CRYPTOCURRENCY 2018: WHEN THE LAW CATCHES UP WITH GAME-CHANGING TECHNOLOGY

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Blockchain technology and the virtual currency, or cryptocurrency, that uses this technology are revolutionizing the way businesses function and deliver goods and services. Even as cryptocurrency becomes a widely debated topic, gaining the critical attention of regulators and policymakers, individuals and businesses are investing billions of dollars in cryptocurrency annually.

To understand how blockchain and cryptocurrency may impact you, your business, and your industry, it is important to understand what cryptocurrency is and how the underlying blockchain works. This article provides a brief introduction to these concepts as well as a primer on cryptocurrency legal issues.

BLOCKCHAIN AND CRYPTOCURRENCY

In short, blockchain is a digital, decentralized ledger that uses software algorithms to record all transactions distributed across a peer-to-peer network. Using blockchain, or "distributed ledger" technology, users can confirm transactions without the need for a central certifying authority, such as a central bank. Each party, or "node," participating in the blockchain network maintains a copy of the distributed ledger and acts as a "witness" to each transaction. The "transparency" of the transactions is a cornerstone of the technology. The transactions are grouped into "blocks," validated, and then added to the shared ledger.

While blockchain is the foundation of cryptocurrency, it has other uses. The potential applications of blockchain reach far beyond cryptocurrency. Various industries, including financial services, healthcare, retail, and the public sector, are exploring, developing, or already using the technology. Blockchain brings enormous promise; the transparent and immutable system is touted as safe from fraud, identity theft, tampering, and (at least initially) political control.

Despite blockchain's other practical uses, cryptocurrency is in the spotlight. Cryptocurrency offers a peer-to-peer payment option that allows users to securely send or receive electronic payment. Cryptocurrency is decentralized digital currency secured through encryption techniques to control the creation of monetary units and to verify the transfer of funds.[1] Unlike traditional currencies, cryptocurrency eliminates the role of a third party to process electronic payments. Because cryptocurrency is permanently recorded on a digital ledger using blockchain, all transactions are recorded and visible to all users, prohibiting third parties from tampering with payments.

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Broad adoption of the technology has fueled the use of cryptocurrency to fund businesses and investments, leading to the creation of cryptocurrency exchanges, which allow people to buy, sell, and transfer cryptocurrencies. Today, billions of dollars are traded in cryptocurrency. Despite this incredible volume and rapid growth, there is little regulation and oversight. We are only beginning to see litigation, enforcement, and regulation in this blossoming industry.

LEGAL ISSUES IN CRYPTOCURRENCY

A critical distinction will be whether cryptocurrency coins or tokens are securities that should be regulated by the Securities and Exchange Commission (the "SEC"). This issue has received exposure in recent months due to the growing use of cryptocurrency in Initial Coin Offerings ("ICOs"). Similar to an initial public offering, companies use blockchain to issue customized cryptocurrency coins or tokens in exchange for other established cryptocurrency, such as Bitcoin, to raise capital. If cryptocurrency tokens are considered securities (a hotly debated topic), then they must be offered and sold in the U.S. or to U.S. investors in accordance with U.S. securities laws.

The SEC's Investigative DAO Report And Latest Guidance

In July 2017, the SEC released its investigative report on the Decentralized Anonymous Organization's (the "DAO") coin offering.[2] The SEC concluded that the facts and circumstances of a particular ICO determine if it is a security. The SEC analyzed whether tokens issued by the DAO constituted "investment contracts" under the United States Supreme Court's long-established standard in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). Under this test, an investment is a security under the Securities Act of 1933 and the Securities Exchange Act of 1934 if there is an investment of money in a common enterprise with a reasonable expectation of profits to be derived primarily from the entrepreneurial or managerial efforts of others.[3], [4]

While the SEC concluded that the DAO tokens constituted unregistered offerings of securities, it declined to bring an enforcement action, instead issuing its investigative report (the "Report") as an advisory opinion. While the Report does not classify all ICO token offerings as securities offerings, it serves as a warning to new and existing coin offerors and paved the way for private litigation.

The SEC offered additional caution to the ICO market on December 11, 2017 when it issued a cease and desist order to Munchee Inc., a smartphone app developer that sold digital tokens to raise funds (the "Munchee Order")[5] , and Jay Clayton, the SEC Chairman, released a "Statement on Cryptocurrencies and Initial Coin Offerings" (the "Clayton Statement"). [6], [7] The Munchee Order emphasizes that the SEC will apply the facts and circumstances analysis under *Howey* to ICOs irrespective of token labels or classifications by offerors. Similarly, the Clayton Statement scrutinizes the characterization of tokens and includes an example for when token use may not be considered securities. Through this latest guidance, the SEC has clearly signaled its intent to monitor the ICO market and proactively enforce securities regulations.

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Litigation - Class Action Lawsuits

As the popularity of cryptocurrency grows, important questions about how to properly categorize cryptocurrency within the existing U.S. regulatory framework need to be answered. Recently filed class action lawsuits against alternative coin startups may be the first cases to clarify what cryptocurrency is and how it should be governed.

***StormsMedia, LLC v. Giga Watt, Inc. et al.*, 2:17-cv-00438 (E.D. Wash. Dec. 28, 2017)**: On December 28, 2017, plaintiffs filed a putative class action in the U.S. District Court for the Eastern District of Washington against Giga Watt, Inc. ("Giga Watt"). In the wake of Giga Watt's ICO, investors allege "that Defendants promoted and conducted an unregistered offering of securities."

In June 2017, Giga Watt sought investors to launch a cryptocurrency mining facility. Under the ICO, investors could contribute Bitcoin, Ether (the token for Ethereum), or U.S. dollars in exchange for either: 1) cryptocurrency tokens issued by Giga Watt, called "WTT," representing the right to use Giga Watt's Bitcoin mining hardware rent-free for 50 years; or 2) Bitcoin mining equipment to be set up and deployed at Giga Watt's facility. The WTT tokens were self-valued at approximately $1.00-1.20 and predicted to rise following the success of the Giga Watt facility.

A central issue in the suit is whether the Giga Watt tokens issued before the launch of the mining facility are securities. Plaintiffs allege that they are, explaining: "The Giga Watt investors invested in a common enterprise and with an expectation that their investments would increase in value and produce for them a substantial return — all pivotal occurrences that would be derived solely from the efforts of others, namely Defendants."

On January 19, 2018, Giga Watt reached a resolution with the lead Plaintiff and dismissed the lawsuit without prejudice to potential class members.

***Audet, et al. v. Garza, et al.*, 3:16-cv-940 (D. Conn. June 15, 2016)**: On October 11, 2017, the U.S. District Court for the District of Connecticut denied a motion to dismiss a putative class action complaint alleging, among other things, that defendants Stuart Frazier and GAW Miners ("GAW") engaged in fraud in connection with the purchase and sale of securities, as well as the offer and sale of unregistered securities.

Plaintiffs alleged that GAW sold products and investment contracts to thousands of ICO investors, claiming that they would receive a return in the form of profits from cryptocurrency mining or other investments in cryptocurrency. One such venture involved the sale of "Hashlets," or cryptocurrency tokens corresponding to a share of the profits that GAW would earn by mining virtual currencies. Defendants allegedly sold more than $19 million in Hashlets, far exceeding GAW's computing power. In another alleged scheme, GAW offered "Hashpoints," convertible promissory notes that could be purchased or mined in exchange for "Paycoin," a cryptocurrency that GAW intended to launch in the future.

Again, Plaintiffs' claims rest on whether "Hashlets," "Hashpoints," and "Paycoin" "constitute investment contracts, and thus 'securities' under … the Exchange Act." Dispositive motion practice has not yet reached this issue.

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The "Tezos" Lawsuits: *GGCC, LLC v. Dynamic Ledger Solutions, Inc.*, et al., 3:17-cv-06779 (N.D. Cal. Nov. 26, 2017); *Okusko v. Dynamic Ledger Solutions, Inc., et al.*, 3:17-cv-06829 (N.D. Cal. Nov. 28, 2017); *Baker v. Dynamic Ledger Solutions, Inc., et al.*, 3:17-cv-06850 (N.D. Cal. Nov. 29, 2017); *MacDonald v. Dynamic Ledger Solutions, Inc. et al.*, 3:17-cv-07095 (N.D. Cal. Dec. 13, 2017)[8]: The founders of a new cryptocurrency, "Tezos," are facing several class action lawsuits stemming from a July, 2017 ICO alleging that Defendants violated securities laws by selling unregistered securities.

Defendants' ICO raised more than $232 million in contributions of Bitcoin and Ether to fund a novel blockchain network. To do so, Defendants created the Tezos Foundation, which ran a "fundraiser" where contributors made donations to the foundation. In exchange for the "donations," the foundation recommended that, for each Bitcoin "donated," contributors receive 5,000 "Tezos Tokens" when the Tezos blockchain was created.

A critical issue is whether Tezos Tokens fall within the definition of "securities" that must be registered before issuance to investors. In arguing that the Tezos Tokens are securities, Plaintiffs state, "[h]ere, the economic realities are that Plaintiff and the Class invested [Bitcoin] and [Ether] in order to receive Tezos Tokens, which they expected to be worth more than their [Bitcoin] and [Ether] investment."

If Defendants file motions to dismiss, this could be one of the first cases to reach this issue.

***Wildes, et al. v. BitConnect International PLC, et al.*, 9:18-cv-80086 (S.D. Fla. Jan. 24, 2018)**: Following BitConnect's January 17, 2018 closure, investors have filed a putative class action complaint seeking damages and a return of their investments claiming that BitConnect and its founders engaged in a Ponzi scheme, the offer and sale of unregistered securities, fraud, unfair and deceptive trade practices, and civil conspiracy.

Investors allege that they were fraudulently induced to deposit millions of dollars worth of Bitcoin into BitConnect's "Exchange Platform" for "BitConnect Coins," and then loaned the BitConnect Coins back to BitConnect. BitConnect then funded trading activities for the investors using this pool of BitConnect Coins. Plaintiffs claim that BitConnect was a Ponzi scheme that generated no real returns. Investors claim that their investment in BitConnect was in a security under state and federal law.

We will monitor developments in this newly filed case.

Additional Regulation: Tax Implications, Anti-Money Laundering Policies, Commodity Issues, Cybersecurity Concerns, and More

As policymakers shape the regulatory framework that will govern cryptocurrency, additional considerations for those purchasing, selling, or offering cryptocurrency are evolving.

For example, faced with increasing questions about purchase and sale of cryptocurrency, the IRS has been forced to intervene. On March 25, 2014, the IRS issued Notice 2014-21,[9] offering guidance as to how general

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tax principles apply to transactions involving virtual currencies. The IRS concluded that virtual currencies, which can be converted into traditional currency, are considered "property" for tax purposes and treated as a capital asset, such as stocks, bonds, and investment properties.

In addition to tax, cryptocurrency is likely to be regulated under various regulatory regimes (ironic given its intention of being an alternative to government controlled fiat currency). For example, whether a sponsor of a token offering or token exchange meets the U.S. Bank Secrecy Act's definition of a "financial institution" will determine if the sponsor must assist the U.S. government in the detection and prevention of money laundering. These financial institutions may have obligations to maintain cybersecurity policies and procedures under cybersecurity regulations pursuant to the U.S. Gramm-Leach-Bliley Act and various state laws. And, the secondary market for the trading of cryptocurrency tokens may require further consideration of whether the tokens or coins are "commodities" under U.S. commodity laws, such as the Commodity Exchange Act.

Cryptocurrency activity has not only received attention from the federal government, states have also become involved in the regulation and taxation of cryptocurrency transactions. For example, in January, 2018, Vermont introduced the first bill of its type focused on exempting new digital currency companies from certain state taxes.[10] While Vermont has taken a friendly approach to cryptocurrency business, other states, such as New York, have sought more stringent policies on various cryptocurrency transactions.[11] Those trading in cryptocurrency must consider developing state laws.

Federal and State Enforcement

As federal and state policymakers continue to consider if and how to regulate cryptocurrency transactions, enforcement actions are on the horizon.

For example, the IRS treatment of cryptocurrency may lead to enforcement activity. The IRS contends that only 800 taxpayers reported gains related to Bitcoin from 2013-2015 when more than 14,000 Coinbase users bought, sold, sent, or received at least $20,000 worth of Bitcoin.[12] On November 28, 2017, the IRS secured a John Doe summons in *United States v. Coinbase, Inc.* to serve upon Coinbase, the most popular exchange of cryptocurrency, seeking to identify its customers.

States, too, are getting in on the action. On January 17, 2018, the Massachusetts Securities Division filed an administrative complaint alleging that an ICO run by a Massachusetts resident violated state law by offering unregistered securities.[13] The Massachusetts Securities Division seeks among other relief, to halt the ICO, return roughly $3.1 million to investors, and impose administrative fines.

CONCLUSION - WHAT LIES AHEAD?

As novel uses of cryptocurrency continue to develop and a regulatory framework begins to take shape, one thing is clear: litigation, regulation, and enforcement of cryptocurrency remain in a state of flux. Individuals and

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businesses must stay educated regarding this rapidly developing area. The potential for blockchain and cryptocurrency is too great to ignore; however, the current legal landscape requires careful, informed decision-making.

For more information, please contact the authors or your regular K&L Gates contact.

Notes:

1. Bitcoin and other cryptocurrencies self-generate "coins" or "tokens." "Miners" use computer software to solve complex algorithms to validate (or "mine") transaction "blocks," and, in turn, receive a predetermined portion of a token or coin.
2. The Report is available at: https://www.sec.gov/litigation/investreport/34-81207.pdf.
3. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); *see SEC v. Edwards*, 540 U.S. 389, 393 (2004); *see also United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852–53 (1975).
4. There is much debate as to whether tokens with a consumptive use, or "utility tokens," may not be considered securities under this test. Some argue that where purchasers are motivated by a desire to use or consume the rights that the token represents, the securities laws do not apply.
5. The Munchee Order is available at: https://www.sec.gov/litigation/admin/2017/33-10445.pdf.
6. The Clayton Statement is available at: https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.
7. For additional information on the Munchee Order and the Statement, please see K&L Gates' December 2017 articles: 1) "A Case of the Midnight Munchees: SEC Action Signals Caution in ICO Offerings," available at: http://klgates.com/en-US/a-case-of-the-midnight-munchees-sec-action-signals-caution-in-ico-offerings-12-31-2017/; and 2) "United States Securities Law Compliance and Liability Implications of SEC Chairman's Statement on ICOs," available at: http://www.klgateshub.com/details/?pub=United-States-Securities-Law-Compliance-and-Liability-Implications-of-SEC-Chairmans-Statement-on-ICOs-12-31-2017.
8. Class action plaintiffs filed a similar case in the U.S. District Court for the Southern District of Florida, but the named Plaintiff has since voluntarily dismissed the case without prejudice. *See Gaviria v. Dynamic Ledger Solutions, Inc., et al.*, 6:17-cv-1959 (M.D. Fla. Nov. 13, 2017).
9. Notice 2014-21 is available at: https://www.irs.gov/pub/irs-drop/n-14-21.pdf.
10. Vermont's proposed bill is available at: https://legislature.vermont.gov/bill/status/2018/S.269.
11. New York's virtual currency code is available at: http://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf.
12. *United States v. Coinbase, Inc.*, C.A. No. 17-cv-01431-JSC, 2017 WL 5890052, at *4 (N.D. Cal. Nov. 28, 2017).
13. *In the Matter of: Caviar and Kirill Bensonoff*, E-2017-0120 (Mass. Sec. Div. Jan. 17, 2018).

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