A Publication of the Texas State Securities Board
Regulating the securities industry and
protecting investors since 1957

Investor Alert: Cryptocurrencies

WIDESPREAD FRAUD FOUND IN CRYPTOCURRENCY OFFERINGS

April 10, 2018

In response to a sharp increase in the number of cryptocurrency investment opportunities being marketed to Texans, the Enforcement Division of the Texas State Securities Board (TSSB) conducted a four-week investigation of securities offerings tied to virtual currencies.

Starting Dec. 18, 2017, the Enforcement Division began investigating promoters of cryptocurrency investments who appeared to be illegally and fraudulently using online advertisements, social media, and other public solicitations to attract Texas investors.

Attorneys and investigators opened 32 investigations over the course of four weeks. Not surprisingly, 19 of the companies claimed they would in some way use Bitcoin – the most widely known cryptocurrency and online transaction system – by accepting it as an investment, trading it, or investing in businesses and technologies involving bitcoin.

Among the findings in the 32 investigations:

- No promoters were registered to sell securities in Texas, a violation of the Texas Securities Act;
- 30 promoters were broadly using websites, social media, and online advertising to market to Texans;
- Seven promoters were offering securities tied to a *new* cryptocurrency;

Cryptocurrency Resources

Updated 02/01/2019

- 17 Enforcement actions taken against companies involved in cryptocurrency-related investment offerings
- Investor alerts on the risks in cryptocurrency investing and commonly used fraud techniques
- Cryptocurrency glossary

VIDEO

- CFTC webcast, "Combatting Cryptocurrency Fraud"
- FTC webcast, "Decrypting Cryptocurrency Fraud"

www.ssb.texas.gov/cryptocurrency-resources

- At least five promoters all but ignored investing risks by guaranteeing returns, some as high as 40% per month;
- Only 11 promoters provided potential investors with a physical address;
- At least six promoters were actively recruiting sales agents without verifying they were registered with the Securities Commissioner; and
- Six of the offerings involved payment of a commission to investors who recruited new investors into the scheme.

In some instances, investors were told they could expect lucrative profits once the newly minted virtual coins, often called tokens, were introduced into the market. In other instances, promoters tied the new coins to investment programs, including programs that involved "staking," or lending the coins in return for interest payments.

Investigations opened during and after the sweep provided critical information relating to the offer and sale of cryptocurrency investment products, and the Securities Commissioner took seven actions against illegal or fraudulent cryptocurrency promoters.

Enforcement staff is continuing to investigate other suspect offerings uncovered during the sweep.

It is important to note that the TSSB is not regulating the cryptocurrencies themselves, only the investments that claim to use virtual currencies in an investment program.

Most important, enforcement actions effectively stopped promoters from capitalizing on the buzz surrounding Bitcoin and other cryptocurrencies to defraud Texas residents.

The Texas State Securities Board developed this resource to summarize important information uncovered during the agency's investigations and enforcement actions.

Our goal is to empower Texans, allowing them to identify suitable securities offerings while avoiding a cutting-edge, but little-understood, investment opportunity.

60 Cryptocurrency Investigations – So Far

From September 2017-March 2018, the Enforcement Division opened more than 60 investigative files to review cryptocurrency investments.

That total includes the files opened during the four-week sweep.

We Want to Hear from You

About this report:

Robert Elder, Communications & Investor Education, relder@ssb.texas.gov.

Joseph Rotunda, Enforcement Chief, jrotunda@ssb.texas.gov

Submit a tip or complaint to the Enforcement Division:

(512) 305-8392 or enforceinfo@ssb.texas.gov

New Technologies. New Products. Same Old Emotions.

Securities markets are constantly changing in response to new investment products, new industries, advances in technology – and the power of human emotion.

Rarely have those factors converged with such force as in cryptocurrency investment offerings.

Bitcoin, Ethereum, and other virtual currencies are providing new ways to pay for goods and services, bypassing intermediaries such as credit card companies and e-commerce merchants. New companies are springing up to facilitate cryptocurrency transactions and working to improve the underlying technology through which transactions are conducted.

The potential of cryptocurrencies isn't limited to the facilitation of transactions, as the private and public sectors are finding efficiencies by adopting technologies that fuel cryptocurrencies. One is the ledger system known as the "blockchain" that accounts for transactions using Bitcoin and other cryptocurrencies.

The potential to cash in on what could be a global revolution in web-based transactions has put investor enthusiasm into overdrive.

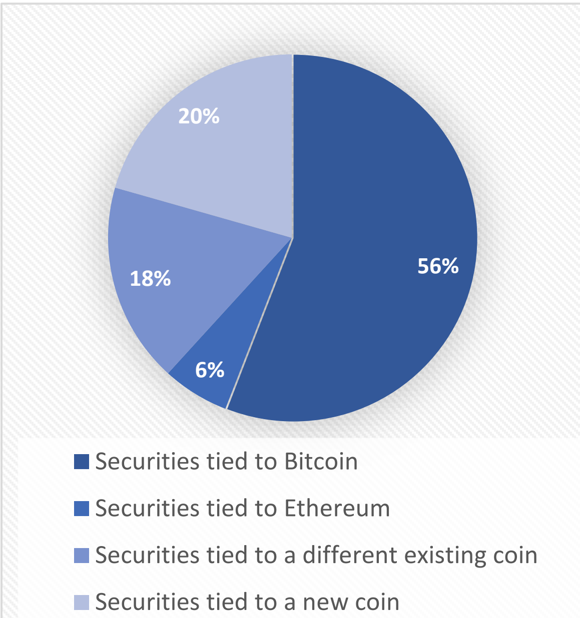
On Dec. 16, shortly before the Enforcement Division started its regulatory sweep, the price of bitcoin reached $19,343, the high for 2017 and a *231% increase* from Nov. 12.

As the price of major cryptocurrencies spiked, promoters of cryptocurrency investments ramped up their marketing to Texans.

Bitcoin Is King, But Promoters Tout Other Cryptocurrencies

Although Bitcoin is the most popular cryptocurrency, recent reports indicate that at least 1,600 cryptocurrencies have been introduced into the market. Besides Bitcoin, established cryptocurrencies include Ethereum, Litecoin, and Ripple, all of which can be traded on exchanges.

Most legitimate cryptocurrencies – and a few that only border on legitimate – offer investors a "white paper" that describes the coin and the plans to develop it. It is a key document for investors considering purchasing cryptocurrencies.



There are abundant signs of a cryptocurrency mania.

You may have heard about some of these curious virtual currencies, some of which have attracted millions of dollars from investors.

One is Dogecoin, a currency that features the likeness of a dog that was a popular internet meme.

Potcoin was created to pay for transactions related to cannabis.

My Big Coin is a token supposedly backed by a vast store of gold.

Ponzicoin proudly lived up to its name. The issuer described it as a “parody art performance” and refunded investors’ money.

KEEP IN MIND Investors chasing lucrative returns by investing early in a token should know they are speculating on an untested cryptocurrency. They risk losing their entire investment if the currency fails in the marketplace.

Flip a Coin. Or Token.

Investment opportunities will reference both coins and tokens. They are often used interchangeably, but they are not the same thing.

Bitcoin is the most prominent example of a digital currency. It is based on a blockchain, a publicly accessible ledger that records all transactions. A bitcoin is digital money that can be bought, sold, or earned.

A token isn't a currency. Tokens are typically sold to fund startups, giving investors a share of the company's business project. They can increase in value if traded on an exchange, which is why some fraudulent operators promise investors an exchange listing will occur.

In certain instances, a promoter offers to let an investor to buy tokens early, in a "private offering" before opening sales to other investors.

The promoter tells investors it will use their money to develop a platform to ensure the tokens will increase in value once they are released in the market and traded like stocks on exchanges. In other instances, promoters tout the profitability of investment programs such as cryptocurrency mining or creating applications or other software closely related to cryptocurrencies.

KEEP IN MIND Although cryptocurrency promoters may give the impression they operate in a technologically advanced industry that isn't subject to governmental oversight, these securities are regulated under Texas law.

As an example, the Enforcement Division began investigating BitConnect after learning that it was using a legion of sales agents to advertise a lending program tied to its cryptocurrency, BitConnect Coins.

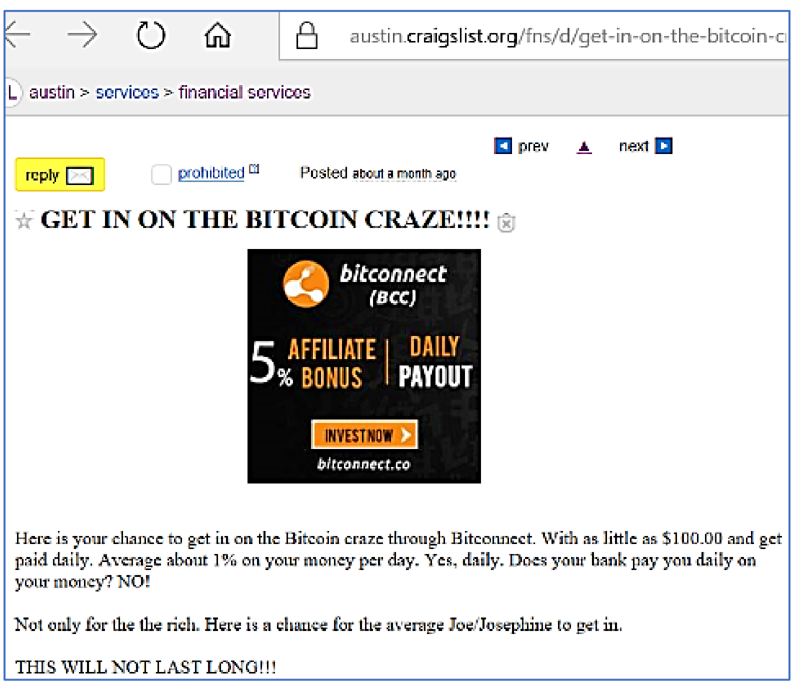
BitConnect told investors they could purchase BitConnect Coins through its website and then "lend" their BitConnect coins to the company. Its "BitConnect bot" would then pool their funds to generate a profit. BitConnect claimed participation in the lending program would entitle investors to interest payable at up to 40% per month in addition to daily interest of up to 0.25% per day.

Although the lending program constituted a security regulated by statute, BitConnect failed to comply with regulations requiring it to undergo a thorough background check to determine whether the cryptocurrency lending program was fair, just and equitable.

It also failed to comply with laws that required the review and registration of its sales force. Not surprisingly, the cryptocurrency lending program turned out to be a fraudulent scheme that threatened to inflict huge financial losses on Texans.

KEEP IN MIND Securities are not limited to traditional investments such as stocks and bonds. Investors who purchase new types of securities are entitled to the protections of securities laws.

The Enforcement Division secured an [emergency action] to stop the sale of the cryptocurrency lending program to Texans. Almost immediately after receiving notice of the emergency action, the



Bitconnect advertisement on craigslist

anonymous managers of the scam announced BitConnect was closing its lending program, and BitConnect Coin's market capitalization, which reached a high of $2.6 billion on Jan. 6, soon lost 98% of its value.

In the end, many investors were left with nearly worthless tokens and a loss of almost all their investment principal.

Outrageous Claims of Profitability

The investigations revealed that 30 of the 32 promoters were using online advertisements, webpages, and social media to broadly recruit investors.

These solicitations almost universally touted the extreme profitability of the issuer's cryptocurrency investment programs.

Many solicitations played on bitcoin's sharp increase in price, even though the investment being marketed to investors had nothing to do with bitcoin.

One promoter claimed that if investors "had bought Bitcoin for $1,000 Back [sic] in 2013, they would have been worth more than $3 million today."

This kind of marketing – look at what you *could have earned* if you could predict the future – is commonly used by stock promoters who compare the shares of their companies to companies whose stock has performed well in the past.

One promoter claimed their cryptocurrency was priced at "only $.28 cents [sic] each" and would soon rocket to $188.

Those solicitations that did not reference Bitcoin still claimed they could deliver improbably high returns, such as 40% per month.

"[T]his is your chance to make the purchase of your lifetime, to be in from the start, to get the life you deserve," the company said, and "the more you can afford to spend the more your life will change!"

In March 2018 Merriam-Webster added new terms to its dictionary to clarify the "sometimes perplexing domain of digital financial exchanges."

Among the entries:

Cryptocurrency

Initial Coin Offering

Blockchain

Bitcoin was added in the ancient digital year of 2016.

Left unsaid were the inherent risks of cryptocurrencies like increased national and international regulation; the high volatility in pricing; or the prospect of hackers penetrating security systems and disrupting an investment program or absconding with cryptocurrencies.

In fact, at least five of the 32 promoters subject to the targeted investigations appear to have brushed aside concerns about risk by guaranteeing returns on their investment.

GLOSSARY

Bitcoin. A specific currency in an electronic payment system that acts as an alternative to fiat currency. It exists only on computers and the internet. It is not backed by a government, and its price is not set by a centralized authority.

Cryptocurrency. A digital currency secured through cryptography, or codes that cannot be read without a key.

Blockchain. A permanent online ledger that functions as a public accounting of cybercurrency transactions that have been executed. New “blocks” are added to the blockchain after the confirmation of each set of transactions.

Blockchain technology. The technology that enables the electronic payment system for virtual currencies, but not tied to any specific currency. Companies are using blockchains to create a permanent record of transactions of such things as sales of investments, corporate records, and legal documents.

Mining. The process of applying high amounts of computing power to solve complex equations that verify transactions in a virtual currency. Miners who solve the equations are awarded new units of the virtual currency.

Initial Coin Offering (ICO). In an ICO, an entity issues virtual coins, often called tokens, to raise capital. A “token sale” is simply distributing a new cryptocurrency to investors, who typically pay for the tokens in bitcoin or another established cryptocurrency.

Ghosts in the Machine

The sweep revealed that several promoters of suspect offerings are not telling investors where they are physically located.

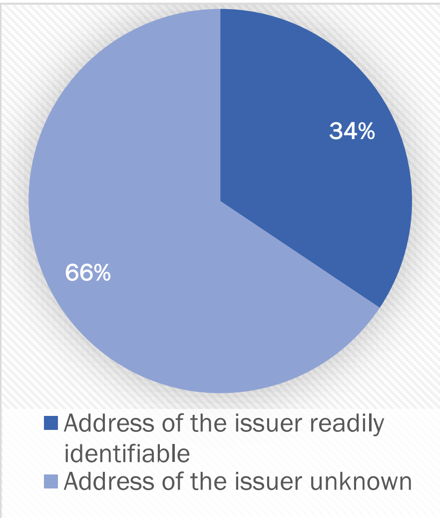
Out of 32 investigations, the Enforcement Division learned that only 11 promoters were providing investors with their physical address. The other 21 offerings may exist only in cyberspace, and investors may be directed to send their money to a business that exists only on the internet, controlled by anonymous managers who cannot be contacted through a telephone call, a certified letter or a visit to the office.

Moreover, investors may not be able to locate a promoter to serve it with legal process or attempt to pursue other remedies once they have been defrauded.

KEEP IN MIND Promoters of cryptocurrency schemes use the internet to conceal their identity and location. If you invest in a mystery company, particularly one located overseas, you're at great risk of never recouping your money if the investment is a scam.

Earlier this year, the Texas Securities Commissioner entered an **Emergency Cease and Desist Order** against DavorCoin, accusing the issuer of illegally and fraudulently offering investments in a cryptocurrency lending program to Texas residents.

According to the action, investors were told that they could expect monthly interest of up to 48% by purchasing and lending DavorCoin's own cryptocurrency, also referred to as davorcoin.



The order indicates, however, that DavorCoin was concealing the identity of its principals and its physical location. The company claimed that its cryptocurrency was created by otherwise anonymous bankers and traders from major financial institutions based in London, Paris and other EU cities and that, due to tax and regulation risks, it could not disclose its domicile.

That information may not have seemed important to investors at the time DavorCoin was riding high with a market capitalization of approximately $67.6 million prior to the action.

After the action, DavorCoin closed its lending program and its market value fell to almost zero. Investors who lost money were left with little recourse against a company that appears to exist only in cyberspace.

Who Am I This Time?

Anyone can set up a savvy, professional online presence that falsely portrays a team of experts skilled in managing capital. Charming portraits and lengthy profiles may convey a sense of comfort and security, but virtually anyone from anywhere may be lurking behind the flashy graphics.

KEEP IN MIND: Promoters of fraudulent investments use the internet to deceive investors. Turn the tables: Use search engines and other online tools to investigate suspect offerings and verify a promoter's claims. There's also common sense.

The Enforcement Division uncovered a scheme where a promoter was using images from unassociated websites and falsely claiming that the

Learn About Traditional Investing

The TSSB offers publications to help people learn about more traditional investing:

The *Texas Investor Guide*, a free 68-page book on the time-tested principles of investing and how to avoid financial fraud.

Our "Core Four" principles of investing, in printable PDFs:

- Making Investments Control risk and costs as you build a portfolio
- Investing for Retirement Using tax-sheltered accounts, from 401(k)s at work to personal IRAs
- Choosing a Financial Professional The right adviser to fit your needs
- Scams and Unsuitable Investments Bad investments and worse promoters

photographs depicted the professionals responsible for an investment firm. It secured an emergency action against LeadInvest, a business selling investments tied to cryptocurrency through a website that prominently displayed images and profiles of its team of advisors and legal professionals.

The investigation revealed that the photographs of the team were images appropriated from other websites. For example, a portrait of "Lucy Besson," a professional allegedly responsible for cryptography and data analysis, was really a stock photograph of a model.

A portrait of "Simone Roger," a professional responsible for business development and operations, was a photograph of an unaffiliated attorney lifted from her firm's website.

It gets worse.

A photograph (left) of LeadInvest's Code of Ethics Association first appeared in a decade-old publication from the George Washington School of Law. The photo, taken at a conference at the law school, depicted former U.S. Solicitors General and U.S. Supreme Court Justice Ruth Bader Ginsburg.

Verify, Then Trust

Securities laws generally require that securities professionals demonstrate their qualifications by passing a competency examination and undergoing a thorough background check.

The Securities Board also conducts routine examinations of their firms to make sure they are in full compliance with the law and not engaging in any type of inequitable or fraudulent practice.

Is an Investment Promoter Registered? Here's How to Find Out

Issues of securitized cryptocurrencies must generally be registered with the State Securities Board.

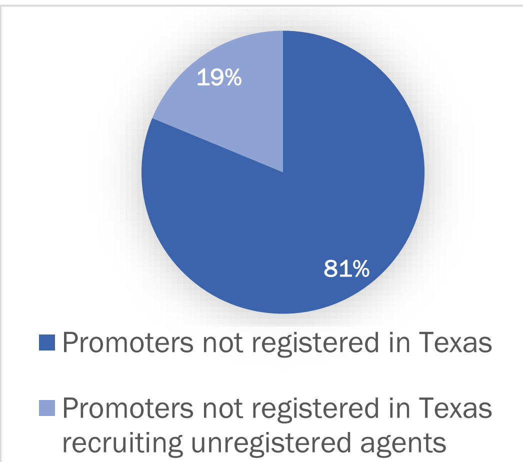
Check the registration status of an issuer of securities. *If registered*, you can obtain a free background report.

You can also contact the Registration Division at (512) 305-8300, or email your request.

Any promoter who is *not registered* raises a three-story red flag about the investment.

These requirements are important. They're designed to ensure that the public is protected from unlicensed and unscrupulous actors.

None of the 32 promoters of cryptocurrencies being investigated by the agency as part of the sweep were registered to sell securities in Texas. Moreover, at least six of these promoters were actively recruiting sales agents to sell their investment program without first verifying the sales agents were registered with the Securities Board.



Salespeople who offer securities without being registered are operating outside the law. Investors should not simply trust a promoter's representations regarding its registration, but they should verify a company's sales agents with state securities regulators.

For example, the Enforcement Division's investigation of R2B Coin revealed that the issuer purportedly based in Hong Kong, was allegedly telling investors that the distribution of its cryptocurrency was processed and managed by Williams Corp. Limited. As part of the sales pitch, R2B Coin claimed that Williams Corp. was a "licensed global firm," a "licensed and brokered" firm and a "licensed securities dealer."

Such representations are made to add a sense of legitimacy and safety to an offering.

Any investor conducting due diligence on the offering would have learned that, contrary to the R2B Coin's claims, Williams Corp. was not and is not registered to sell securities with either the State Securities Board or with the Financial Industry Regulatory Authority, a non-governmental regulator of brokers. The sense of legitimacy and safety was nothing more than a false statement, and the Securities

Commissioner brought an emergency action against R2B Coin for misleading and deceiving investors.

Don't Become A Crypto-Marketer

Instead of relying on registered professionals to sell their products to the public, promoters of securities tied to cryptocurrencies may instead be recruiting investors to pitch the investments to their family, friends and others using blogs, social media, websites and online advertisements. In return, investors may be promised not only a generous return on their principal investment, but also a position in a multi-level marketing matrix that ensures they'll receive lucrative commissions on sales they generate.

Six of the 32 offerings subject to the sweep involved the payment of a "finder's fee" or some other type of commission to investors who brought new persons into the scheme.

An online advertisement by USI-Tech

This is nothing more than a multi-level marketing scheme. An investor who recruits other investors is violating the law by offering securities without the proper license and offering securities that are not registered for sale in Texas. The consequences can be severe, as they face administrative, civil or criminal enforcement actions.

The Securities Board has acted against promoters of securitized cryptocurrencies that were actively recruiting investors to sell securities without the proper license. For example, the Securities Commissioner entered an Emergency Cease and Desist Order against

USI-Tech Limited, a company purportedly operating out of Dubai managed by an otherwise anonymous "top-class development team."

USI-Tech Limited was selling unregistered investments referred to as "BTC Packages" that supposedly derived their value from the issuer's non-exclusive interest in a series of Bitcoin mining contracts. It was promising generous returns, allegedly touting that purchasers of BTC Packages "have enjoyed profits of up to 150%" through the issuer's use of "unique algorithms" and a "conservative trading strategy" that "greatly minimize[d] the risk."

USI-Tech Limited was telling investors they could "generat[e] up to 35% commissions on 12 referral levels" through its "unique referral marketing plan," which appears to be a multi-level marketing scheme.

The pitch was enticing, however, because USI-Tech Limited claimed to pay the commissions to investors "without any qualification barriers." It provided excerpts of a "binding legal opinion letter" that stated USI-Tech Limited was a "legal business in good standing." USI-Tech Limited was also telling investors that it had "certified legal products in the USA per the FTC (Federal Trade Commissions) [sic]."

The claims were misleading. USI-Tech Limited was not licensed to sell the BTC Packages in Texas and the BTC Packages were not registered for sale in Texas. Its representation that existing investors would be paid generous commissions were deceptive because persons who offer and sell securities in Texas, including the BTC Packages, must generally be registered with the Securities Board.

There is no question the evolution of cryptocurrencies provides legitimate businesses with new and exciting means of raising capital and promoting dynamic new technologies.

At the same time, however, the Enforcement Division's investigations revealed that the revolution in digital money is creating an environment ripe with illegal and fraudulent securities offerings.

We Want to Hear From You

About this report:

Robert Elder,
Communications & Investor Education
relder@ssb.texas.gov

Joseph Rotunda,
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