

SEC's Action Against \$600 Million ICO May Have Implications for the Company's Partners and Service Providers

On January 25, 2018, the US Securities and Exchange Commission ("SEC") brought an action in federal court against AriseBank, the issuer of an initial coin offering ("ICO"), and its founders for conducting an unregistered securities offering and making false statements in connection with the offering.

Perhaps most surprising in the AriseBank matter is the speed and magnitude of the alleged fraud: the defendants are alleged to have obtained over half a billion dollars through illegal means in just over three months' time. This type of alleged massive fraud creates equally massive risks not just for possible bad actors at AriseBank but for legitimate businesses that have engaged with AriseBank, ranging from virtual currency exchanges where AriseBank offered its coins to the banks and money transmitters that AriseBank used to transact in fiat currency.

The SEC and others have characterized AriseBank's ICO as "an outright scam" and the SEC action as "the biggest action yet for the agency trying to police a red-hot market that's raised billions from a range of investors."¹

Notably, the SEC not only obtained an emergency freeze of the issuer's assets but also the appointment of a receiver charged with recovering assets on behalf of investors in the ICO. If the seized assets are insufficient to make those investors whole, the receiver may—as is increasingly common in cases of major frauds and Ponzi schemes—bring actions against

parties, such as banks and exchanges, that provided services to AriseBank in connection with the ICO. Such suits routinely allege that financial services companies were either negligent in failing to detect and prevent the misconduct or that they aided and abetted the misconduct.

Background

According to the SEC's complaint, AriseBank claims to have been founded in March 2017 by two Texas individuals to provide a decentralized banking platform for consumers and to raise capital through the AriseCoin ICO.² Among the products advertised by AriseBank were an automated algorithmic trading application for cryptocurrencies, an expiring (time-limited use) cryptocurrency, an AriseBank-branded debit card and deposit accounts insured by the Federal Deposit Insurance Corporation ("FDIC").³

From October 2017 until January 2018, AriseBank claimed to have engaged in a multi-step ICO that raised \$600 million in a public sale of AriseCoin and \$1 million in a private sale. One of the founders of AriseBank allegedly stated in public comments that "a private company can issue private stock to ANYONE who wants to invest in their company and/or products without the SEC's involvement in any way." He also claimed to "have geared up for the coming fight with the SEC."⁴ During this time, AriseBank received endorsements from well-

known public figures, including a former professional athlete and a founder of a cryptocurrency exchange that had entered into a partnership with AriseBank.⁵

Texas Department of Banking

On January 5, 2018, the Texas Department of Banking (“DOB”) issued a cease-and-desist order against AriseBank, its founders and another person associated with the company for violations of Texas banking law.⁶ The DOB found that AriseBank operated a website on which it claimed to be a cryptocurrency bank with locations in Texas, the United Arab Emirates and Switzerland, yet AriseBank was not chartered or authorized to engage in the business of banking in Texas and was prohibited under Texas law from using the term “bank” in its name. The DOB ordered AriseBank and its founders to stop implying that they engage in the business of banking in Texas and to change their website to clearly disclose that their products are not available to Texas residents. AriseBank was given 21 days to comply with or contest the order.

AriseBank responded on January 18, 2018, by issuing a press release in which it claimed to have acquired a 100-year-old US commercial bank (KFMC Bank Holding Company) and a 25-year-old investment banking and management firm (TPBG).⁷ It stated that these acquisitions would allow it to “offer its customers FDIC-insured accounts and transactions.”⁸ On January 26, 2018, the DOB publicly released the cease-and-desist order, noting that AriseBank had not responded to it and therefore it was a final order.⁹ According to the press, one of the founders of AriseBank responded publicly by saying that “these cryptocurrencies [have] long been outside the purview of the State of Texas, the United States Government or any government entity for that matter.”¹⁰

SEC Lawsuit

On January 25, 2018, the SEC filed under seal a civil action against AriseBank and its founders.¹¹ The SEC alleged that AriseBank and its founders were engaging in an ongoing, fraudulent and unregistered offering of securities because the AriseCoin ICO was an unregistered securities offering and that AriseBank and its founders had made many materially false statements and omissions to induce investment in the ICO. The SEC disclosed in this filing that one of the founders was previously charged with felony theft and tampering with government records and that he pled guilty to those charges and remains on probation. It also disclosed that the president of AriseBank had multiple arrests and convictions, including having served a five-year sentence for felony robbery and having been ordered to pay a \$250,000 fine. It appears that none of this biographical information had been publicly disclosed by AriseBank in connection with the ICO.

The SEC sought the following relief from AriseBank and its founders: (i) an injunction against further securities law violations or participation in an offering of digital securities or acting as an officer or director of an SEC-reporting company, (ii) the disgorgement of gains from the securities law violations, (iii) a civil money penalty, (iv) the freezing of all AriseBank assets and (v) the appointment of a receiver to oversee the assets of AriseBank.¹²

On January 25, 2018, a federal judge granted the SEC’s requests to freeze AriseBank’s assets and appoint a receiver. The receiver then attempted to secure the cryptocurrency assets held by AriseBank prior to the unsealing of the court’s order on January 29, 2018. According to the press, one of the founders of AriseBank claimed that the “FBI and SEC agents stormed AriseBank’s office in the middle of the night” and that the receiver had seized control of AriseBank’s assets.¹³ As of February 2, 2018, the receiver has indicated that the founder has been

unable to account for the alleged \$600 million in ICO proceeds and may have taken steps to remove certain assets from receivership estate.¹⁴

Takeaways

For entities that have done business with AriseBank. It appears that a number of well-known and reputable third parties were involved with AriseBank, e.g., through partnerships, endorsement relationships and service provider arrangements. We are not aware of any evidence that any of these persons or entities knew, or should have known, of AriseBank's alleged fraud. That said, it remains to be seen if the receiver will attempt to seek recovery from these third parties to the extent that AriseBank's assets are insufficient to repay investors. Such parties should conduct a prompt review, supervised by experienced counsel, to understand and minimize their potential exposure.

For entities doing business with cryptocurrency companies. Those entering into agreements with virtual currency market participants to provide services (e.g., payments, web hosting or endorsements) should conduct detailed due diligence to ensure that they are not dealing with a bad actor who could expose them to potential reputational damage or legal liability based on allegations that they were negligent in failing to detect and prevent fraud or that they aided and abetted fraud. Distinguishing between innovation and irregularities in this complex, rapidly evolving space may be difficult, and experienced counsel can help.

For entities promoting ICOs and cryptocurrencies. Ensuring compliance with SEC laws and regulations, as well as state and federal securities, commodities and money transmission laws, is complicated and fraught with peril. Virtual currency issuers, promoters and exchanges should retain experienced securities and financial regulatory lawyers to assist them in proactively and affirmatively ensuring their compliance with applicable law.

For retail purchasers and investors. All participants in ICOs and the virtual currency markets should be aware that while the SEC and other government agencies are actively taking steps to reduce and prevent fraud, some frauds will evade prompt detection. Accordingly, investors should carefully investigate prospective ICOs, read the SEC's investor bulletins and other guidance for investors relating to ICOs and online investments, and follow the maxim of "if it sounds too good to be true, it probably is!"¹⁵

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Endnotes

- ¹ SEC, *SEC Halts Alleged Initial Coin Offering Scam* (Jan. 30, 2018), Matt Robinson, *SEC Freezes Crypto Assets of \$600 Million Initial Coin Offering*, BLOOMBERG (Jan. 30, 2018).
- ² *Complaint, SEC v. AriseBank*, No. 3:18-CV-00186 (N.D. Tex., Jan. 25, 2018).
- ³ AriseBank subsequently announced that it would not offer FDIC-insured accounts to its users. AriseBank, *AriseBank™ Announces Correction on Recent Company News Citing FDIC Status and Acquisitions*, PR NEWSWIRE (Jan. 25, 2018).
- ⁴ *Complaint*, at 7-8.
- ⁵ Aaron Mak, *AriseBank Claims It Raised \$600 Million. The SEC Alleges the Company Is ‘An Outright Scam’*, SLATE (Jan. 30, 2018).
- ⁶ *In the Matter of AriseBank*, No. 2018-001 (Tex. DOB, Jan. 5, 2018).
- ⁷ AriseBank, *AriseBank™ Announces First-Ever Acquisition Of Traditional Banks By A Crypto Platform Expects ICO To Exceed \$1B Due To Popular Demand*, PR NEWSWIRE (Jan. 18, 2018). In its subsequently filed lawsuit, the SEC confirmed that the FDIC has no record of AriseBank acquiring an insured depository institution or of KFMC being an insured depository institution or bank holding company.
- ⁸ *Id.*
- ⁹ DOB, *Texas Department of Banking Commissioner Issues Cease & Desist Order Relating to AriseBank* (Jan. 26, 2018).
- ¹⁰ Penny Crosman, *Wild claims, armed raids: The blockchain bank that wasn't*, AMERICAN BANKER (Jan. 29, 2018).
- ¹¹ *Complaint, SEC v. AriseBank*, No. 3:18-CV-00186 (N.D. Tex., Jan. 25, 2018).
- ¹² *Id.*, Order Appointing Receiver, *SEC v. AriseBank*, No. 3:18-CV-00186 (N.D. Tex., Jan. 25, 2018).
- ¹³ Penny Crosman, *Wild claims, armed raids: The blockchain bank that wasn't*, AMERICAN BANKER (Jan. 29, 2018).
- ¹⁴ *Motion, SEC v. AriseBank*, No. 3:18-CV-00186 (N.D. Tex., Feb. 2, 2018).
- ¹⁵ SEC, *Investor Bulletin: Initial Coin Offerings (July 25, 2017)*; SEC, *Investor Alert: Bitcoin and Other Virtual Currency-Related Investments* (May 7, 2014); SEC, *Be Alert for Telltale Signs of Online Investment Fraud* (Sept. 13, 2006).

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