to cryptocurrencies within a four-week span. On April 10, 2018, the TSSB released a report summarizing the results of its investigation. Among the report’s most notable findings were:

- Thirty of the 32 promoters used websites, social media, and online advertising to market their investments to Texans, but none of the 32 promoters had registered to sell securities in Texas;
- At least five promoters guaranteed returns, some as high as 40 percent per month;
- At least six promoters attempted to recruit sales agents to sell their investment program without verifying that the sales agents were registered with the TSSB; and
- Six of the offerings involved the payment of a “finder’s fee” or other commission to investors who recruited other investors, such as family or friends.

Importantly, the TSSB’s report stated that it is “not regulating cryptocurrencies themselves, only the investments that claim to use virtual currencies in an investment program.” But what the TSSB regards as an investment scheme tied to cryptocurrencies (as opposed to the underlying cryptocurrencies themselves) remains to be seen. And as we describe below, in at least one case, the TSSB claimed that a new cryptocurrency was in fact a security and issued an order against its promoter for failing to register it with the TSSB.

THE ENFORCEMENT SWEEP

Since the start of the TSSB investigation, the Commissioner has issued nine C&D orders against promoters of alleged illegal or fraudulent investments in cryptocurrency-related offerings. We briefly describe each below.

USI-Tech

One of the first targets of the TSSB's investigation was Dubai-based USI-Tech Limited (USI-Tech). On December 20, 2017, the Commissioner issued an emergency C&D order to halt USI-Tech's cryptocurrency investment offering, the first such order issued by any state securities regulator. The order stated that neither USI-Tech's offering nor its agents were registered in Texas, and that the promoters were engaged in fraud.

USI-Tech marketed an investment offering known as a BTC Package that allegedly derived its value from a "non-exclusive interest in a series of Bitcoin mining contracts." USI-Tech advertised that purchasers of the BTC Packages "have enjoyed profits of up to 150%." Further, USI-Tech provided what was purported to be a "binding legal opinion letter" stating that USI-Tech was a "legal business in good standing," and told investors that it had "certified legal products in the USA per the FTC." The C&D order pointed out, however, that the TSSB regulates the registration of securities in Texas, not the Federal Trade Commission.

BitConnect

On January 4, 2018, the Commissioner issued an emergency C&D order against BitConnect, a United Kingdom-based company, due to its alleged illegal and fraudulent offering of investments in a cryptocurrency lending program. BitConnect issued its own cryptocurrency called BitConnect Coins. In an investment scheme called the BitConnect Lending Program, investors purchased BitConnect Coins and then lent their coins to others. The promoters claimed that the program generated returns as high as 40 percent per month. The Commissioner concluded that this investment and others offered by BitConnect were securities that were not registered as required by the Act. Shortly thereafter, BitConnect announced the closure of its cryptocurrency lending and exchange programs, citing the emergency C&D order as a "hindrance."

R2B Coin

R2B Coin is a company based in Hong Kong that sold a pre-mined cryptocurrency called r2b coin that it claimed to be "the most stable digital currency in the world." R2B Coin represented to investors that r2b coin was distributed by the Williams Corp. Ltd., a company that it claimed was a "licensed global firm" and "licensed securities dealer" based in Hong Kong and Dubai. The Commissioner alleged that R2B Coin

also told investors that the r2b coin "will never go down in value" and claimed that investors could be "passive" and just "sit back and watch" their investment grow. These and other allegedly false and misleading statements led the Commissioner to seek an emergency C&D order against R2B Coin on January 24, 2018 for misleading and deceiving investors, and for Williams Corp. Ltd.'s failure to register to sell securities in Texas.

DavorCoin

On February 2, 2018, the Commissioner issued an order against DavorCoin for fraudulently offering investments in a cryptocurrency lending program to Texans. DavorCoin allegedly promised investors lucrative profits if they invested in a lending program based on a new cryptocurrency called davorcoin. This lending program, according to the TSSB, was an offer of unregistered securities under Texas law. The order also alleged that DavorCoin committed fraud by concealing the identity of its principals and its creators and by making numerous false and misleading statements, including that davorcoin could be traded like stock on popular exchanges.

Prior to the Commissioner's order, davorcoin had a market capitalization of approximately \$67.6 million. After the order, DavorCoin closed its lending program and the davorcoin market value fell to virtually zero.

Investors in Crypto LLC

On February 15, 2018, the Commissioner entered an order in which Daniel Neves, the CEO of Investors in Crypto LLC, agreed to stop selling investments in a cryptocurrency trading program until he and his firm register with the TSSB or qualify for an exemption. Neves and his firm offered the investments through public advertisements in an online financial services forum and through popular social media platforms. The Commissioner said, in connection with this order, that the TSSB "welcomes the cooperation of firms that indicate they want to comply with registration requirements."

LeadInvest

On February 26, 2018, the Commissioner issued an emergency C&D order against LeadInvest. LeadInvest made offers through a website that claimed to show images of LeadInvest's

advisors and legal team, but in reality those images were misappropriated from other websites. Notably, LeadInvest included one image that it claimed showed people who formed its Code of Ethics Association but that in fact was of several former U.S. Solicitors General and U.S. Supreme Court Justice Ruth Bader Ginsburg at a conference in 2005. Other images purportedly of LeadInvest staff were stock images of models from other unrelated websites.

The order claims that LeadInvest illegally and fraudulently offered at least three investment programs: a cryptocurrency mining program; the opportunity to have a “specialist” manage investors’ principal; and an investment program based on lending money to LeadInvest in return for interest payments.

Financial Freedom Club, Inc., et al.

On April 5, 2018, the Commissioner entered an emergency C&D order against Mark Moncher, a convicted felon, and his company, Financial Freedom Club, Inc., among others. The Commissioner claimed that the group was offering an unregistered cryptocurrency trading program that promised to deliver 8% returns each week. As part of the scheme, the promoters encouraged investors to file materially false or misleading reports with financial institutions, a criminal offense in Texas. In addition, the promoters offered promissory notes tied to the sale of marijuana and that promised “100% guaranteed” returns. The Commissioner charged them with fraud in connection with the offer or sale of a security and with failing to register to sell securities in Texas.

Bitcoin Trading & Cloud Mining Ltd.

Bitcoin Trading & Cloud Mining Ltd., also known as BTCRUSH, is allegedly offering investments in a cloud-based cryptocurrency mining program to Texas investors through a website. According to an emergency C&D order dated May 8, 2018, BTCRUSH is promising investors 4.1 percent interest per day with a “100% satisfaction guarantee” and showing videos that falsely depict the purported mining operations with stock video that is available online. The Commissioner charged BTCRUSH with registration violations, misrepresentations regarding the profitability of the operation, and failure to disclose risks associated with cryptocurrencies and mining operations.

Forex EA & Bitcoin Investment LLC

Also on May 8, 2018, the Commissioner issued another emergency C&D order against Forex EA & Bitcoin Investment LLC and its principals, who allegedly are operating a cryptocurrency-focused investment scheme out of New York that targets Texas investors. According to the C&D order, the company is claiming that investments involve no risk and are guaranteed to not lose money. The Commissioner charged the company and its principals with registration violations and fraud in connection with a securities offering.

LOOKING FORWARD

The cryptocurrency market shows no signs of slowing down. Through the first quarter of 2018, cryptocurrency investments continued at a record-setting pace, with more than \$6 billion raised through initial coin offerings alone. At the same time, regulators continue their efforts to stamp out fraudulent offerings to protect investors. Beyond Texas, regulators in Florida, North Carolina, Kansas, and Massachusetts have issued warnings to investors about potential scams involving cryptocurrencies, or brought enforcement actions against alleged fraudsters. And regulators in New York recently started investigating the policies and practices of cryptocurrency trading exchanges.

We are hopeful that legislators and securities regulators in Texas and beyond will provide clear guidance for the burgeoning cryptocurrency market. In the meantime, however, in Texas we expect to continue to see C&D orders as the principal tool to regulate this market. Thus, promoters and investors alike need to be alert to the risks inherent in offering and purchasing investment products tied to cryptocurrencies in Texas. Promoters should take care to accurately describe their investment programs, disclose the risks associated with them, and register with the TSSB (unless they qualify for an exemption). Investors need to take the time to understand cryptocurrency offerings before investing in them and should be skeptical of promises of outsize returns or incomplete information about the investment product, strategy, and the management team.

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