Regulation of the unregulated: How bitcoin and cryptocurrencies show that the government can regulate anything

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Bitcoin was born shrouded in mystery.

Using the alias Satoshi Nakamoto, an anonymous creator sought to produce an electronic asset that could be exchanged worldwide without the involvement of any central governmental banking system.

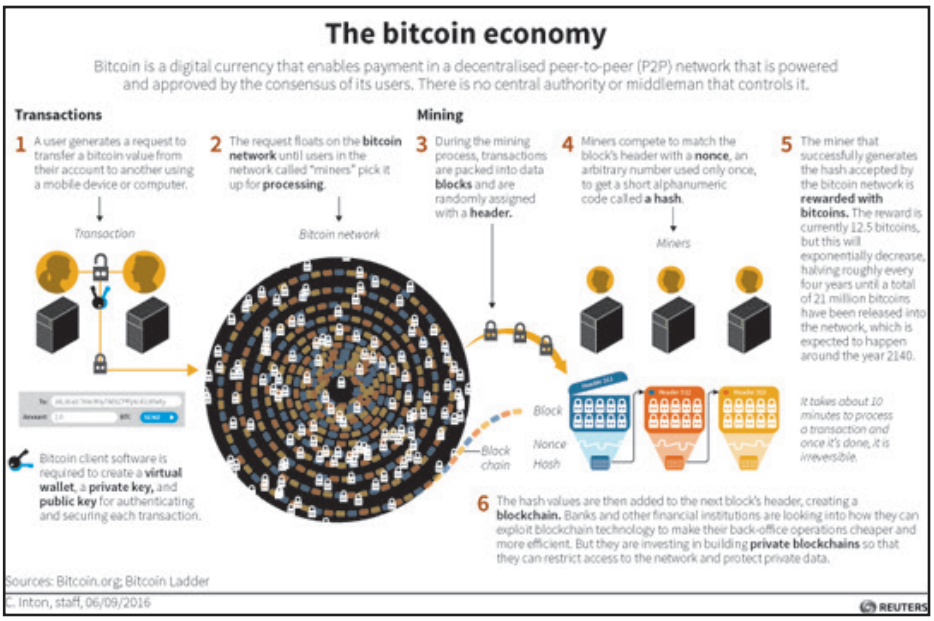
The exchange of a "thing of value" would not require banks or trust in another party. Instead, it would rely on an unregulated, uncontrolled, independent, non-hackable verification system. Since bitcoin by its very nature was not being supported by any government or entity, it was not subject to established laws.

HOW DOES IT WORK?

Bitcoins and other virtual currencies, also known as cryptocurrencies, are intrinsically valued based on supply and demand, just like physical commodities. They are valued at the price someone will pay in order for someone else to sell.

Supply, laws, regulations, public perception, utility and a host of other variables contribute to the valuation of the various types of cryptocurrencies. While there are many variations of cryptocurrencies today, most work along the same outline as bitcoins.

A bitcoin is a virtual asset that does not exist in the physical world. Instead, it consists of an entry on a public ledger known as a "blockchain," and it is owned by the possessor of a secret number, or "private key."



This graphic illustrates how the bitcoin economy works.

The private key has a mathematical relationship with the public number in the ledger entry. The public ledger contains a chronological record of all the prior ownership changes of the bitcoin.

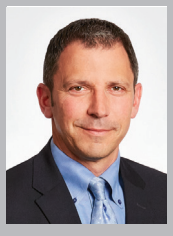
Bitcoins can be analogized to the National Hockey League's Stanley Cup. Just as all the teams, players and coaches who won the championship are listed on the trophy, you can see in the bitcoin (via the ledger entry) the identity of the most recent owner.

The bitcoin is transferred when the next owner provides a public key and the previous owner uses their private key to publish a record into the public ledger announcing the ownership has changed to the new public key.

Users transfer bitcoins to others by utilizing bitcoin software. Each prospective bitcoin user utilizes the software to create a bitcoin wallet, which is simply a file containing randomly generated numbers that are treated as the public-private key pairs for future bitcoin transactions.

The public key is much like an email address — it is an endpoint for a transaction. Much like an email address is given out to a sender in anticipation of receiving a message, a bitcoin address is given out in anticipation of receiving a payment.

Bitcoins sent to a bitcoin address are owned by the person who has knowledge of the private key associated with the address.



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The "bitcoin network" is a system that creates and tracks the transfer of ownership of each bitcoin and acts as a distributed ledger combined with a timestamp server, creating a single unretractable public record of all transactions in chronological order, thus ensuring correct current ownership.

The bitcoin network is not operated by any single organization. Instead, it is a decentralized system consisting of all users of the bitcoin software worldwide.

> Bitcoins and other virtual currencies, also known as cryptocurrencies, are intrinsically valued based on supply and demand, just like physical commodities.

While other cryptocurrencies preceded it, bitcoin — at first slowly and then like wildfire — became the dominant cryptocurrency traded worldwide. In fact, its trading price skyrocketed from around $900 at the start of 2017 to nearly $20,000 by the middle of December.

It seemed impossible to lose money, and many new cryptocurrency entrants sought to mimic its meteoric rise.

OTHER CRYPTOCURRENCIES

While the bitcoin network, software and blockchain method are very complicated, they are also very easy to mimic. The barriers to entry for a person or group seeking to create their own cryptocurrency and sell it as the "next bitcoin" are not very high.

Even before 2017, many cryptocurrencies (including Litecoin, Ethereum, Ripple and hundreds more) were released into the world marketplace. Money began to flow into companies that were offering their version of cryptocurrency through what was called an initial coin offering.

While the U.S. government (through the Financial Crimes Enforcement Network) had previously issued regulatory guidance on bitcoin, the rise in the popularity of ICOs and lack of significant regulation led the government to step up its regulatory influence as 2017 drew to an end.

THE SEC'S ROLE

In mid-December 2017, Securities and Exchange Commission Chair Jay Clayton warned that the agency would be specifically scrutinizing cryptocurrencies and ICOs under the applicable laws governing the offer and sale of securities.

This public warning was simply a restatement of long-established case law and practice used by the SEC and other state and federal regulators to regulate investment opportunities.

Since the U.S. Supreme Court's decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), a security has been broadly defined to include any "investment of money in a common enterprise with profits to come solely from the efforts of others."

This definition has been applied broadly over the years. In one instance, the SEC took action against a company that sought to sell investment contracts for live beavers for breeding purposes. The company promised a "road to riches" as the first company in "the world to learn the secrets of the beaver." *Cont'l Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967).

Whether it be bitcoins or beavers, the Supreme Court has made it clear that securities laws apply to "virtually any instrument that might be sold as an investment." *SEC v. Edwards*, 540 U.S. 389 (2004).

Securities are more than just equity interests in companies or debt instruments. The definition also includes "investment contracts."

Let us briefly revisit the *Howey* decision, which was the first major case in this area.

In this case, a company was selling portions of orange groves to investors. As part of the sale, the company included a contract for the management of the orange groves. This meant that if you bought one of these packages you would get a portion of the orange groves, someone else would take care of them and you would earn profits on the whole deal based on your percentage interest in the groves.

The sale of these contracts turned out to be a security and thus subject to the securities laws. The high court, using what is now known as the "*Howey* test," defined a security as that which includes "an investment of money in a common enterprise with profits to come solely from the efforts of others."

When the *Howey* test is applied in the context of cryptocurrency or an ICO, the investment vehicles appear to fall within the definition of a security. The investor buying the asset or contract never takes possession of the item and relies on the efforts of others for the investment to grow in value.

In terms of the definition of "investment contract," the purchaser has made an investment for value in a common enterprise (the mining assets or the ICO) with profits to come solely from the efforts of others (the miner or company engaged in the ICO).

It should be noted that where these interests are represented by ownership interests in an entity (such as a limited liability company, corporation or other entity) and such interests are issued for value, the analysis need not dwell on whether an "investment contract" exists because the equity issued is clearly a security.

As the new "greatest thing" since beavers or orange groves, cryptocurrencies and ICOs are simply the latest investment opportunity subject to securities laws. Even though they represent a thing of value (like gold or currencies) or utility, they are not released from the significant securities compliance obligations and potential liabilities that follow.

The SEC has made clear that, in its view, issuances of cryptocurrency (through ICOs) are securities offerings, and issuers that fail to run the gauntlet associated with such offerings do so at their extreme peril. This threat is not merely theoretical.

In a well-publicized event, in January the SEC sued cryptocurrency issuer AriseBank and its two founders for securities violations relating to the company's then-ongoing ICO. *SEC v. AriseBank et al.*, No. 18-cv-186, *complaint filed*, 2018 WL 623772 (N.D. Tex. Jan. 25, 2018).

AriseBank was looking to raise $1 billion in working capital for a "decentralized bank," and it claimed to have more than $600 million in the door when the SEC filed suit.

The SEC also sought and obtained an immediate temporary restraining order and seizure of assets, bringing AriseBank's business to an immediate halt.

According to public statements made by people with knowledge of the events, some of the assets were seized at gunpoint in a dramatic scene more consistent with seizures of weapons or drugs.

While the AriseBank action was the most publicized and dramatic action the SEC has taken against ICO issuers, it is by no means the only action.

In April 2018 the SEC filed civil and criminal complaints against coin issuer Centra Tech and its principals, alleging fraud and the sale of unregistered securities in connection with a large ICO. *SEC v. Sharma et al.*, No. 18-cv-2909, *complaint filed*, 2018 WL 1603904 (S.D.N.Y. Apr. 2, 2018).

The SEC has also issued cease-and-desist letters to other companies that were in various stages of holding ICOs. It certainly appears that the days of ICO issuers flying below the SEC's proverbial radar are numbered, if not a thing of the past.

It is important to note, however, that no court has yet held that cryptocurrencies are securities or that an ICO is a securities offering. Nor has any court concluded that cryptocurrencies are not securities. The issue simply has never been decided one way or another.

FINCEN STEPS IN

The Financial Crimes Enforcement Network was one of the first regulators to step into the world of cryptocurrencies.

In March 2013 it issued interpretive guidance titled "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies." This guidance was intended to clarify the applicability of the regulations implementing the Bank Secrecy Act to people who create, obtain, distribute, exchange, accept or transmit virtual currencies.

Under the BSA, any "money services business," or MSB, is required to register with FinCEN. Any individual who is part of an unlicensed money transmitting business could be fined, imprisoned for up to five years or both under FinCEN's regulatory enforcement scheme.

An MSB includes any person doing business (whether or not on a regular basis or as an organized business concern) that operates as, among other things, a "money transmitter."

A money transmitter is broadly defined as a person who provides "money transmission services" or any other person engaged in the transfer of funds.

Money transmission services means the acceptance of currency, funds or other value that substitutes for currency from one person and the transmission of currency, funds or other value that substitutes for currency to another location or person by any means.

Parties must be licensed to participate in such transactions. If they are not, they risk being deemed an "unlicensed money transmitting business" subject to liability under FinCEN's regulatory scheme.

FinCEN has made it clear that a money transmitter that accepts and transmits a convertible virtual currency, or buys or sells convertible virtual currency in exchange for currency of legal tender or another convertible virtual currency for any reason, is a money transmitter under the agency's regulations, unless otherwise exempt under very limited circumstances.

A person or entity that acts as a money transmitter is required to, among other things (in addition to complying with state money transmitter licensing requirements):

- Register as an MSB with FinCEN.
- Conduct a comprehensive risk assessment of its exposure to money laundering.
- Implement an anti-money laundering program based on such risk assessment.
- Often, at the state level, carry a significant bond.
- Comply with the recordkeeping, reporting and transaction monitoring obligations set down in Parts 1010 and 1022 of 31 C.F.R. Chapter X.

In March 2018 FinCEN additionally weighed in on ICOs, stating in part that depending on the nature of the cryptocurrency being issued, developers of ICOs may be deemed to be MSBs required to comply with requirements on anti-money laundering/combatting the financing of terrorism.

FinCEN acknowledged that it is working closely with the SEC and the Commodity Futures Trading Commission to clarify and enforce the AML/CFT obligations of businesses engaged in ICO activities.

THE CFTC'S POSITION

Since 2015 the CTFC has taken the position in litigation that bitcoin and other virtual currencies should be defined as commodities and thus subject to agency regulation. The issue had not been resolved by any court until March, when Judge Jack Weinstein of the U.S. District Court of the Eastern District of New York held that cryptocurrencies are in fact properly characterized as commodities. *CFTC v. McDonnell et al.*, 287 F. Supp. 3d 213 (E.D.N.Y. 2018).

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The issue arose in the context of a motion to dismiss filed pro se by a defendant in a case of alleged fraud in connection with CabbageTech Corp.'s solicitation of cryptocurrency and fiat currency from customers, purportedly in exchange for "virtual currency trading advice" and purchases of cryptocurrencies on behalf of customers.

Patrick K. McDonnell, the owner and principal of CabbageTech, moved to dismiss the complaint, claiming the CFTC had no right to regulate virtual currency as a commodity.

Judge Weinstein rejected that argument, finding that "virtual currencies are 'goods' exchanged in a market for a uniform quality and value," and thus "fall well within the common definition of 'commodity.'"

Judge Weinstein noted that "Congress has yet to authorize a system to regulate virtual currency."

He went on to catalog the myriad range of options for regulation of cryptocurrency based on existing frameworks — from no government regulation whatsoever to regulation by the CFTC, the SEC, the IRS, the Justice Department, the Treasury Department and myriad state agencies.

The opinion highlights the fundamental problem courts face in trying to graft a

complex network of laws and regulations onto a relatively new technology that, depending on the circumstances, can look like a commodity, security or other traditional forms of investment.

Unless and until Congress definitively establishes which laws and regulations apply to cryptocurrency, the regulatory bodies will be in a virtual tug-of-war, with issuers and investors either caught in the middle or watching with interest from the sidelines.

Judge Weinstein's opinion in the CabbageTech case does not bind any other court. As the first published court decision on this important issue, however, it is likely to carry significant persuasive value, at least until an appellate court weighs in on the matter.

It is also important to note that the ruling was highly fact-dependent. The question of whether a cryptocurrency is a commodity will always depend on the specific underlying facts and circumstances.

THE IRS AND TAX LAWS

The tax laws have always applied to gains and losses of all types, and the question is how sales and purchases of cryptocurrencies fit within the tax code. Before the meteoric rise of bitcoin the IRS had stated that cryptocurrencies are property, not currency. As property, the applicable taxes will depend on how the property is acquired, used and sold.

Unless it is held as inventory or certain other exceptions apply, cryptocurrency is a capital asset. If it is held for more than a year and then sold, the transaction will generate a long-term capital gain or loss. Taxpayers need to track their tax basis in the cryptocurrency.

With respect to cryptocurrency acquired at different times for different amounts, issues also arise with respect to determining which cryptocurrency was sold. Certain parties may have Form 1099 or other tax-reporting requirements with respect to the sales.

Of course, taxpayers are required to report income, gain or loss from these transactions on their tax returns, regardless of whether they receive a Form 1099.

When used to pay employees or independent contractors, pay for goods or services, or satisfy any liability, the transfer is treated as a taxable sale of the cryptocurrency. The fair market value of the cryptocurrency transferred, minus the holder's tax basis in the cryptocurrency transferred, generally is taxable gain or loss.

Depending on the context in which the transfer occurs, various income tax reporting obligations may apply. With respect to payments to service providers, for example, Form W-2 or Form 1099 reporting generally is required.

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When a person "mines" cryptocurrency, the fair market value of the currency as of the date of receipt is to be counted as gross income. If the mining constitutes a trade or business, self-employment tax may apply. Further, expenses incurred in a trade or business, such as energy costs, may be deductible.

When a taxpayer exchanges a cryptocurrency for a different cryptocurrency held by another person, a taxable exchange has occurred. Each party is a buyer and seller, and each will have gain or loss equal to the fair market value of the cryptocurrency they transfer minus the tax basis in the transferred cryptocurrency.

The Tax Cuts and Jobs Act amended Section 1031 of the Internal Revenue Code, effective generally for exchanges completed after Dec. 31, 2017, so that the like-kind exchange rules apply only to exchanges of real estate.

Prior to the amendment, Section 1031 applied to a broader class of exchanges, and many taxpayers took the position that exchanges of cryptocurrencies qualified for Section 1031 treatment.

The taxation of cryptocurrencies issued in ICOs will depend on what the "virtual asset" is meant to be by both the issuer and the acquirer. Is it equity? A right to receive a future value? An intended virtual currency? Because the tax implications of cryptocurrencies are complicated, tax counsel should be consulted.

IF IT CAN BE CREATED, IT CAN BE REGULATED

2017 may well be viewed historically as both the apex and the swan song of ICOs in the United States. The massive rise in bitcoin's price over the course of the year certainly contributed to an exponential increase in investor interest in cryptocurrencies.

Because supply will almost always respond to demand, those looking to raise money (whether for legitimate or illegitimate reasons) saw ICOs as a quick and easy way to do so. But with increased popularity and rising interest came the inevitable efforts by regulators to bring order and sanity to what had quickly become a "Wild West" ICO market.

While detractors will argue that the pendulum has swung too far the other way — with too much regulation and uncertainty stunting growth and opportunity — others will cite the protection of investors as being paramount and will insist that legitimate coin issuers will thrive in a more heavily scrutinized environment.

As with all such debates, there is undoubtedly truth on both sides of the argument. In any event, those looking to issue and trade in cryptocurrency will have to navigate the regulatory gauntlet to avoid serious — and perhaps ruinous — legal action. WJ