SEC vs. Block Bits Capital LLC

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Issue(s):

The SEC has come after a group of companies and founders using the Block Bits Capital name. Both the companies Block Bits Capital LLC ("Block Bits Capital") and Block Bits Capital GP I LLC (Block Bits GP) as well as the co-founders Japheth Dillman and David Mata are the defendants in this complaint. Both co-founders co-own both of the companies in an equal split, while the organization Block Bits GP manages the funds of Block Bits Capital. Block Bits Capital is the company through which clients interact. The main issue brought up by the plaintiff, the SEC, is that the businesses and people involved were committing fraud though the sale of unregistered securities during company operation. They are ordering the defendants to accept an injunction on their company operations as well as pay back excessive damages to customers who were defrauded. Questions regarding Block Bits Capital et al.'s legal culpability as well as the SEC's jurisdiction over this case are discussed.

Rule(s):

The years of the Great Depression, between 1933-1936, gave rise to a series of statutes that control securities and commodities markets within the United States. These statutes include the Securities Act of 1933 ("Securities Act"), the Security Exchange Act of 1934 ("Exchange Act"), and the Commodities Exchange Act (CEA) of 1936. While these statutes have been amended many times throughout history, they have stood the test of time. The vast majority of crypto-company fraud is in violation of one of these major statutes. In particular, the SEC highlighted that it is sections 5(a), 5(c), and 17(a) of the Securities Act that is being violated as well as sections 10(b) and Rule 10b-5 of the Exchange Act. The Advisors Act of 1940 has also been violated, but the details of this statute are outside the scope of this legal brief, which will only look into potential violations of the securities acts. Since the phrase "means and instrumentalities of interstate commerce" of the Securities/Exchange Acts is so broad, it is difficult for an investment contract or business agreement to be exempt from these laws.

Sections 5(a) and 5(c) of the Securities Act are violated whenever a company does not report the initial offering of the sale of a security to the SEC through a prospectus form. Section 17(a) is violated whenever conspiracy or tactics of deceit upon purchasers is present during the sale of a security through a firm. Sections 10(b) and rule 10b-5 of the Exchange Act are violated whenever there are schemes in place to prevent truthful and transparent dissemination of information regarding securities for sale to the public. The SEC requires that all securities have up-to-date reports regarding management, reserves, investments, or other business related information. Frequent re-reporting is required on a quarterly or yearly basis.

Fact(s):

Block Bits Capital made two claims about its business operations that turned out to be false. Firstly, the company purported that it was an "Automated Cryptocurrency Fund," with sophisticated algorithms in place that autonomously engaged in cryptocurrency trades. The second claim was that 40% of fund's assets were invested in cold storage, which is essentially an

offline storage mode - think of it as storing physical copies of your cryptocurrency in a "vault" of some kind (i.e a hardware wallet). As stated earlier, both of these claims were false, as the two co-founders were the ones manually engaging in trades and moving money around for risky investments. On top of these fake claims regarding business operations, the co-founders also took excessive personal compensations from the fund.

Digging deeper into the first claim, regarding automated trades, the defendants never ended up having any algorithms written to begin with that engaged in automated trades. It was Mata himself and a third-party account that were manually engaging in trades. The two co-founders made it seem like a Decentralized Autonomous Organization (DAO) of some kind was in place, where they even claimed the auto-trader performed better than letting the currency be managed by hand. A big selling point was how efficient this DAO would function when compared with human-managed funds. The founders claimed they created an auto-trading bot in-house that could arbitrage across 30 exchanges and multiple currencies, while providing mind boggling returns. The defendants ended up raising about $960k and even let the investors purchase limited partnership interests in the fund. It turns out that performance results for the DAO were fabricated and that no functional auto-trader was tested or deployed.

Digging into the second claim, the co-founders stated they would keep 40% of their funds within "cold storage" (presumably hardware wallets) to have a part of the fund's money in risk-free investments, but none of the investment money was ever put into hardware wallets to begin with. In fact, this money was put into a number of high-risk investments, including Initial Coin Offering (ICO) investments and loans to start-ups. These risk-free investments were also purported to provide high returns to stakeholders somehow.

Argument/Application:

According to the rules in violation and the facts available regarding company operations, it is highly likely that the defendants involved were promoting a Ponzi scheme through the sale of an unregistered security. All of the purported automated trading features and high-yield cold storage reserves were just marketing gimmicks to lure in investors. The company lied outright about two of their main business features, since neither was formally implemented to begin with. Co-founders Dillman and Mata never applied to the SEC to register their fund as a security and were also manually moving funds around at their discretion and to their benefit.

Counter-argument:

It could be argued that Block Bits Capital did not violate any securities laws because their fund was not a security to begin with. Since debates are still ongoing as to whether crypto-products are commodities or securities, it could still be argued that it is the Commodity Futures Trading Commission (CFTC) that has jurisdiction over this case. Since the DAO fund within Block Bits Capital was allegedly performing forex and arbitrage trades with various currencies, it could fall under the regulatory purview of the CEA and not the Securities Act, as it is primarily commodities involved here.

Conclusion:

The internet counts as an instrument of interstate commerce, so any advertisements or websites that promote fundraising efforts in the form of a security or the outright sale of a security could come into violation of the Securities and Exchange Acts. It could be up to some debate as to whether the CFTC or SEC have jurisdiction over the enforcement of justice on Bit Blocks Capital et al. While certain operations of the crypto-fund could full under the jurisdiction of the CFTC, such as the forex trading elements, the fact that there was an ICO of $960k as well as the staking of coins in cold storage for future economic benefits means Block Bits Capital was also selling securities. If a company is involved with trading/selling both commodities and securities, it shouldn't be a problem for both the CFTC and SEC to work together to seek the necessary damages.