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Legal update ——— November 2018

Dispute Resolution and Litigation
Cryptocurrency and Fraud

A cryptocurrency is an electronic coin or token, usually adopted through a blockchain ledger which will record its transactions (for more information on blockchain technology, see our previous article on the subject). There are currently hundreds of different cryptocurrencies in existence; many of which were created for a specific purpose (i.e. perhaps to facilitate fast and cost effective international transactions, for gaming and social media or for data storage and security). In respect of the former, the ability to transfer value (through a cryptocurrency) could bypass major currency fluctuations or bank charges.

Cryptocurrency is purchased and sold through exchanges. Those transfers are recorded on a blockchain ledger and are controlled by public or private 'keys' stored which are stored in electronic wallets (and which allow a cryptocurrency to be transferred). The actual cryptocurrency is maintained through its public ledger. Perhaps until the bull market which came to a head in early 2018, and which saw the price of Bitcoin rise as high as $19,000 per coin (in contrast the current price is around $6,000), there was for some a certain stigma attached to cryptocurrency. Bitcoin, the first mainstream cryptocurrency, was historically used (and in some case will still be) to buy and sell drugs, launder money and fund terrorism through the dark web. In addition, the process of solving the complex computational problems when validating a transfer gets progressively harder on each occasion, meaning that more computing power (and electricity) is required and which highlights significant environmental challenges that cryptocurrency has not yet addressed.

Generally speaking, a cryptocurrency is not backed by underlying assets (such as gold) and, therefore its intrinsic value can be difficult to quantify. In addition, the price of a cryptocurrency can be notoriously volatile, which at its current state can mean that investors and enthusiasts can make significant profits, or losses.

The process by which cryptocurrencies are created is called an Initial Coin Offering (**ICO**) and which is akin to an Initial Public Offering (being the process by which a company offers it shares to the public on an exchange). At the start of an ICO, the founders of a coin will prepare a document known as a whitepaper which will set out what the business use of the coin is. The key to a successful ICO is establishing credibility (as well as ensuring that financial regulatory boundaries are not inadvertently crossed). The regulatory position is not addressed in this article, save for pointing out that it is complicated and that specialist advice should be sought out to ensure that the general prohibition within the Financial Services and Markets Act 2000 is not contravened.

Cryptocurrencies have been a target market for fraudsters, who look to abuse vulnerabilities in the system. In August 2018, the Financial Times confirmed that there had been 203 reports of cryptocurrency fraud in June and July 2018, which resulted in a total of £2.1m being lost (averaging at £10,096 per person). On some occasions, it is the creators who benefit by funnelling all money out of the business which creates and maintains the coin (leaving the business as a worthless shell). On others, it is investors who deliberately manipulate the market as a 'pump and dump' fraud. There are widely publicised occasions in which the creators make dishonest or untrue statements, or operate Ponzi schemes (see for example RECoin in the USA). The last major category is where vulnerability in the organisation conducting the ICO is targeted (perhaps through its website), which often results in the address for a wallet being altered (unbeknown to the organisation or the investors who transfer funds directly to a fraudster instead of the business).

Organisations and investors must remain vigilant. Organisations must ensure that they have policies and procedures in place to prevent and detect fraud and, as well as ensuring their regulatory obligations are met, should take advice as to how they can mitigate their own risk (potentially by way of insurance products, or limitation of liability clauses in contractual

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documentation). Investors should remain savvy and remember that if something sounds too good to be true, it usually is! The key for either victim, however, is to respond quickly.

Technology and innovation should be embraced and it is not unthinkable that additional regulation will stabilise the volatility and cryptocurrency will play a recognised and important part in global financial markets. Until that time, there is a lot of work to be done to protect the interests of organisations and investors.

Trowers & Hamlins have advised on cases involving relating to cryptocurrency and fraud. Please contact the team for further information.

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