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Taming the “Wild West”: Regulators Take Aim at Unregulated Virtual Currencies

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Legitimate companies seeking to operate in the virtual currency space will be well advised to pay close attention to the changing environment and adapt their practices accordingly.

On May 24, 2013, the arrests in Spain, Costa Rica, and New York of five men associated with Liberty Reserve S.A. touched off a media frenzy over the world of virtual currency. The U.S. Attorney’s Office for the Southern District of New York (“SDNY”) announced criminal charges against Liberty Reserve, creator of a widely-used virtual currency, and seven individuals, asserting in the indictment that Liberty Reserve was nothing more than a money-laundering business intentionally “designed to help criminals conduct illegal transactions and launder the proceeds of their crimes.”¹ The arrests were part of a vast international law enforcement effort: authorities from 17 different countries reportedly helped with the investigation and takedown, which included, in addition to the arrests, a number of

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wiretaps, multiple search warrants, the seizure of five domain names and 45 bank accounts, and the filing of a civil action against 35 intermediary websites seeking the forfeiture of the intermediaries' domain names. U.S. Attorney Preet Bharara cast the takedown as an "important step towards reining in the 'Wild West' of illicit Internet banking."² The SDNY believes the \$6 billion case is the largest international money-laundering prosecution in history.

While the SDNY press release depicts Liberty Reserve as a brazen criminal organization — "the bank of choice for the criminal underworld" — it also was quick to distinguish Liberty Reserve's activities from those of "traditional banks or legitimate online processors." The takedown and the accompanying fanfare, coupled with the government's explicit nod to "legitimate online processors," underscores the uncertainties involved with virtual currencies and the increasingly important role that they are beginning to play in commerce. The last few years have seen virtual currencies transition from use only on the fringe of the Internet economy, to now, when they are beginning to be viewed as legitimate means of exchange. Authorities have jumped into the fray, seeking to regulate, but not ban, the world of virtual currencies. In March, the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") issued guidance on application of the Bank Secrecy Act to virtual currency, and one member of the Commodity Futures Trading Commission has indicated that the CFTC should look into whether consumers need protection in the virtual currency arena.³ Well-established enterprises and investors also are entering the picture, helping bolster the credibility of the virtual currency business: companies like Apple are beginning to explore the potential uses for virtual currency⁴ and, perhaps most famously, virtual currencies recently received a big boost of publicity when Cameron and Tyler Winklevoss — of Facebook fame — reportedly invested nearly \$11 million in Bitcoin.⁵

The Liberty Reserve takedown — while dramatic and purportedly aimed at a sprawling and blatant money laundering organization — at bottom demonstrates that the authorities can and will police the world of virtual currencies. Having taken the step toward "reining in the 'Wild West' of illicit Internet banking," the authorities have helped clear the way for a regulated, while admittedly less colorful, world of legitimate virtual currencies. Regulation is the price of legitimacy for the virtual currency world and, if executed prop-

erly, should enable legitimate companies to compete and innovate, while protecting consumers and policing against money laundering. There no doubt will be bumps along the way. The virtual currency world is still relatively new, and the regulatory landscape will change as the business evolves. As we discuss further below, legitimate companies seeking to operate in the virtual currency space will be well advised to pay close attention to the changing environment and adapt their practices accordingly.

THE WILD WEST OF YORE

Alternative currency exchanges have been around for nearly as long as there has been currency, and the form of “coin” and system of exchange seems limited only by the scope of a person’s imagination. The *hawala* system, common in the Middle East and India, dates back to at least the 8th century. Historically, a problem with many alternative currency exchanges has been that they are unregulated, and therefore susceptible to money laundering and abuse by the people operating the exchange system. Everything from works of art to t-shirts and dishwashers on the Black Market Peso Exchange have been used to launder money. And while the *hawala* system has perfectly legal uses, it also has been used for nefarious purposes, ranging from avoiding the embargo on Iran to allegedly financing terrorism.

Two early virtual currency companies — OSGold and E-Gold Ltd. — tied the value of their online currencies to purported reserves of gold bullion. OSGold offered its customers online banking services, but, as it turned out, the company and its founder, David Copeland Reed, also were using OSGold to operate a multi-million dollar Ponzi scheme. After fleeing to Mexico with duffel bags of cash, Reed eventually was caught, convicted, and, in March of this year, was sentenced to 51 months in prison.⁶ E-Gold, like Liberty Reserve, allegedly facilitated money laundering through its lax customer verification protocols and, in 2008, was charged with money laundering, conspiracy, and operating an unlicensed money transmitting business.⁷ According to the recent indictment, Liberty Reserve and its “LR” dollars are simply the next wave of alternative currency systems designed to facilitate money laundering. In fact, the principals of Liberty Reserve cut their teeth with E-Gold, operating an E-Gold intermediary called Gold Age, Inc., which led to

them being convicted in 2006 of operating an “unlicensed money transmitting business.” Apparently undeterred, they then allegedly moved to Costa Rica and “set about building a digital currency that would succeed in eluding law enforcement where E-Gold had failed.”⁸

THE LAW ARRIVES — VIRTUAL CURRENCY REGULATIONS

Early virtual currencies like OSGold and E-Gold no doubt presented challenges for people with legitimate interests in creating or using innovative methods of exchange. So it came as no surprise when FinCEN, on March 18, 2013, issued guidance on the application of the Bank Secrecy Act to virtual currency.⁹ The FinCEN guidance divides the virtual currency world into three — sometimes difficult to distinguish — players: administrators, exchangers and users.

- An “administrator,” like Liberty Reserve, issues virtual currency and “has the authority to redeem (to withdraw from circulation) such virtual currency.”
- An “exchanger” is involved in the exchange of a virtual currency for traditional, hard currency or other virtual currency.
- A “user” “obtains convertible virtual currency and uses it to purchase real or virtual goods or services,” whether by purchasing, earning or digital “mining.” The means of obtaining the virtual currency are not important. Users are not regulated under the FinCEN guidance.

The distinction between the three players in the virtual currency world is central to the guidance: Virtual currency “administrators” and “exchangers” are considered “money transmitters” and are regulated under the guidelines, while mere “users” are not. As a money transmitter, a virtual currency administrator or an exchanger is required to register as a money services business (“MSB”) and is subject to FinCEN’s regulations, as any ordinary money-transmitting service dealing in traditional currency would be. Among other things, an MSB must register with the Treasury Department and renew its registration every two years.¹⁰ Virtual currency administrators and exchangers also are subject to numerous other FinCEN regulations, including re-

quirements that they implement an anti-money laundering program,¹¹ as well as record keeping requirements and reporting obligations.¹² Failure to register as an MSB is punishable by civil penalty, and operating as an MSB without registering is a criminal offense.¹³ FinCEN's decision to characterize virtual currency administrators and exchangers as MSBs has implications for state regulation as well, including state-specific licensure requirements.

At first blush, the definition of "user" could be a bit confusing. By tying the definition to the *purchase* of goods or services, the FinCEN guidelines do not tell us whether a *seller* of goods or services that accepts virtual currency is a mere "user" or an "exchanger" governed by the Bank Secrecy Act. Helpfully, FinCEN's Director recently clarified that companies receiving virtual currencies as payments for goods or services also qualify as "users" and are not regulated under the guidance.¹⁴

Thus, in essence, the issuers of virtual currencies and the intermediaries that convert virtual and real word currency back and forth are the players that are most affected by FinCEN's guidance. In this context, Bitcoin appears to be an interesting case. As of this time, it does not appear that there is any specific person or entity that could be described as an "administrator" for Bitcoin.¹⁵ There are, however, many Bitcoin exchangers, and it is exchangers that we will now discuss.

THE LAWMEN RIDE IN

Mt.Gox Seizures

After FinCEN issued its guidance, regulators were quick to pounce. In May, the U.S. Department of Homeland Security secured warrants to seize the contents of two accounts held by Mt.Gox, a Japanese company and Bitcoin's largest exchanger.¹⁶ The seizures were purely a regulatory action — there was no criminal indictment and no resulting arrests. Homeland Security claimed both that Mt.Gox had failed to register with FinCEN as a money transmitting service, and that a subsidiary had falsely represented to Wells Fargo, when opening a bank account, that the company was not engaged in the money transmission business. Homeland Security seized the contents of an account at Wells Fargo, as well as Mt.Gox's account at an Iowa payment processor called Dwolla that Bitcoin customers used to deposit traditional

currency and buy Bitcoins. The seizure of the Dwolla account also affects the Bitcoin users who purchased Bitcoins from Mt.Gox — the money they transmitted to Dwolla for these purchases was frozen as well.

The Mt.Gox account seizures underscore the importance of staying on top of regulatory changes in a rapidly evolving environment. According to the affidavit submitted in support of the seizures, Mt.Gox opened its Wells Fargo account in May 2011, nearly one year before FinCEN issued its regulatory guidance that made clear that Mt.Gox is an MSB.

Liberty Reserve

The allegations detailed in the SDNY case against Liberty Reserve present a stark example of how virtual currencies can be used to facilitate crime. The indictment details how Liberty Reserve was the “bank of choice” of an underworld consisting of drug traffickers, computer hackers, child pornographers and other criminals. The indictment asserts that the vast majority of Liberty Reserve’s more than one million users worldwide relied on the company’s digital currency to facilitate criminal enterprises and launder their criminal proceeds.¹⁷

Nor was this a case where criminals took advantage of weak controls to launder money through Liberty Reserve. Rather, Liberty Reserve’s creators allegedly established the company with the specific goal of facilitating criminal activity, and allegedly made many of the company’s structural decisions to further this end. For example, while Liberty Reserve required its users to provide a name and address, the company allegedly did not verify the information provided, allowing one undercover agent to create an account in the name of “Joe Bogus,” at “123 Fake Main Street” in “Completely Made Up City, New York.”¹⁸ Further masking its users’ identities, Liberty Reserve required customers to use third-party exchangers to effect transactions and provided a list of preferred exchangers on its website. By refusing to accept any traditional currency itself, Liberty Reserve’s users and their specific transactions effectively were hidden from the company, which helped Liberty Reserve avoid a paper trail. As if this were not enough, Liberty Reserve also offered its users the opportunity to pay an additional fee for complete anonymity in any given transaction.

Parallel with the criminal case, FinCEN announced that Liberty Reserve

would be listed as “a financial institution of primary money laundering concern” pursuant to the USA PATRIOT Act.¹⁹ Together with this determination, FinCEN filed a notice of proposed rulemaking to implement “special measures” against Liberty Reserve, which, if adopted, effectively would cut off Liberty Reserve from the U.S. financial system and would prohibit U.S. financial institutions from opening or maintaining accounts connected to Liberty Reserve.²⁰

HOW THE WEST IS WON — VIRTUAL CURRENCY BEST PRACTICES

Regulators’ increased focus on virtual currency — on balance — should be viewed as a positive development for law-abiding individuals and businesses who use or accept virtual currency or are otherwise involved in the virtual currency economy. Actions like those against Liberty Reserve and FinCEN’s recent regulatory guidance ultimately should provide an increased legitimacy to virtual currency. By regulating, but not banning, virtual currencies, the U.S. government effectively is confirming that virtual currency administrators and exchangers should act like, and will be treated much like, the brick-and-mortar banks we see at every corner or the currency exchangers seen in international airports.

But as traditional financial institutions well know, regulation — and the legitimacy it brings — comes at a cost. Like their traditional counterparts, virtual currency administrators and exchangers will need to pay careful attention to the multitude of laws and regulations to which they are now clearly subject. Liberty Reserve and the Mt.Gox action provide useful examples of the potential missteps. In addition to registering as an MSB, “know your customer” due diligence is a critical practice for virtual currency administrators and exchangers. Mt.Gox, for example, just announced such an initiative.²¹ The indictment of Liberty Reserve focused heavily on the alleged total lack of transparency that allowed criminal elements to flourish. Transparency, both to potential customers and regulators, will be vital to the legitimacy of virtual currency and the ability of virtual currency to make deeper inroads into the mainstream economy.

For virtual currency users, including retailers who are thinking of accept-

ing virtual currencies, the considerations will be somewhat different. Before opening a virtual currency account or deciding to accept virtual currency, consumers and businesses should do their own due diligence, making sure that their chosen virtual currency administrator and/or exchanger has properly registered as an MSB. Using an unregistered provider could lead to a user's assets being frozen as the result of an enforcement action against the administrator or exchanger, as in the case of Mt.Gox.

NOTES

¹ *U.S. v. Liberty Reserve et al.*, No. 13-cr-00368 (S.D.N.Y.).

² U.S. Attorney's Office, Southern District of New York, Press Release, *Manhattan U.S. Attorney Announces Charges Against Liberty Reserve, One Of World's Largest Digital Currency Companies, And Seven Of Its Principals And Employees For Allegedly Running A \$6 Billion Money Laundering Scheme* (May 28, 2013), available at <http://www.justice.gov/usao/nys/pressreleases/May13/LibertyReservePR.php>.

³ Interview with CFTC Commissioner Bart Chilton, *CFTC Explores Bitcoin*, CNBC (May 7, 2013), available at <http://video.cnbc.com/gallery/?video=3000166533>.

⁴ John Koetsier, *Apple files 'iMoney' patent for virtual currency, digital wallet, and...free stuff*, Venture Beat (June 6, 2013), available at <http://venturebeat.com/2013/06/06/apple-files-imoney-patent-for-virtual-currency-digital-wallet-and-free-stuff/>.

⁵ Nathaniel Popper & Peter Lattman, *Never Mind Facebook; Winklevoss Twins Rule in Digital Money*, N.Y. Times (Apr. 11, 2013), available at <http://dealbook.nytimes.com/2013/04/11/as-big-investors-emerge-bitcoin-gets-ready-for-its-close-up>.

⁶ Marcus Asner handled the prosecution of David Copeland Reed while working as an Assistant U.S. Attorney for the Southern District of New York.

⁷ *United States v. E-Gold, Ltd.*, CR-07-109 (D.D.C. 2008).

⁸ *United States v. Liberty Reserve et al.*, No. 13-cr-00368 (S.D.N.Y.).

⁹ Department of the Treasury, *Financial Crimes Enforcement Network, Application of FinCEN's Regulations to Persons Administering, Exchanging or Using Virtual Currencies*, FIN-2013-G001 (Mar. 18, 2013).

¹⁰ 31 CFR § 1022.380.

¹¹ 31 CFR § 1022.210.

¹² 18 U.S.C. § 1960; 31 CFR § 1022.300 *et seq.*; 31 CFR § 1022.400.

¹³ 31 CFR § 1022.380(e).

¹⁴ The text of Jennifer Shasky Calvery's speech at the April 16, 2013 National Cyber-Forensics Training Alliance conference are available at http://fincen.gov/news_room/speech/pdf/20130416.pdf.

¹⁵ There is, of course, the Bitcoin Foundation, but it does not purport to issue or redeem Bitcoins. Bitcoin was designed and released by the pseudonymous Satoshi Nakamoto. In very brief terms, a limited number of Bitcoins are to be created, or "mined," by computers running the Bitcoin protocol. As such, unless these computer networks and their operators were deemed to be "issuers" of Bitcoins, there does not appear to be an administrator for Bitcoin. We must stress, of course, that Bitcoin is a new phenomenon, and that future developments related to such technologies cannot be known.

¹⁶ The May 9, 2013 Wells Fargo seizure warrant is referenced in the May 14, 2013 affidavit; In the Matter of the Seizure of the contents of one Dwolla account, No. 13-1162 SKG (D. Md. May 14, 2013), *available at* <http://money.cnn.com/interactive/technology/dhs-mtgox-bitcoin/>.

¹⁷ Anti-Money Laundering Statute, 18 U.S.C. §§ 1956 and 1957; Prohibition of Unlicensed Money Transmitting Business, 18 U.S.C. § 1960.

¹⁸ U.S. Attorney's Office, Southern District of New York, Press Release, *supra* n. 2.

¹⁹ Pub. Law 107-56; *see* 78 Fed. Reg. 34169 (June 6, 2013).

²⁰ 78 Fed. Reg. 34008 (June 6, 2013).

²¹ Mt. Gox, Press Release, *Statement Regarding Account Verifications* (May 30, 2013) *available at* https://mtgox.com/press_release_20130530.html.