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## KEEPING UP WITH THE CRYPTOS

### Cryptocurrencies Likely “Best Fraud Show” in 2018

by S. Gregory Hays<sup>1</sup>

Charles Ponzi, the notorious fraudster, was always the showman and loved the spotlight. In his last interview before his death in 1949, he told a reporter:

Even if they never got anything for it, it was cheap at that price. Without malice aforethought I had given them the **best show that was ever staged** in their territory since the landing of the Pilgrims! It was easily worth fifteen million bucks to watch me put the thing over.<sup>2</sup>

With last year’s dramatic price increases and this year’s decline coupled with rampant fraud, the cryptocurrency market may be the “best fraud show” to watch in 2018. When I started drafting this article in early January, the price of Bitcoin was around \$16,000 and the price at the time of publication on 2/12/18 is approximately \$9,000, a 50% decline this year. The total market cap of all cryptocurrencies fluctuated by almost \$560 billion between January 1<sup>st</sup> and February 12<sup>th</sup>. The cryptocurrency story changes every day with new developments and rumors from around the world. Given the fraud and speculation, it is important for receivers to understand cryptocurrencies as regulators introduce new regulations and pursue the fraudsters and tax cheaters.

A few interesting and alarming cryptocurrency data points as of February 12, 2018 are summarized below. These figures, which change daily, are based on currently available sources referenced herein to provide a point of reference to provide an overview of the market:

#### Cryptocurrencies

- 1,526 cryptocurrencies (coins & tokens)
- 170 new initial coin offerings this year
- \$434 billion market cap for all cryptocurrencies
- \$500 billion increase in market cap in 2017
- 5,000 cryptocurrency investment frauds<sup>3</sup>
- 1 SEC receiver appointed

#### Bitcoin

- \$150 billion market cap
- 40% of Bitcoins are owned by 1,000 people<sup>4</sup>
- 17% to 23% estimate of all Bitcoins mined that have been lost<sup>5</sup>
- 70% of Bitcoin trading is in China
- 30% of Koreans own Bitcoins<sup>6</sup>
- 98% of trading addresses have less than \$100 invested<sup>7</sup>
- 58% of purchasers are under age 34<sup>8</sup>
- 20% of Bitcoin purchases are with debt<sup>9</sup>
- 802 total investors in the US have reported Bitcoin income to the IRS
- \$172 million in hacks at prices at the time of theft<sup>10</sup>
- 1 hour to process a Bitcoin transaction<sup>11</sup>
- \$28 transaction fee when most accounts have less than \$100<sup>12</sup>

#### The Speculative Cryptocurrency Market Is a Sideshow

Many industry experts and speculators asserted at the beginning of the year that Bitcoin would continue its dramatic climb and would double or triple in price this year. Other investors saw the bubble and shorted Bitcoin in anticipation of a crash and profited with the 43% YTD decline. Many retail investors are fascinated by Bitcoin but it appears to others as merely wild gambling. On January 10, Warren Buffett said: “I can say almost with certainty that they will come to a bad ending.”<sup>13</sup> According to an early January analysis of the transactions on the CBOE Exchange, most retail investors were long, while hedge fund money was short.<sup>14</sup>

A comparison to gold prices helps put this speculation into perspective. **In mid-December when Bitcoin was at \$20,000, one Bitcoin had almost the same value as a pound of real gold.** At the February 12th price of \$9,000, a Bitcoin is worth about 6.8 ounces of real gold. A recent article suggested there is a potential negative correlation between investors’ interest toward gold and cryptocurrencies.<sup>15</sup> Other articles suggest investors are leaving gold for Bitcoins.<sup>16</sup> At the first of the year, the market cap of cryptocurrencies



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approached \$800 billion and there is only approximately \$200 billion in real gold at Fort Knox.<sup>17</sup>

The speculative market is being driven by investor factors that have been described in various articles as including:

1) Fear of Missing Out (“**FOMO**”), which occurs when new investors hear stories of spectacular gains and new millionaires and rush to be part of the story to avoid being left behind.

2) Hold on for Dear Life (“**HODL**”), which is how many articles explain the investment strategy of just hoping for the best during volatile price swings. There is a great deal of HODL discussion with the currently declining market.

3) Fear, Uncertainty and Doubt (“**FUD**”), which refers to the spreading of false or misleading information to foes of cryptocurrency.<sup>18</sup>

## Categories of Cryptocurrencies: Altcoins vs Tokens

There are two categories of cryptocurrencies which are commonly called altcoins and tokens. Altcoins are new cryptocurrencies launched after the success of Bitcoin and generally project themselves as better substitutes or have a new twist to Bitcoin. They are often based on Bitcoin's open-sourced protocol with changes to the original code, but the common characteristic is they have their own independent blockchain. Tokens on the other hand represent a particular asset or utility that resides on top of another blockchain that facilitates a decentralized application. There are currently about 300 more altcoins than tokens, and all are listed on Coinmarketcap.com as cryptocurrencies.

The marketing and monetization of altcoins or token is in a public offering like an IPO is known in the industry as an Initial Coin Offering or (“**ICO**”). Analyses have shown that the lowest priced ICO's produced the highest returns in 2017, and this demonstrates the pure speculation with investors purchasing the least expensive altcoins and tokens. One recent altcoin that received a lot of media attention is Ripple which trades under symbol XRP. The coin surged from 24 cents in December to a high of \$3.86 on January 4<sup>th</sup> and is trading at \$1.00 on 2/12/18. The sudden surge is profiled on Bitcoin.com and the article summarizes: “Ripple isn't the first asset to be shilled to the moon and back, and it certainly won't be the last. When the cryptocurrency history books are written, ripple will go down as a textbook case of mass hysteria.”<sup>19</sup>

Other examples of altcoins are Bitcoin God that trades under the symbol “**GOD**”<sup>20</sup> and Fantasy Market which is a coin referred to as “Bitcoin for Porn.” The Fantasy Market owner disappeared recently and apparently stole investors' money.<sup>21</sup> GOD was launched on January 12<sup>th</sup> and initially doubled in price and is now 67% below the offering price. There are many unusual investment options among the 1,526 cryptocurrencies.

## The “Blockchain” Is the Real Show

Bitcoins and other cryptocurrencies are created with “blockchain” technology. While much of the cryptocurrency news revolves around currency speculation, most coverage ignores the new technology underlying the offerings. In simplest terms, blockchain is a digital ledger of records that are linked, secured and shared across many computer networks. Many experts claim the blockchain technology has the potential to be a game-changing and disruptive force. Many major companies are exploring how to use the distributed ledger technology and smart contracts in their businesses, but that does not justify the irrational trading in new start-ups.

A real question is why there are 1,526 new companies when major technology companies appear to be on the sidelines. Consider that Facebook, Amazon, Google, or Apple could use the blockchain tech-

nology in a private blockchain or even start their own currency. One recent article discussed this and stated: “if blockchain did in fact have the technical merits that people claim it does, it's unlikely that the technologists at these [major tech] companies would seemingly care so little about it...given that companies like Facebook, Amazon, Google and Apple are not doing much with blockchain, even in the face of ever-increasing frenzy surrounding this technology, one could not be blamed for doubting blockchain's potential as a game-changing paradigm.”<sup>22</sup>

Other major tech companies are implementing the use of blockchain technology. One example is IBM which is running 35 blockchains they simply refer to as “active networks” where there are “multiple institutions actively exchanging things of value thorough a distributed ledger.”<sup>23</sup> The implementation of blockchain technology by major corporations will be the important story to focus on this year.

## How are Bitcoins Mined and Who Is Mining?

While the details of the complicated process of mining Bitcoins is beyond the scope of this article, Bitcoin mining is the computing process that verifies transactions and adds them to the public ledger, called the blockchain, to earn a reward of new bitcoin. Mining involves compiling all recent transactions and then solving a difficult puzzle quickly. The first miner to complete the task gets a reward for the transactions and the new Bitcoin. More than five years ago, mining was a rather simple process that could be done on a laptop computer, but it has grown to be a complicated and expensive process that requires extensive computer power and a tremendous amount of energy. The cost in electricity to mine Bitcoins in the US is estimated to be between \$3,000 and \$6,000 in energy costs per Bitcoin.<sup>24</sup> There are many interesting videos on mining on the web that show the largest miners and the thousands of computers used in the mining. Recently thousands of UK government computers were hijacked and the processing power was stolen to mine cryptocurrency in a process that has become known as “**cryptojacking**”.

There are currently 16.8 million Bitcoins that have been mined out of a maximum of 21 million. According to research from Chainalysis, between 2.8 and 3.8 million Bitcoins are lost forever, which is 17% to 23% of the total coins mined. At today's prices, that is in the \$25 to \$34 billion range. This does not include stolen coins as they are still in circulation. It does include 1 million Bitcoin that the founder of Bitcoin mined in 2009 and all the coins that have disappeared or have been lost. In the early years of Bitcoin (2009 to 2013), the coins had little value and many miners did not safeguard the private keys to their coins, and have now lost their ability to recover the Bitcoins.<sup>25</sup>

## Who Is Buying Bitcoins?

The market is being fueled by millions of young males across the globe using credit cards to finance the investment. Very few people over age 40 participate in the speculation and gambling in digital gold. A recent article on Bitcoin.



com regarding a 2018 survey of investors stated: “A supermajority of the holders are male, under 34 years of age (58%), white. One analyst phrased the results as basically admitting ten percent of millennials own Bitcoin while older Americans break one percent.”<sup>26</sup>

The vast majority of millennial investors were only kids during the dotcom bust and were college-age during the Great Recession and have not experienced a bubble collapse. A recent poll by LendEDU, a student loan refinance company, indicates that 20% of all Bitcoin buyers are using credit cards to fund investments. This study was based on an online poll. The study said that 90% of the Bitcoin borrowers planned to pay off the debt by selling Bitcoins.<sup>27</sup> With the recent price declines, many recent investors may have had a rude awakening with high credit card balances.

Much of the trading volume is coming from China, Russia and South Korea. It is reported that in South Korea one third of all workers have purchased Bitcoins.<sup>28</sup> In Russia, more than 56% of the population knows about Bitcoin, and it is the most popular word in Russian social media.<sup>29</sup>

David Stockman, former budget director for Ronald Reagan, recently summed up the investor class by stating:

It's basically a **class of really stupid speculators** who have convinced themselves that trees grow to the sky. It will burn out in a spectacular crash. All of these latter-day speculators will have their hands burned to a crisp, and they will learn the proper lesson.<sup>30</sup>

## Is Bitcoin a Ponzi Scheme?

Many economists, advisors, international governments, and media representatives have labeled Bitcoin and other cryptocurrencies as a Ponzi scheme. While Bitcoin does not fit the legal definition of a Ponzi scheme in the United States, since the Great Recession the term Ponzi scheme has been more widely used in the media to describe frauds in general. The term is generally used around the world to refer to any form of a swindle or fraudulent investment scam.

Bitcoin and other cryptocurrencies have been in a worldwide speculative bubble, but investors are not being paid back directly with funds of other investors or have other specific characteristics associated with the legal definition of a Ponzi scheme.<sup>31</sup> There is no profit being generated on economic activity and only transfers of value from one group to another. However, there appear to be many Ponzi schemes associated with raising funds to invest in Bitcoin, altcoins and tokens.

The IMF published a working study on Ponzi schemes in 2014 that said Bitcoin was a “naturally occurring Ponzi.” The author, Kaushik Basu, World Bank economist, explains a natural Ponzi as “financial bubbles that form without the manipulator’s baton but from finished natural market forces and with one person’s expectations feeding into another’s.”<sup>32</sup> I had not heard the term “naturally occurring Ponzi” before and do not understand what is “natural” about virtual, digital currency. At the time, the IMF generally indicated Bitcoins were in a bubble. Receivers in the US would generally call such schemes “Ponzi-Like” instead of a “naturally occurring Ponzi.”

Some cryptocurrencies are indeed Ponzi schemes. One offering was shut down after an Emergency Cease and Desist Order was entered on January 4th by the Texas State Securities Board against British company Bitconnect. Bitconnect subsequently closed on January 17th. Bitconnect provided Bitcoin owners an opportunity to sell their Bitcoins to Bitconnect and buy Bitconnect Coins (BCC). The BCC were then lent out and investors were to earn a guaranteed profit of up to 120% per year. The BCC coin price tumbled from \$437.31 on December 29th to \$2.97 on February 12th.<sup>33</sup> However, what is amazing is that BCC has a new ICO in the works called BCCX and plans to raise \$588 million.<sup>34</sup>

Bitcoin Savings and Trust is another example of a Bitcoin Ponzi scheme that was shut down in 2012. The promoter raised more than 700,000 Bitcoins and promised 7% weekly returns.

## Types of Fraud in Cryptocurrencies / Cryptocrime

Because Bitcoins and other cryptocurrencies are untraceable and exist only in a virtual world, they are a vehicle for criminals to hide money and conduct illicit activities. They also are susceptible to hackers to steal and resell anonymously. Larry Fink, CEO of Black Rock, recently stated: “Bitcoin just shows you how much demand for money laundering there is in the world. It’s an **index of money laundering**.”<sup>35</sup>

A report entitled “*The Changing Nature of Cryptocrime*” prepared by Chainalysis in January 2018 stated that the use of Bitcoins to buy drugs on the darknet has declined from 30% in 2012, when Silk Road was popular, to less than 1% in 2017. However, the report notes over \$660 million of Bitcoin was sent to darknet markets in 2017 even though the largest darknet markets have been shut down by law enforcement. Chainalysis states that “Bitcoin is no longer just about cryptocrime, and that cryptocrime is no longer just about the illicit exchange on the darknet markets, but it is increasingly focused on the theft of Bitcoin as a highly valued financial asset.”<sup>36</sup> As Bitcoins have become more valuable, “crypto-theft increased at least 7-fold. Crypto-thieves tend to steal Bitcoins through scams, ransomware, and hacks.”<sup>37</sup> The report states: “Hacks have been responsible for at least \$172 million worth of Bitcoins between 2013 and 2017, using prices at the date of the hack. Recent hacks, of NiceHash in December 2017 and Bitfinex in August 2017, have been the most valuable given the high Bitcoin prices at the time of the hacks.”<sup>38</sup>

There is a wide range of fraudulent activity from totally false coin offerings, pump and dump schemes on the dark web,<sup>39</sup> ransom claims, extortion, money laundering, and the hacking theft of coins. One team of computer science professors analyzed the frauds by producing a study from voluntary reports in online forums, and categorized them into four groups: Ponzi schemes, mining scams, scam wallets and fraudulent exchanges.<sup>40</sup> The professors have more work coming out this spring based on further market analysis. They identified a new scam nearly every day between June 2011 and November 2016 which totals 1,780 distinct scams by reviewing reports on cryptocurrency message board site bitcointalk.org.<sup>41</sup>

A website named **Badbitcoin.org** lists over 5,000 frauds for the primary cryptocurrencies. The site states its mission as: “We aim to expose the sites that deliberately set out to defraud you, and list them before they can do too much harm... If it is in our badlist, it is an intentional fraud. You have been warned.”<sup>42</sup>

## Market Manipulation

The underlying deception in Charles Ponzi’s scheme was a foreign exchange gap where he made a profit by selling return stamp coupons that he acquired in Italy. The discrepancy in value between different exchanges is an invitation for fraud. There are, for example, large discrepancies between exchanges and some articles have indicated South Korea exchanges trade as much as 30% higher than other exchanges. ETF funds have been established to capitalize on these exchange price differences. There are numerous recent articles on pump and dump schemes in the cryptocurrencies.

## The Next Big Treasure Hunt Scheme?

Many receivers have unraveled so-called “Treasure Hunt” frauds over the years and these type of scams have existed for centuries.<sup>43</sup> At least

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one creative schemer may raise money to search for the private keys to Satoshi Nakamoto's (Bitcoin's purported founder) unspent 1 million Bitcoins that were purportedly acquired in 2009 (worth about \$9 Billion as of 2/12/18). No one knows the true identity of Satoshi Nakamoto or if these coins will ever be located. Some creative fraudster is likely out there promoting his or her ability to find those missing Bitcoins as an "investment opportunity." It would be an easy scheme to orchestrate, and, when the schemer gets caught, he or she will no doubt claim they had the algorithm to find the keys to the fortune and were simply hacked, presuming that no one will be able to trace or verify the scheme.

## Events That Might Trigger a Paradigm Shift from FOMO and HODL Investor Attitudes

Some of the types of events that might continue to trigger a shift from the speculative investor attitudes that created the bubble in 2017 are as follows:

**1) Regulatory Action.** Federal regulatory agencies, state securities agencies, and international governments are all proposing regulations and pursuing fraud cases. The SEC and CFTC have filed new actions in 2018 and are determining how to best pursue the fraudsters. The CFTC has labeled Bitcoin a commodity and the SEC is pursuing the ICO market and other frauds.<sup>44</sup> US Treasury Secretary Steven Mnuchin recently said "one of the things we will be working very closely with the G-20 is making sure this doesn't become the Swiss Bank account." He further said he wants to ensure "bad people cannot use these currencies to do bad things."<sup>45</sup> SEC chairman Clayton stated before a U.S. Senate hearing on February 6<sup>th</sup> that ICO's will be met with tighter regulations. Chairman Clayton stated "I believe every ICO I've seen is a security" and "You can call it a coin, but if it functions like a security, it's a security."<sup>46</sup>

**2) IRS Pursuing Income Taxes and Penalties for Failure to Report.** Gains in cryptocurrencies are taxable, and investors may have to sell coins to pay taxes. The IRS has indicated that very few investors have reported any Bitcoin profits. A recent IRS report indicated only 802 customers of Coinbase, an exchange, reported Bitcoin-related activity in 2015. Furthermore, the new tax reform bill eliminated an exemption for like-kind exchanges meaning all crypto transactions are now a taxable event. The IRS is deploying new software to identify crypto tax cheats and investors might realize they need to properly report.<sup>47</sup> While most investors believe that they are anonymous and have no need to report transactions to the IRS, the IRS is likely to pursue taxes and assess penalties that can range from 20% to 50% of any income generated from the cryptocurrency transactions. Last year the IRS did subpoena records for transactions from 2013 to 2015 for 14,000 customers with more than \$20,000 of virtual currencies.<sup>48</sup> At today's prices, the IRS is pursuing investors with approximately 3 Bitcoins. Robert Wood, a tax lawyer in San Francisco, recently suggested that Bitcoin owners who want to clear up past transgressions should report foreign Bitcoin accounts using the IRS's amnesty program for foreign bank accounts. He recently wrote in Cointelegraph "With extensive data swapping deals between the IRS, foreign governments and foreign banks, almost no offshore account is secret anymore."<sup>49</sup> Cryptocurrency investors should assume the IRS is likely going to take more aggressive action in 2018 on taxable income associated with cryptocurrencies. Many investors that used Bitcoins to invest in ICO's might be in for a rude awakening when the transaction is taxed at the Bitcoin price at the time of the exchange. On Feb. 8 the IRS announced formation of a new task force of international crime investigators.

**3) Bitcoin Exchange Hack.** There was a major hack in the Mt. Gox exchange in Japan in 2014. Mt. Gox handled 70% of Bitcoin transactions and over 850,000 Bitcoins were missing, even though 200,000 were later found. Evidence presented by Tokyo security company Wiz-

Sec led them to conclude that "most or all of the missing bitcoins were stolen straight out of the Mt. Gox hot wallet over time."<sup>50</sup> At today's price these missing coins are worth \$4.5 billion and someone likely has or is searching for them. Even a small hack of a few hundred Bitcoins sounds like a big number in the media. In January 2018, another exchange in Japan was hacked for \$534 million. Coincheck bills itself on its website as "the leading bitcoin and cryptocurrency exchange in Asia". This hack is "expected to rank as the biggest such them on records, eclipsing the \$400 million [at the time of the hack] in bitcoin stolen from Mt. Gox in 2014."<sup>51</sup> Slang in the market for victims of such major hacks is referred to as being "Goxxed."<sup>52</sup>

**4) Bitcoin Mining Disruption.** The miners run thousands of computers and are susceptible to hacking or power outage. If Bitcoin prices fall below the cost of electricity required to mine coins, there will be further disruption as the miners do not process transactions. China recently announced the closing of mining operations, which might lead to more volatile moves in prices, make it slower and more expensive to make Bitcoin transactions, and possibly threaten the security of the network.<sup>53</sup> With the recent Bitcoin price decline to \$7,000 and the cost of mining which is estimated to be \$3,000 to \$6,000, mining could become unprofitable and disrupt the market.

**5) A Major Fraud in Another Cryptocurrency Would Impact Bitcoin.** A hack in one of the 1,526 other cryptocurrencies (with a combined market cap estimated at \$284 billion) could impact Bitcoin and have a ripple impact across all the coins. Economist Panos Moudoukoutas describes this as a Lehman or Enron style fraud event that could "quash Bitcoin demand due to a 'run on the bank' scenario, which would lead big banks and governments to slow the currency down."<sup>54</sup>

**6) High Transaction Fees.** Fees can increase due to a number of factors, including delayed mining that would make digital currencies less useful as a currency. The average price to process a Bitcoin transaction is \$28 which makes it too expensive to process small transactions.<sup>55</sup> Despite the high transaction fees, there are many low dollar accounts but some investors do remove coins from their wallets for safekeeping. The transaction cost for altcoins is considerably less.

**7) Delayed Transaction Time.** Due to the increased complexity, there are longer delays in transaction times to clear a transaction. A transaction requires 6 confirmations from miners before the transaction is processed, and reports indicate that the average transaction time is one hour. The transaction times can take from 30 minutes to 16 hours in certain high demand periods.<sup>56</sup>

**8) Market Manipulation.** There are many stories on market manipulation by various groups and even government officials. One recent pump & dump scheme was in Bitcoin Diamond (BCD) where the market price multiplied 40 times on the Kucoin exchange causing the exchange to issue a warning when the price shot from \$30 to over \$800. One article suggested investors "set an unrealistically high sell order, just in case the unthinkable happens."<sup>57</sup> In this case, the spike from Asian traders happened in a matter of minutes and the price of BCD on 2/12/18 is \$21.

**9) Market Data Changes or Manipulation.** In January, Coinmarketcap.com changed the algorithm in its exchange to delete certain Korean exchanges that had abnormal prices. This change was made without notifying any parties and resulted in a decrease in market cap of cryptocurrencies of \$100 billion.<sup>58</sup> Several new companies plan to enter the market data information. One hedge fund that is capitalizing on the discrepancies in the markets is BitSpread, which is a Cayman Islands-based fund that trades on variations in the price for various cryptocurrencies.

**10) Multiple Forks.** Forks or splits in the currencies get around the argument of presumed scarcity that was created by the 21 million cap

on Bitcoin supply. Additional forks could create confusion in administration and conflicts between currencies. With over 80% of all Bitcoins already mined, the supply is limited and thereby susceptible to more forks like the Bitcoin Cash fork last year.

**11) Large Short Positions.** Trading in crypto futures is new and will expand in 2018 as new exchanges are added. Data from the CFTC “shows that hedge funds overall entered 2018 betting bitcoin prices would fall far outweighed those betting it would rise by a factor of four. As of January 16, such short positions still outnumbered those taking the opposite bet.”<sup>59</sup>

**12) Whales Start Selling – The Market Could Be Flooded by Over Supply.** What if someone starts selling Satoshi Nakamoto’s 1 million Bitcoins or the missing 650,000 Mt. Gox Bitcoins and floods the market? With 1,000 people controlling 40% of Bitcoins, any of the biggest owners could start selling resulting in disruption. Rumors alone about the biggest sellers could impact markets. Due to an open public ledger, third parties can see the sale transactions.

**13) A Horde of Lost Bitcoins Is Found and Suddenly Liquidated.** Estimates are that 25% of all Bitcoins have been lost over the years by miners that forgot the keys. Rapper 50 Cent claims he recently found 700 bitcoins he had forgotten about from album sales in 2014 that are now worth about \$7.7 million.<sup>60</sup> Wonder if 50 Cent disclosed these coins in his bankruptcy case.

**14) Rating Agencies Provide Retail Investors Legitimate Analysis.** There has been no independent scrutiny of Bitcoin or altcoins by traditional rating agencies. On January 24th, financial rating agency Weiss released reports on 74 of the most popular currencies providing scores from A to D. The company explained that a rating of A or B was equivalent to a “buy” rating, a C was “hold” and D and E are equivalent of a “sell” rating. Bitcoin was rated a C+.<sup>61</sup> The release of the ratings sparked outrage on social media and a denial-of-service cyberattack against the rating agency.

**15) Blockchain ETF Funds.** The emergence of new funds that invest in blockchain related companies may impact the market. In January, two funds were launched raising \$180 million in the first two weeks. The SEC required the two funds to remove the name “blockchain” from their names amid the frenzy associated with bitcoin or blockchain. Instead of investing directly in cryptocurrencies, these funds buy stock in companies that have invested in blockchain like Overstock.com, Nvidia and Square.<sup>62</sup> At some point, there will likely be more ETF funds that invest directly in the cryptocurrencies.

**16) Higher Interest Rates.** An increase in interest rates could impact demand, but many investors are already buying coins on credit cards and paying high interest rates.

**17) Change in Credit Card Policies.** Many of the exchanges accept credit cards to buy coins. Numerous credit card companies offer low or 0.0% interest cards for a year. Apparently, many people use those offers to buy Bitcoins or other cryptocurrencies. One web site suggests Bitcoin buyers get a new credit card that advertises bonus reward for spending and earn the rewards points as well!! One anti-fraud expert recently stated: “Crypto has ten times the fraud seen in the credit card market... Thieves have it easy with Bitcoin.”<sup>63</sup> Will credit card companies continue to allow this crypto risk in their portfolio? South Korean credit card companies are now blocking payments to overseas cryptocurrency exchanges.<sup>64</sup> Many other credit card companies this year have decline to accept Bitcoin purchases as the exchanges.

**18) Sudden Profit Taking.** Any sudden surge in profit taking could disrupt the exchanges and cause a lack of liquidity.

**19) Flash Crash.** Given the worldwide demand with new exchanges and possible data issues or hacks, there could be flash crashes due to problems at the exchanges.

**20) A Denial-of-Service (“DoS”) Attack.** Many small, retail investors take actions based on social media and can easily organize and swarm any web site with thousands of people in a DoS style attack. A group of attackers can make a network unavailable to users by disrupting services much like a crowd of people might block a door and not let legitimate parties enter. Such an attack occurred when Weiss Ratings announced their cryptocurrency ratings on January 24th.

**21) A 51% Attack.** There could be an attack on a blockchain by a group of miners controlling more than 50% of the network’s computing power. This is hypothetical type attack, but some experts suggest that “attackers would be able to prevent new transactions from gaining confirmations, allowing them to halt payments between some or all users. They would also be able to reverse transactions that were completed while they were in control of the network, meaning they could double-spend coins.”<sup>65</sup>

**22) Sybil Attack.** A type of computer attack that breaks down security that is named after a woman with a multiple personality disorder where a computer takes on multiple identities to steal information or disrupt communications.<sup>66</sup> It is likely hackers are trying to figure this out or any other means to hack and steal cryptocurrencies.

Numerous events could cause the continued recent decline in the cryptocurrency markets. However, given the significant number of unsophisticated retail investors around the world, it may require a major event to change investors’ attitudes for the long-term.

## Recently Filed Litigation Against Cryptocurrencies

Several lawsuits have been recently filed by regulatory agencies and investors that provide interesting insight on fraud including the transfers of Bitcoins to purchase investments in altcoins and token. The regulatory actions focus on whether the ICO is a securities offering. A few of the larger recent cases are as follows:

**AriseBank** - The SEC filed a complaint on January 25, 2018 in Dallas, Texas alleging AriseBank and two individuals were operating a \$600 million Ponzi scheme and a receiver was appointed.<sup>67</sup> In its press release on January 30, 2016 the SEC stated: “We allege that AriseBank and its principals sought to raise hundreds of millions from investors by misrepresenting the company as a first-of-its-kind decentralized bank offering its own cryptocurrency to be used for a broad range of customer products and services. We sought emergency relief to prevent investors from being victimized by what we allege to be an outright scam,” said Stephanie Avakian, Co-Director of the SEC’s Enforcement Division. “This is the first time the Commission has sought the appointment of a receiver in connection with an ICO fraud. We will use all of our tools and remedies to protect investors from those who engage in fraudulent conduct in the emerging digital securities marketplace,” said Steven Peikin, Co-Director of the SEC’s Enforcement Division. Shamoil T. Shipchandler, Director of the SEC’s Fort Worth Regional Office, said, “Attempting to conceal what we allege to be fraudulent securities offerings under the veneer of technological terms like ‘ICO’ or ‘cryptocurrency’ will not escape the Commission’s oversight or its efforts to protect investors.”<sup>68</sup>

**My Big Coin** - The CFTC filed a complaint on January 16, 2018 alleging the company was a \$6 million Ponzi scheme.<sup>69</sup>

**Bitconnect (BCC)** - a class action was filed in Florida on Jan 24, 2018 against a number of entities and promoters claiming the companies were a Ponzi scheme.<sup>70</sup>

**Monkey Capital** - a class action was filed in Florida on December 19, 2017 for \$3.8 million in cryptocurrency transfers to an ICO that was to promote virtual currency news, a private cryptocurrency exchange and a decentralized hedge fund.<sup>71</sup>

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**Giga Watt, Inc.** - a class action was filed in Washington on December 28, 2017. Investors transferred \$20 million in Bitcoins for investments in starting a mining operation.<sup>72</sup>

**Tezos (XTZ)** - a class action complaint was filed on December 31, 2017 on behalf of investors for a potential class that transferred \$232 million in Bitcoin and Ethereum to a new ICO.<sup>73</sup>

## Cryptocurrencies and the Receiver

Receivers will likely play a critical role in unwinding ICO frauds and pursue recoveries for duped investors. Receivers will have their typical fiduciary roles in recovering assets, and pursuing claims against the insiders, accountants and attorneys that assisted in orchestrating the illegal offerings. Several computer firms are emerging that claim to have an ability to trace cryptocurrencies and will be important to assist receivers in the process of tracing hidden coins.

The claims against professionals involved in the ICOs may be complex. John Reed Stark, a former SEC attorney and cybersecurity expert, recently wrote: "The panoply of illegalities associated with ICOs could fill its own legal treatise, including the unlawful: 1) offer, sale and promotion of securities; 2) operation of a stock exchange; 3) sale of an unregistered mutual fund; 4) sale, advertising and promotion of commodities; and the list goes on."<sup>74</sup> SEC Chairman Clayton recently stated "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 securities laws, which deprives investors of the substantive and procedural investor protection requirement of our securities laws."<sup>75</sup> Chairman Clayton further indicated attorneys preparing the offerings would be targets and stated: "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."<sup>76</sup> As previously mention, Chairman Clayton stated before the senate on Feb. 6<sup>th</sup> that all ICO's he has seen are securities.

My advice to receivers is to start monitoring the cryptocurrency news and regulatory actions. Given the speculation, international trading volume, investor borrowing, fraudulent money being invested, investors rolling "winnings" from early investments into new

ICO investments, hacking, regulatory action, and the IRS pursuing taxes, it is impossible to give any certainty as to market direction. However, as more scams are uncovered, receivers will likely be appointed to unravel the frauds and search for assets. With the dotcom implosion, there were often only computers remaining. In cryptocurrency fraud cases, hopefully there will be some assets and claims for receivers to pursue to make a recovery for duped investors. 🏠

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## ENDNOTES

<sup>1</sup> Mr. Hays is President of NAFER and Managing Principal of Hays Financial Consulting, LLC in Atlanta, GA. He has over 28 years of experience in unwinding investment fraud cases including many appointments as a federal equity receiver and as a bankruptcy trustee.

<sup>2</sup> Charles Ponzi and "The Best Show Since the Landing of the Pilgrims", New England Historical Society, available at <http://www.newenglandhistoricalsociety.com/charles-ponzi-best-show-since-landing-pilgrims/> (emphasis added).

<sup>3</sup> See *infra* at footnote 42.

<sup>4</sup> See Olga Kharif, *The Bitcoin Whales: 1,000 People Who Own 40 Percent of the Market*, Bloomberg (December 8, 2017), available at <https://www.bloomberg.com/news/articles/2017-12-08/the-bitcoin-whales-1-000-people-who-own-40-percent-of-the-market/>.

<sup>5</sup> See *infra* at footnote 25.

<sup>6</sup> See *infra* at footnote 28.

<sup>7</sup> See BitInfoCharts / Wealth Distribution, available at <https://bitinfocharts.com/top-100-richest-bitcoin-addresses.html> (many investors hold multiple addresses to avoid holding coins in one wallet).

<sup>8</sup> See *infra* at footnote 26.

<sup>9</sup> See *infra* at footnote 27.

<sup>10</sup> See *infra* at footnote 36.

<sup>11</sup> See *infra* at footnote 56.

<sup>12</sup> See *infra* at footnote 55.

<sup>13</sup> Berkeley Lovelace, Jr. *Buffett on Cryptocurrencies: 'I can Say Almost with Certainty that They Will Come to a Bad Ending'*, CNBC (Jan. 10, 2018), available at <https://www.cnbc.com/2018/01/10/buffett-says-cryptocurrencies-will-almost-certainly-end-badly.html>.

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<sup>15</sup> See Helen Partz, *Gold Sales Spike During Crypto Market Crash, Highlighting Inverse Correlation*, Cointelegraph (January 19, 2018), available at <https://cointelegraph.com/news/gold-sales-spike-during-crypto-market-crash-highlighting-inverse-correlation>.

<sup>16</sup> See Jon Buck, *Investors Dumping Gold for Bitcoin?* Cointelegraph (Dec. 11, 2017), available at <https://cointelegraph.com/news/>

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<sup>19</sup> See Kai Sedgwick, *The Rise and Fall of Ripple is a Case Study in Mass Hysteria*, Bitcoin.com (Jan. 20, 2018), available at <https://news.bitcoin.com/the-rise-and-fall-of-ripple-is-a-case-study-in-mass-hysteria/>.

<sup>20</sup> Bitcoin God claims to be the first charity platform built on a blockchain. The website for Bitcoin God is available at [www.bitcoingod.org](http://www.bitcoingod.org). Trading is listed on [coinmarketcap.com](http://coinmarketcap.com) under the "Bitcoin God".

<sup>21</sup> See Jasper Hamill, *Boss of 'Bitcoin for Porn' Cryptocurrency Fantasy Market Accused of 'Disappearing' With Investor's Money*, available at <http://metro.co.uk/2018/01/08/boss-bitcoin-porn-cryptocurrency-fantasy-market-accused-disappearing-investors-money-7213986/?ito=cbshare>.

<sup>22</sup> Gaurav Mokhasi, *Why Aren't Companies Like Facebook, Amazon, And Google Doing More With Blockchain Technology?* Forbes, Quora (Dec. 20, 2017), available at <https://www.forbes.com/sites/quora/2017/12/20/why-arent-companies-like-facebook-amazon-and-google-doing-more-with-blockchain-technology/#6aaf49e53d91/>.

<sup>23</sup> See Billy Duberstein, *My Interview with IBM's Vice President of Blockchain Technologies, Jerry Cuomo*, The Motley Fool (Jan. 7, 2018), available at <https://www.fool.com/investing/2018/01/07/my-interview-ibms-vice-president-of-blockchain.aspx/>.

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<sup>25</sup> See Jeff John Roberts and Nicholas Rapp, *Exclusive: Nearly 4 million Bitcoins Lost Forever*, New Study Says, Fortune (Nov. 25, 2017), available at <http://fortune.com/2017/11/25/lost-bitcoins/>.

<sup>26</sup> C. Edward Kelso, *Survey: 60% of Americans Have Heard of Bitcoin, 5% Own, Bitcoin.com* (Jan. 24, 2018), available at <https://news.bitcoin.com/survey-60-of-americans-have-heard-of-bitcoin-5-own/>.

<sup>27</sup> See David Z. Morris, *Way Too Many People Are Using Credit Cards to Buy Bitcoin*, Fortune (Jan. 13, 2018), available at <http://fortune.com/2018/01/13/credit-cards-to-buy-bitcoin/>.

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<sup>29</sup> Lubomir Tassev, *More than Half of Russians Know About Bitcoin Now*, Bitcon.com (Jan. 21,



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- <sup>34</sup> See Kai Sedgwick, *Not Content Scamming \$1.5 Billion, Bitcoin Wants Another \$500 Million for ICO*, *Bitcoin.com* (Jan. 19, 2018), available at <https://news.bitcoin.com/not-content-with-scamming-1-5-billion-bitconnect-wants-another-500-million-for-its-ico/>.
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- <sup>38</sup> See *id.*
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