
## Bank Counsel Roundtable

# Blockchain and Cryptocurrencies: From a Legal Perspective

**March 22, 2018**

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## Materials



## Resources Available on Dorsey.com

**Webinar Playback:** *How IP Litigation Will Be Impacted By New Technologies: AI, Smart Devices, and Cryptocurrencies*, Gina Cornelio and Jeremy Elman (March 14, 2018)
**Available at**: https://www.dorsey.com/newsresources/events/videos/2018/03/webinar-playback-ip-litigation-new-technologies

**Seminar Playback**: *FinTech — Perspectives and Legal Issues*, Stuart Hemphill, Jenny Lee, Joseph Lynyak and Kevin Maler (February 21, 2017)
**Available at**: https://www.dorsey.com/newsresources/events/videos/2017/02/seminar-playback-fintech-and-legal-issues

**Dorsey Blog:** SEC Actions
Available at: http://www.secactions.com/

## Bank Counsel Roundtable

# Blockchain and Cryptocurrencies: From a Legal Perspective

## Speaker Biographies

**Joseph Lynyak, III**
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Joe Lynyak is a Partner in Dorsey's Finance & Restructuring Group and a member of the Banking Industry Group. He practices in both the Firm's Washington, D.C. and Southern California offices. Joe possesses a broad knowledge base regarding foreign banks and domestic banks, savings associations, bank holding companies, finance companies, mortgage banking companies and their subsidiaries and affiliates. His practice includes providing financial intermediaries advice in the areas of regulatory and strategic planning, application and licensing, legislative strategy, commercial and consumer lending, examination, supervision and enforcement, and general corporate matters. Joe's FDIC-insured financial institution clients benefit from his experience in the special state and federal statutory and regulatory requirements—including safety and soundness issues—that apply to regulated financial intermediaries. He regularly counsels clients on matters such as retail operations, privacy, identity theft, consumer compliance, application and underwriting, payments systems, Internet, electronic commerce, examination, supervision and enforcement, operational and strategic planning matters. Joe is a frequent lecturer on legal topics involving the operation and regulation of financial service companies. Specific regulatory topics upon which Joe has advised clients and spoken at conferences include the Dodd-Frank Act, prudential regulation, the Volcker Rule, the Bank Secrecy Act (and other anti-money laundering provisions), mortgage lending and the CFPB.

**Thomas Gorman**
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Thomas Gorman is a Partner in Dorsey's Government Enforcement & Corporate Investigations Group. He represents clients in Federal law enforcement investigations/enforcement actions. These investigations involve the full array of corporate, security, financial, and economic issues and frequently are viewed as "bet the company" actions. Issues include security fraud, financial and accounting precepts, insider trading and market manipulation, FCPA and anti-corruption, derivatives, antitrust and money laundering. Business litigation actions include difficult and often uncharted issues and theories on both the plaintiff and defense side of court actions. Claims are based on the federal securities laws, the commodity statutes, the antitrust laws, RICO and frequently included questions regarding accounting, economics and business systems. Tom represents clients on compliance and internal investigations including resolution of questions and issues for business organizations, whether discovered by

the firm or from a Government subpoena, CID or inquiry typically begins with an examination of the firm's compliance systems, often requires an internal investigation and may conclude with carefully crafted remedial steps to augment the compliance systems, precluding a future repetition of the issue. Tom served for seven years in positions of increasing responsibility on the staff of the Securities and Exchange Commission in Washington, D.C. Those positions included Senior Counsel, Division of Enforcement and Special Trial Counsel, Office of the General Counsel. In those positions, Tom was responsible for the investigation and litigation of securities enforcement actions, accounting and auditing cases and defending suits brought against the Commission and its staff. Before joining the staff of the SEC, Tom served for two years on the staff of the Public Defender's Office in Cleveland, Ohio and as an adjunct professor of law at the Cleveland-Marshall College of Law; Cleveland State University.

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Kim Severson is a Partner in Dorsey's Tax, Trusts and Estates group. Kim regularly advises clients on the federal income tax aspects of mergers and acquisitions, reorganizations and restructuring, corporate distributions and other transactions with shareholders, debt and equity financings, entity formation, securitizations and structured finance. She also provides tax planning advice to closely-held businesses, tax-exempt entities, and parties in bankruptcy proceedings. Kim is Chair of the Firm's Policy Committee and Co-Chair of the Firm's Tax Practice Group.

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Adrian is a Partner in Dorsey's Emerging Companies practice. He has over 15 years of experience advising early stage companies and investors alike, and has been a trusted advisor through every stage of company development including formation, financing, acquisitions and public offerings. Adrian also has extensive experience with private and public securities offerings, university and competitive licensing, strategic arrangements, joint ventures, incubators, and fund formation. Adrian's work includes specialized experience representing life sciences companies.

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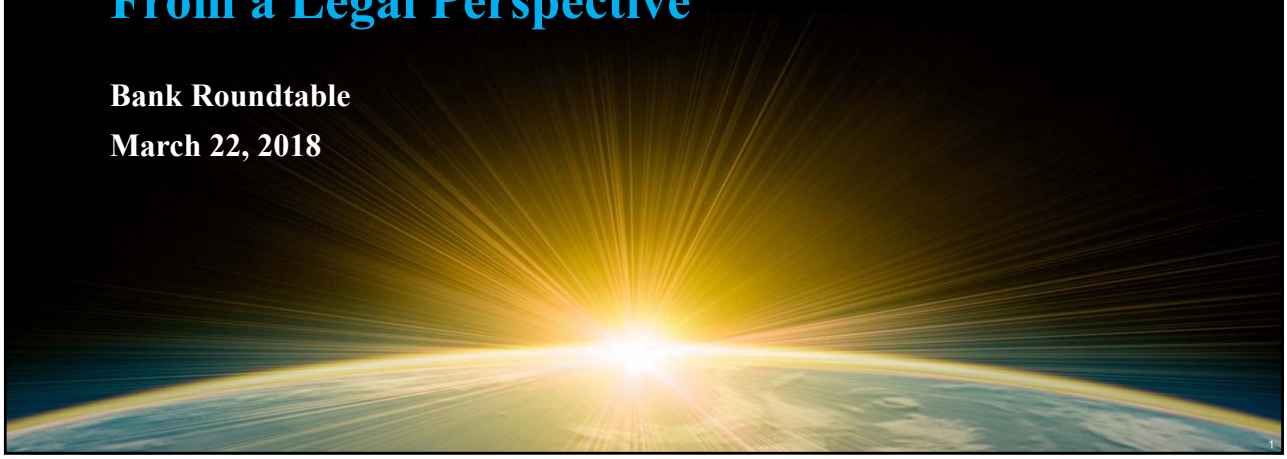
# Blockchain and Cryptocurrencies — From a Legal Perspective

**Bank Roundtable**

**March 22, 2018**



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## Agenda

- **Basic concepts**
  - **Blockchain**
  - **Coins**
  - **Tokens**
- **Tax**
  - **As determined by the IRS**
  - **Kim Severson**
- **SEC and CFTC Laws**
  - **The Howey test**
  - **Tom Gorman**
- **ICOs and Regulation D offerings**
  - **Adrian Rich**

# Introduction

- Blockchain and cryptocurrency have created a frenzy
- Fraud and criminal activity
- An international investment bubble
- A nomenclature disconnect
- Sponsor disdain for traditional capital raising processes
- Uneven (or non-existent) international legal views
- Rapidly evolving U.S. state and federal regulatory policy positions
  - Concerns regarding investor fraud accompanied by wild valuation swings



# Introduction

- Presentation premise—
  - The technology is new and evolving and there are many misconceptions in the marketplace caused by the complexities of Blockchain
    - Traditional legal principles are fundamental and continue to apply, notwithstanding Blockchain's evolution and complexity
    - There are lawyers who understand both the legal principles and the underlying technology (e.g., Adrian Rich)
  - This presentation will discuss this emerging area from the perspective of the legal practitioner, including—
    - FinTech
    - IP
    - Tax
    - SEC and CFTC, and
    - Capital raising

## How Confusing Has it Become?


**John Oliver to the Rescue!!!!**

*Last Week Tonight* with John Oliver (HBO)

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## A Quick Background

- **What is a "Blockchain," and how is it different from other types of web applications?**
  - **A Blockchain is a *diversified ledger* that is resident on literally thousands or millions of computers, and records transactional data, such as the ownership of an item (*e.g.*, a bitcoin, Coin or Token), the transfer of the same and the possible transaction or function related to the item**
  - **A Blockchain can be open to all or can be proprietary and limited to a designated universe of participants**
- **Unlike data that can be placed on one computer and modified by changing the data on someone's individual computer, the Blockchain *collectively* verifies the existence of an item, a function or transfer, and cannot be altered except by the entire Blockchain making the change**

Eliminates the Need for a Verification Authority

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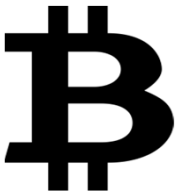
## A Quick Background

- **Bitcoin and Coins**
  - **Bitcoin is the first decentralized cryptocurrency that resides on a Blockchain ledger, and is a substitute for fiat currency**
  - **A Coin is a variation of Bitcoin's open source code**
    - **The majority of Coins are a variant of Bitcoin, built using Bitcoin's open-sourced, original protocol with changes to its underlying codes, therefore conceiving an entirely new Coin with a different set of features**
  - **Currently there are over 4000 Coins in existence**





## A Quick Background

- **Token**
  - **A token is a secondary asset or application within a Blockchain ecosystem**
    - **Such as the Ethereum blockchain**
    - **A token runs the secondary application**
    - **Tokens can represent basically any assets that are fungible and tradeable, from commodities to loyalty points to even other cryptocurrencies**
    - **Theoretically a token needs no human authentication to run**
      - **Permits the creation of so-called "electronic contracts"**

## FinTech and IP

- **Blockchain and cryptocurrency are another form of FinTech**
  - **Mining contracts**
  - **Innovative payment systems**
  - **Counterparty agreements**
- **IP concerns may be somewhat specialized**
  - **Ability to protect IP may be compromised by use of white papers**
- **FinTech and IP issues summarized at—**
  - **https://www.dorsey.com/services/fintech**

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## Tax Considerations

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## Tax Considerations

- **Tax treatment of cryptocurrencies may differ from treatment by other federal regulators**
- **A short survey of tax treatment:**
  - **Tax treatment of cryptocurrency**
  - **Sale or exchange of cryptocurrency**
  - **Tax basis and tax accounting of cryptocurrency**
  - **Capital, ordinary trade or business or personal gain or loss**
  - **Mining cryptocurrency**
  - **Initial Currency Offerings or "ICOs"**
  - **Information reporting requirements**
  - **IRS enforcement efforts**



## Tax Treatment of Cryptocurrency

- **IRS treats cryptocurrency as "property" for U.S. tax purposes**
  - **NOT treated like U.S. dollars or currencies issued by non-U.S. governments**
  - **Current IRS guidance limited to "virtual currencies" that have an equivalent value in "real" currency**
  - **Tax principles applicable to property transactions generally apply to transactions using virtual currency**
  - **Cryptocurrency may be capital asset held for investment, inventory held by a dealer for sale in a trade or business, or personal asset, depending on facts**
- **State tax treatment**
  - **Which state tax regimes apply (*i.e.,* nexus)?**
  - **Dose the relevant state's tax laws mirror or conform to federal tax rules?**
  - **Sales and/or other transfer tax issues**

## Sale or Exchange of Cryptocurrency

- **Each time a U.S. taxpayer sells cryptocurrency or uses cryptocurrency to make a purchase of goods or services, there is a taxable event**
- **Taxpayer will recognize taxable gain or loss on sale of the cryptocurrency equal to:**
  - **Difference between taxpayer's tax basis in currency sold; and**
  - **Amount realized**
- **Amount realized by transferor of cryptocurrency will be U.S. dollar amount received, U.S. dollar equivalent of foreign currency received, or fair market value of "property" received (*e.g.*, the fair market value of cryptocurrency received)**



## Sale or Exchange of Cryptocurrency

- **Taxpayer will recognize taxable gain or loss on each use of cryptocurrency to purchase goods or services, equal to:**
  - **difference between taxpayer's tax basis in currency used; and**
  - **amount realized**
- **Amount realized on use of cryptocurrency to purchase goods or services will be fair market value of goods or services received**

## Tax Basis and Tax Accounting

- Tax basis is generally the fair market value (in U.S. dollars) of cryptocurrency received
  - Is FMV measured at end of day? At exact moment received?
  - Should FMV value of goods or services exchanged for cryptocurrency control?
- Taxpayer should track basis and acquisition date of each unit of cryptocurrency
- Specific identification of each individual unit of cryptocurrency appears required
  - No current IRS authority allowing other tax accounting methods (such as LIFO, FIFO or average basis)
- Application of tax accounting rules extremely uncertain
  - IRS guidance needed



## Capital, Ordinary Trade or Business or Personal Gain or Loss?

- Capital assets are assets held for investment purposes
  - Long-term capital gains of non-corporate taxpayers are eligible for preferential tax rates (currently 20%)
  - Short-term capital gains of non-corporate taxpayers subject to tax at ordinary graduated income tax rates (maximum 37%)
  - No preferential corporate rate—21% rate applies
  - Capital losses are subject to significant limitations
  - Capital gains are long-term if asset has been held for more than one year

## Capital, Ordinary Trade or Business or Personal Gain or Loss?

- **Ordinary assets are assets held by taxpayer primarily for sale to customers in the course of the taxpayer's trade or business**
  - **Gains taxable at ordinary income rates (21% for corporations, maximum 37% for non-corporate taxpayers)**
  - **Losses incurred in trade or business generally deductible (may be subject to limitations)**
- **Assets held for personal purposes (*e.g.*, hobby, entertainment)**
  - **Gains from cryptocurrencies held as personal assets taxable, losses not deductible**



## "Mining" Cryptocurrency

- **When U.S. taxpayer successfully "mines" cryptocurrency, fair market value of cryptocurrency as of date of "receipt" is generally includible in Taxpayer's gross income**
- **"Miner" generally has tax basis in cryptocurrency equal to its fair market value at time of "receipt"**
- **"Miner" will generally recognize gain or loss on subsequent sale or disposition**
  - **Will be ordinary gain or loss if miner is a dealer and cryptocurrency is inventory in miner's business**
- **If miner is not an employee, income will be subject to self-employment tax**

## Initial Currency Offerings ("ICOs")

- **Tax consequences differ from those of a traditional IPO**
- **An "Initial Coin Offering" or "ICO," unlike an initial offering of stock or partnership interests, is generally taxable to issuer as though issuer sold property, services or both**
- **Issuer generally recognizes taxable gain or loss equal to difference between sale price of the Coin and its tax basis in the Coin sold**
  - **Tax liability can significantly reduce investment revenue raised**
- **Issuer generally subject to tax at ordinary income tax rates if it holds cryptocurrency as inventory for sale in its trade or business**



## Information Reporting Requirements

- **Payments to employees for services are subject to employment and income tax withholding and employer's share of employment taxes**
  - **Wages and employment and income tax withholding must be reported on IRS Form W-2 and related information reports**
- **Payments to independent contractors must be reported on IRS Form 1099-MISC**
  - **Independent contractors subject to self-employment tax**
- **For reporting on Forms W-2 and 1099, amounts paid in cryptocurrency must be reported (and employment taxes withheld and paid) based on the fair market value of cryptocurrency at the time of payment**

## Information Reporting Requirements

- **Third party settlement organizations required to report payments made to a merchant on Form 1099-K, "Payment Card and Third Party Network Transactions," if, for a calendar year:**
  - **Number of payments with merchant exceeds 200 and**
  - **Gross amount of payments to merchant exceeds $20,000**
  - **Value of cryptocurrency on date of payment used to determine whether payments are reportable**
- **Credit card intermediaries and organizations such as PayPal generally subject to these rules**
  - **Reporting rules could apply to cryptocurrency exchanges or intermediaries**



## Information Reporting Requirements

- **Form 1099-B cost basis reporting rules applicable to "covered securities," "brokers"**
  - **But not all cryptocurrency is required to be reported by brokers, cryptocurrency exchanges or other transferors on IRS Form 1099-B or other information reports**
- **Taxpayers must keep detailed records of their cryptocurrency transactions**
  - **Taxpayers should record date purchased or received, tax basis and date of disposition, plus fair market value of property (including other cryptocurrency) or cash received on disposition of cryptocurrency**

## IRS Enforcement Efforts

- IRS has increased enforcement with respect to cryptocurrency in recent years
- IRS formed a "cryptocurrency team" dedicated to monitoring transactions made with cryptocurrencies
- In 2016 IRS issued summons to Coinbase (a cryptocurrency exchange) to turn over data on U.S. taxpayers
  - In early 2018 Coinbase sent a message to about 13,000 customers informing them that it would give information about their accounts to the IRS in response to summons
  - Court had ordered Coinbase to produce documents for accounts with a transaction type—buy, sell, send, or receive—amounting to at least $20,000 in aggregate during one year between 2013 and 2015
- Treasury has identified cryptocurrency as one of its two highest priorities



## Securities Law

## Overview of Regulators

- The SEC and CFTC have been the most active regulators
  - Each has focused on their area of authority
  - Each has emphasized the investor protections under its statutes
- The SEC has determined that Coins and Tokens can be securities
- The CFTC has determined that Coin and Tokens can be commodities
- FinCEN has also asserted jurisdiction in limited circumstances
- The DOJ has brought criminal cases



## SEC—Registration

- Initially the SEC brought an enforcement action alleging a failure to register the interests being sold as securities
  - *In the Matter of Erik T. Voorhees,* Adm. Proc. File No. 3-15902 (June 3, 2014) (settled administrative proceeding involving unregistered shares valued in bitcoin)
- Subsequently, the SEC brought enforcement actions which allege fraud in addition to failure to register charges
  - *SEC v. Plexcorps,* Civil Action No. 1:17- cv-07007 (E.D.N.Y. filed Dec. 1, 2017)
  - Case centers on sale of cryptocurrency by individuals previously enjoined in Canada for selling unregistered interests
  - In four months Defendants signed up 1,500 investors and sold 81 million PlexCoin Tokens, raising about $15 million
  - The SEC claims much of the investor money was misappropriated
  - Case is in litigation

## SEC—The DAO Report

- The SEC issued a Report of Investigation called "The DAO Report" in July 2017, informing the market of its views on registration of Coin and Tokens as securities
- The critical test here is two fold:
  - Step 1: *SEC v. H.J. Howey Co.*, 328 U.S. 293 (1946) which considers:
    - An investment of money
    - In a common enterprise
    - With the expectation of profits
    - From the efforts of others
  - Step 2: The economic reality of the transaction



## SEC—The DAO Report

- The facts developed in the investigation
  - The parties involved were: The DAO, Slock.it UG, Slock,it's co-founders and certain intermediaries
  - The DAO used blockchain technology to operate as a virtual entity
  - The tokens sold represented interests in the enterprise
  - The tokens could be paid for with virtual currency, held as an investment, and sold
  - Investors were told the coins would increase in value as the eco-system developed from others purchasing coins
  - The promoters would also advertise the investment
  - It was projected that the coins would be listed for trading on an exchange shortly after the close of the offering
- Based on these facts the SEC concluded the interests were securities

## SEC—Funds, ETFs and Trading

- **Virtual currencies also present securities concerns such as can they be held by funds and ETFs and traded on an securities exchange**
- **The SEC has received applications for each but *none* have been approved**
  - **Cameron and Tyler Winklevoss, owners of Gemini Bitcoin exchange, sought approval**
  - **A number of applications for bitcoin ETFs and related products have been filed**
  - **None have been approved**
- **There has been a dialogue involving the SEC and market participants**



## SEC—Funds and ETFs

- **For funds and ETFs, the issues were summarized in a letter from the Director of the Division of Investment Management to the Investment Company Institute and the Securities Industry and Financial Markets Association, dated Jan. 18, 2018**
- **The issues/question included:**
  - ***Valuation*: How would NAV be calculated each day**
  - ***Liquidity*: Redemption for funds and ETFs is available daily— can this be done?**
  - ***Custody*: The Advisers Act imposes custody requirements—how would a fund comply?**
  - ***Arbitrage*: ETFs have an arbitrage process re exchange trading prices and NAV calculations (no material deviation)—would volatility disrupt this?**
  - ***Manipulation*: There are concerns regarding fraud in view of liquidity, volatility**

## SEC—Funds and ETFs

- The resolution of the issues noted above—largely tied to liquidity and volatility—are the predicates for resolving questions regarding ownership by funds and ETFs
- The Director also noted that the resolution of these questions would inform decisions regarding:
  - Registration under the Advisers Act
  - Listing standards with Corp Fin and Trading and Markets
  - The Office of the Chief Accountant



## SEC—Trading and Platforms

- The SEC's approach to authorizing trading platforms is similar to the one used regarding funds and ETFs—it keys to the volatility and liquidity of the markets and lack of investor protections
- The approach is summarized in a joint release from the Divisions of Enforcement and Trading and Markets, dated March 7, 2018
- Key points include:
  - Many digital platforms at times refer to themselves as exchanges but lack the requisite protections
  - Some trading platforms claim to have trading protocols but they are not what are used by SEC-registered exchanges
  - Others claim at times to have order books and updated bid/ask prices but again the procedures are not comparable to a registered exchange
- Examination of these points suggest approval may be uncertain at best

## *Munchee*—A Test of the DAO Report

- **The SEC's approach to cryptocurrencies is currently being tested by *In the Matter of Munchee, Inc.*, Adm. Proc. File No. 3-18304 (Dec. 11, 2017)**
- **The case is based on alleged registration violations—there is no fraud charge—the basic facts are:**
  - **The firm developed an iPhone app regarding restaurant reviews**
  - **To raise capital the firm proposed to sell MUN tokens on the Ethereum blockchain**
  - **The firm planned to sell about half of the MUN tokens created**
  - **The tokens were marketed through a website, a white paper and other means**
  - **Key was the ecosystem – the value would go up as more investors bought coins**
  - **After the offering closed the coins were to be registered for trading on an exchange**
  - **The SEC alleged registration violations**
  - **The case is heading for hearing**



## *Munchee*—A Test of the DAO Report

- ***Munchee* presents the registration issue without being encumbered by a fraud charge**
  - **The SEC can clearly argue that the *Howey* test is met**
  - **It can also argue economic reality**
- **The Respondent can argue that unlike most investment contract cases, the key to added value here is not what the company does but the ecosystem—other investors**
  - **The economic reality is not like buying stock in a company but more like seeing if the idea of investing in the coin proves popular**
- **The key here may be the discovery and the presentation at the hearing**

## SEC—Gatekeepers

- **SEC Commissioners and senior staff have been very aggressive in alerting investors to the dangers of investing in the virtual currency markets**
- **In a speech delivered on January 22, 2018, the SEC Chairman warned market professionals—securities lawyers, accountants and others involved with these products about fully complying with their professional obligations**
- **After noting that offerings and trading in the virtual markets frequently use terms that sound like the securities markets without offering the same protections, Chairman Clayton delivered what he called a "simple and a bit stern" message**



## SEC—Gatekeepers

- **The message:**
  - **"I have instructed the SEC staff to be on high alert for approaches to ICOs that may be contrary to the spirit of our securities laws and the professional obligations of the U.S. securities bar . . . [those market professionals and members of the securities bar] need to act responsibly and hold themselves to high standards . . . [the securities laws] assume that securities lawyers, accountants, underwriters, and dealers will act responsibly . . ."**
  - **It is not acceptable, the Chairman stated, to conclude that the ICO is "pretty close," or to just be equivocal, and then let the offering go forward**
- **This gatekeeper theory traces to the earliest days of the SEC Enforcement Division**

## CFTC—Coin as a Commodity

- The CFTC has approached the virtual currency markets in a manner which is similar to that of the SEC
- The two Chairman plus the Directors of the Divisions of Enforcement for each agency have issued joint statements cautioning about the dangers of the markets because of their lack of investor protections
- The Chairman of each agency reiterated these warnings in testimony before Congress earlier this year



## CFTC—Coin as a Commodity

- In 2015 the CFTC determined that virtual currencies (*i.e.*, Coins and tokens) are a commodity within the meaning of the CEA
- The position of the agency was recently upheld in *CFTC v. McDonnell,* Civil Action No. 18-cv-361 (E.D.N.Y. Opinion March 6, 2018)
  - The Court granted the CFTC's request for a preliminary injunction in a fraud case—in part the opinion upheld the determination of the agency re jurisdiction
  - Defendants Patrick McDonnell and his firm, Coin Drop Markets, were essentially marketing expertise on trading virtual currency for a fee
  - The CFTC alleged not only did the Defendants lack any expertise, they misappropriated the investor funds

## CFTC—Coin as a Commodity

- **In ruling in favor of the CFTC on the preliminary injunction the Court held:**
  - **The CEA defines commodity to include "wheat, cotton, rice, corn, oats . . . And all services, rights, and interests . . . In which contracts for future delivery are presently or in the future dealt in."**
  - **"In view of this definition the CFTC issued an order in 2015 finding that virtual currencies can be classified as commodities," citing *In the Matter of: Coinflip Inc.,* CFTC Docket No. 15-29**
    - **The order states that "Bitcoin and other virtual currencies are encompassed in the definition [of a commodity] and properly defined as commodities."**
  - **The Court went on to hold that while the CFTC generally cannot regulate the spot market, under an expansion of its authority in the Dodd-Frank Act, the agency can bring an action under Section 9 of the CEA and Rule 180.1 prohibiting fraud involving any "contract of sale of any commodity in interstate commerce."**
  - **Like the SEC, the CFTC has also brought a number of fraud actions**



## CFTC—Trading

- **Trading involving virtual currencies has been permitted in the commodity markets**
- **The exchanges "self-certify" the approval**
  - **Under that process Designated Contract Markets are permitted to certify new products—the process does not require notice, public comment or the approval of the CFTC**
- **On December 1, 2017 the CME and the CBOE Futures Exchange self-certified new contracts for bitcoin future products**
- **The Cantor Exchange self-certified a new contract for Bitcoin binary options**

## CFTC—Trading

- The CFTC has actively monitored the process, imposing additional investor protections which include:
  - Having derivative clearing organizations set substantially high initial and maintenance margins for cash-settled Bitcoin futures
  - Setting large trader reporting thresholds at five Bitcoins or less
  - Entering into information sharing agreements with spot market platforms
  - Monitoring data from cash markets
- The CFTC has made it clear that these and similar arrangements will apply to any new products



## SEC and the CFTC—the Future

- The SEC, CFTC, FinCEN, DOJ and various banking regulators continue to monitor the cryptocurrency markets and take actions within their respective spheres
- The SEC and CFTC have been particularly aggressive
- An early test of the SEC's efforts may come with the hearing in the *Munchee* case
  - The SEC is also examining investment and trading issues
- The SEC's Enforcement Division has continued to bring registration and fraud actions
  - It is currently conducting a non-public investigation that appears to be a sweep
- The CFTC has taken a similar approach, bringing fraud actions and monitoring trading

## SEC and the CFTC—the Future

- At the same time the market continues to move forward
  - Praetorian Group recently registered a $75 million offering with the SEC
  - Cameron and Tyler Winklevoss, following a suggestion by a CFTC Commissioner, recently proposed creating a self-regulatory organization for virtual currencies
- The final word on virtual currencies may come from the ever evolving market—
  - Facebook recently announced that it was banning ads for the product
  - Twitter announced on Monday of this week that it would take similar action in the future
- In the end, the forces that helped create the market for virtual currencies may have more impact on them than the regulators



## Capital and Financing

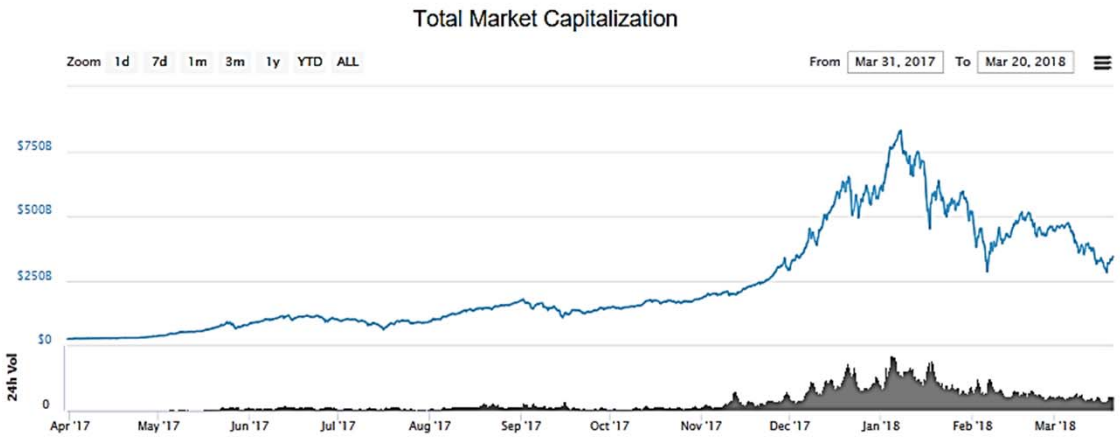
# Initial Coin Offerings

- **ICOs emerged in 2017 as a powerful tool for financing startups**
  - **Q1 2017 - $18.8 Million in 11 ICOs**
  - **Q4 2017 – $3.1 Billion in 196 ICOs**
  - **Full Year – $6.0 Billion in 382 ICOs**
- **ICOs are substantially more successful in raising capital for blockchain startups than traditional equity**
  - **5X more capital was raised through ICOs than traditional investment vehicles**
- **~1,600 issued coins**
- **$350 billion market cap on March 20**
- **~$18 billon traded on March 20**

https://www.coinspeaker.com/2018/01/04/cryptocurrency-ico-market-overview-2017/
https://www.cbinsights.com/research/blockchain-vc-ico-funding/



# All In - A Highly Volatile Market




https://coinmarketcap.com/charts/

## 2017's Most Successful Raises Support the Technology

| | Name | Category** | Collected, $ million | % | Completed |
|---|---|---|---|---|---|
| 1 | Hdac | Infrastructure* | 258 | 15% | December 2017 |
| 2 | Filecoin | Data Storage | 257 | 15% | September 2017 |
| 3 | Tezos | Infrastructure | 232.32 | 13% | July 2017 |
| 4 | EOS Stage 1 | Infrastructure | 230 | 13% | June 2017 |
| 5 | Sirin Labs | Infrastructure* | 157.9 | 9% | December 2017 |
| 6 | Bancor | Infrastructure | 153 | 9% | June 2017 |
| 7 | Polkadot | Infrastructure* | 144.3 | 8% | October 2017 |
| 8 | QASH | Trading & Investing* | 108.2 | 6% | November 2017 |
| 9 | Status | Infrastructure | 107.6 | 6% | June 2017 |
| 10 | Comsa | Trading & Investing* | 95.6 | 5% | December 2017 |
| | Total for top 10 | | 1743.92 | 100% | |

https://www.coinspeaker.com/2018/01/04/cryptocurrency-ico-market-overview-2017/



## 2018 Early Indicators

- **Applications are coming**
  - **Telegram raised $850 Million for text messaging application**
  - **Kodak launched a digital asset – huge jump in stock price**
- **Regulator are increasing scrutiny**
  - **Issuers in US are getting subpoenas**
  - **'Exchanges' may have to be registered**
- **Marketing is becoming more difficult**
  - **Facebook, Twitter and Google banning token offering ads**

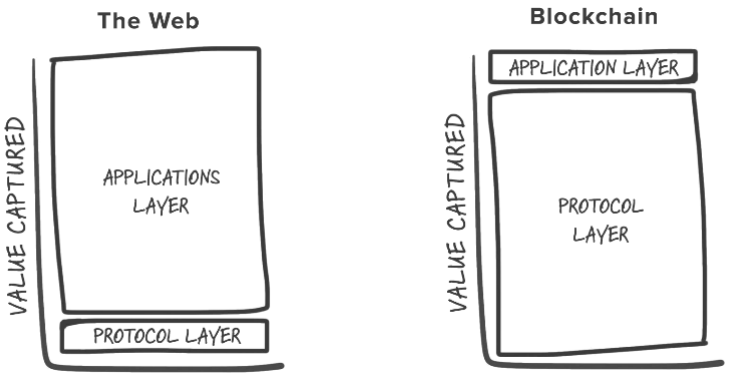
# Tokens

- **Referred to generically as 'cryptocurrency' though they generally do not have all features of a currency**
- **Sold by 'projects' to develop / support the development and expansion of the project**
- **Typically represent some set of rights**
  - **Access a feature or service**
  - **Access a platform**
  - **Voting Rights**
  - **Fractional Ownership of a Digital Asset**

DORSEY always ahead



# Where does the Value Come From?




http://www.usv.com/blog/fat-protocols

DORSEY always ahead

# A 'Typical' ICO

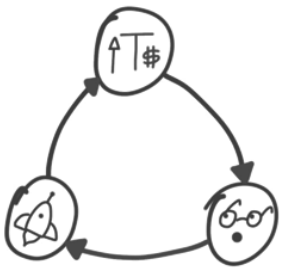
- Pre-Announcement
  - Whitepaper
  - Token Economics
- Token Pre-Sales
  - 'Simple Agreement for Future Tokens'
  - PPM
  - AML / KYC
- Development Period
- Offer and PR Campaign
- Initial Coin Offering
  - Simple purchase agreement

DORSEY always ahead



# ICO's Quick Rise to Popularity

- Democratization of investment opportunities
  - A functional form of crowd funding
- Passionate community of investors
- Quick and easy to set up, with sales taking mere minutes
- Immediately tradable on online exchanges
- Substantial, quick increases in value
- Enforced scarcity of a digital asset
- Immediate value for founders



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# Leading to Huge Returns

- 8,294% in Quark
- 13,595% in FastCoin
- 5,683% in Asch
- 8,313% in MediterraneanCoin
- 5,248% in NoLimitCoin
- 6,045% in MaxCoin
- 7,477% in Golem coins
- 11,328% in Decred coins
- 6,792% in WorldCoin
- 75,063% in Cryptonite
- 59,577% in Influxcoin
- And 823,750% in DubaiCoin

https://www.inc.com/bill-carmody/top-10-initial-coin-offerings-icos-to-watch-heading-into-2018.html



# But Then the Regulators Came In…

**"Merely calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security. Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law."**

**"It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering."**

**- Jay Clayton Sec Chairman**

https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11

## And Started Taking Action

- December 2017 - Munchee SEC Cease and Desist
- January 2018 – BitConnect TX and NC Cease and Desist
- Jan 2018 – SEC freezes assets of AriseBank
- March 2018 – 80 Subpoenas to ICO issuers



## To Address Real Problems

- Fraudulent Offerings
- Poor Investment Knowledge and Practices
  - Low quality / limited diligence and disclosure
  - Failure to understand the market
  - Lack of professional investors
  - Lack of Post Investment Support
  - Misunderstanding of valuation metrics

## Practical Challenges Companies Face Today

- Decisions to Exclude US Investors
- Securities Law Requirements and Implications
  - Holding Periods for Investors
  - No Exchanges to Trade On
- Tax Planning and Structuring
  - Tokens taxed as property on sale in US
- Service Providers Reluctant to Join In
  - Accountants / Auditors
  - Banks



## Recent Developments

- Banks cease lending on security of Bitcoin
- Cryptocurrencies exchanges hacked and losses total billions
  - FinCEN AML regulations apply to exchanges and money transmitters
- Bitcoin and other Coin continue to be used in ransom ware attacks

# Research Materials

Tax—

- IRS Notice 2014-21—
  - https://www.irs.gov/pub/irs-drop/n-14-21.pdf
- IRS news announcement of the publication of Notice 2014-2
  - https://www.irs.gov/newsroom/irs-virtual-currency-guidance

Securities—

- https://www.sec.gov/news/press-release/2018-23
- https://www.sec.gov/news/press-release/2018-23
- https://www.sec.gov/news/press-release/2017-227
- http://nj.gov/oag/newsreleases18/pr20180209a.html
- https://www.scribd.com/document/372516170/Texas-State-Securities-Board-cease-and-desist-order?irgwc=1&content=27795&campaign=VigLink&ad_group=808803&keyword=ft500noi&source=impactradius&medium=affiliate#from_embed
- https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading



# Background Materials

Securities (Continued)--

- https://www.sec.gov/news/public-statement/statement-clayton-giancarlo-012518
- https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors

Financing—

- https://www.coinspeaker.com/2018/01/04/cryptocurrency-ico-market-overview-2017/
- https://www.cbinsights.com/research/blockchain-vc-ico-funding/
- http://www.usv.com/blog/fat-protocols

# Background Materials

**Financing (Continued)**

- **https://coinmarketcap.com/charts/**
- **https://www.coinspeaker.com/2018/01/04/cryptocurrency-ico-market-overview-2017/**
- **https://coinmarketcap.com/charts/**
- **https://www.inc.com/bill-carmody/top-10-initial-coin-offerings-icos-to-watch-heading-into-2018.html**

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eUPDATE
A PUBLICATION OF DORSEY & WHITNEY LLP

**March 20, 2018**

# Virtual Currencies, the Regulators and the Future

**Thomas Gorman**

Virtual currencies have risen from a little known tech curiosity to what some see as the next great investment opportunity in contrast to others who see little but fraud. An alphabet soup of regulators are struggling to apply traditional legal and regulatory principles to the new virtual currencies. Those include the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC"), the Department of Justice ("DOJ"), The Financial Crimes Enforcement Network ("FinCEN"), and certain banking agencies.

A fragmented regulatory approach to the new markets has developed. Nevertheless, tech innovators continue to evolve their approach to the new products and market. Fraudsters continue to search for new ways to make a quick buck at the expense of anyone but themselves. Viewed in the context of these conflicting currents, the future of virtual currencies is anything but clear. An examination of the regulatory cross currents and the evolving market, however, suggests the future direction.

## I. Overview of the Regulators

The SEC and the CFTC have been the most active regulators in the new market. Each has repeatedly warned investors about the lack of investor protections in the virtual currency markets. Each has also focused on the question of whether the transaction involved a security or a commodity and the potential impact of permitting the products to trade in their markets.

At the same time FinCEN announced that in certain circumstances participants in the virtual currency market may be money transmitters. The DOJ has also weighed in by bringing a criminal fraud action.[1]

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1 *See also* FinCEN Fines BTC-e Virtual Currency Exchange $110 Million for Facilitating Ransomeware, Dark Net Drug Sales (July 27, 2017), available at https://www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110-million-facilitating-ransomware; Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (March 18, 2013), available at www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering. The DOJ has criminal authority here also. *See, e.g., U.S. v. Zaslavskiy*, No. 17-MJ-934 (E.D.N.Y. Filed Nov. 1, 2017) (Indictment in connection with initial coin offering supposedly backed by real estate or diamonds; based on fraudulent sale of unregistered securities).

### A. The SEC: Registration, Trading and Professional Obligations

The initial approach of the SEC to virtual currencies was an enforcement action alleging a failure to register the instruments involved. *In the Matter of Erik T. Voorhees*, Adm. Proc. File No. 3-15902 (June 3, 2014) (settled administrative proceeding involving the offering of unregistered shares valued in bitcoin). More recently the agency has brought fraud charges coupled with allegations of failure to register the securities involved. Typical of these actions is *SEC v. Plexcorps*, Civil Action No. 1:17-cv-07007 (E.D.N.Y. Filed Dec. 1, 2017). There the action centered on the claimed sale of a cryptocurrency by individuals enjoined from such sales by a Canadian court before bringing their scheme in the U.S., according to the SEC's complaint. The complaint named as defendants the company, an unincorporated entity, and Dominic Lacroix, a securities law recidivist who controlled the entity. Sabrina Paradise-Royer, believed to be a romantic interest of Mr. Lacroix, is also named as a defendant.

Defendants sought investors for their PlexCoin, claimed to be the next cryptocurrency. First, the Defendants tried to sell their product in Canada. In July 2017, the Quebec Financial Markets Administrative Tribunal entered an injunction against Mr. Lacroix, prohibiting him from future violations of the Quebec Securities Act, based on his sales efforts.

Next they tried the U.S. market. Beginning in August 2017, and continuing until the SEC filed suit on December 1, 2017. Defendants engaged in over 1,500 investor transactions, selling about 81 million PlexCoin Tokens for about $15 million. Investors were induced to enter into these transactions through a series of claims, which included: a representation that a team of experts around the world was involved; that the firm's executives were hidden to avoid poaching by competitions; that new products were being developed; and the potential returns were enormous.

The representations were false, according to the SEC. Defendants misappropriated much of the investor funds. The complaint alleges violations of Securities Act Sections 5(a), 5(c) for unregistered securities and 17(a) and Exchange Act Section 10(b) for fraud. This case is in litigation.[2]

#### 1. The SEC DAO Report: When Registration is Required

The SEC defined its primary approach to virtual currencies, and addressed the central question of whether a security is involved, in a Report of Investigation issued in mid-2017. Exchange Act Release No. 81207 (July 25, 2017) ("DAO Report"). The investigation sought to determine if The DAO, an unincorporated organization, Slock.it UG, a German entity, Slock.it's co-founders and certain intermediaries, violated the federal securities laws by selling unregistered securities.

It focused on the sale of tokens by The DAO, an autonomous organization that used block-chain technology to operate as a "virtual entity."

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2 *See also In the Matter of Bitcoin Investment Trust*, Adm. Proc. File No. 3-17335 (July 11, 2016) (settled action against bitcoin related stock exchange charging registration violations); *SEC v. Gara*, Civil Action No. 3:15-cv-01760 (D. Conn. Filed Dec. 1, 2015) (scheme offering opportunity to mine virtual currency attracted 10,000 investors and raised about $19 million in four months; it was a Ponzi scheme); *In the Matter of BTC Trading, Corp.*, Adm. Proc. File No. 3-16307 (Dec. 8 2014) (settled action against virtual currency trading operation charging sale of unregistered securities and unregistered brokers).

The tokens represented interests in the enterprise that could be paid for with virtual currency. The tokens could also be held as an investment, had certain voting and ownership rights and could be sold on web-based secondary platforms. Based on an analysis keyed to the elements of an investment contract, and focused on the economic reality of the transactions, the Commission determined that the tokens are securities. Specifically, the Commission's analysis centered on whether the tokens were an "investment contract," a form of a security under the definitions in the federal securities laws. The seminal decision in this regard is *SEC v. H.J. Howey Co.*, 328 U.S. 293 (1946). Under that decision, four factors are typically considered: (1) an investment of money; (2) in a common enterprise, (3) with the expectation of profits; and (4) from the efforts of others. *See also, United Housing v. Forman*, 421 U.S. 837, 854-55 (1975). The crux of the analysis is whether investors are pooling their money with the expectation of making a profit through the efforts of others coupled with assessing the economic reality of the transactions. Based on this approach the Commission concluded that The DAO offering was an investment contract and thus a security subject to the federal securities laws.

### 2. The SEC: Funds, ETFs and Trading Platforms

Virtual currencies also present questions under the federal securities laws about whether the products can be held by funds or ETFs and traded on an exchange. To date the SEC has not authorized funds to hold virtual currencies as investments or authorized their trading on an exchange. The agency has received a number of applications related to these issues. For example, in March 2017 the Commission denied a request regarding a trading platform from Cameron and Tyler Winklevoss, owners of Gemini Bitcoin exchange. Earlier this year there were about 14 applications for bitcoin ETFs or related products pending, according to a Reuters report dated January 10, 2018.

The issues presented by permitting funds to invest in virtual currency are detailed in a letter from the Director of the Division of Investment Management dated January 18, 2018 to the Investment Company Institute and the Securities Industry and Financial Markets Association.[3] The letter discusses a series of issues raised by the prospect of permitting funds or ETFs to invest in virtual currencies. Those include:

- **Valuation**: Mutual funds and ETFs are required to value their assets each business day by determining net asset value. Valuation is important, for example, to determine fund performance and the price paid by investors for fund shares and ETFs. The question here is "Would funds have the information necessary to adequately value cryptocurrencies or cryptocurrency-related products, given their volatility, the fragmentation and lack of regulation of underlying cryptocurrency markets, and the nascent state and current trading volume in the cryptocurrency futures markets?"[4]

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3 Letter from Dalia Bass, Director, Division of Investment Management to Paul Schott Stevens and Timothy W. Cameron, dated January 18, 2018, available at https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.

4 *See also NERA*, A Look at Initial Coin Offerings (Dec. 12, 2017) (discussing questions of liquidity and valuation for ICOs), available at: http://www.nera.com/content/dam/nera/publications/2017/PUB_A_Look_at_ICOs_1217.pdf.

- **Liquidity**: A key feature of mutual funds and ETFs is the ability to redeem the shares each day. The applicable rules require that the fund maintain sufficient liquid assets to provide daily redemptions. The question is thus how "funds investing in cryptocurrencies or cryptocurrency-related products . . . [could] assure that they would have sufficiently liquid assets to meet redemptions daily?"

- **Custody**: The Advisers Act imposes certain requirements regarding custody which include verification of holdings. To the extent the fund holds cryptocurrency directly, there is a question about how these requirements would be met: "We note, for example, that we are not aware of a custodian currently providing fund custodial services for cryptocurrencies . . . how would a fund intend to validate existence, exclusive ownership and software functionality of private cryptocurrency keys and other ownership records?"

- **Arbitrage**: ETFs have essentially an arbitrage process that allows for exchange trading of the shares during the day at market prices and redemptions transacted at NAV by authorized participants. There cannot be a material deviation from the market prices and NAV however. The question as to cryptocurrencies is if "this type of process [is] feasible . . . and how would the volatility and trading halts in those markets impact this process?"

- **Manipulation**: The Commission has repeatedly expressed concerns regarding the current operation of the cryptocurrency markets. This is particularly true with regard to the substantially less investor protections available in those markets. There is a significant question regarding how these issues will be resolved and the impact of that solution on the other points listed above.

The Director concluded by noting that the resolution of the issues will inform not just question regarding funds but also registration and trading: "The resolution of many of the questions we have raised in the context of a product seeking registration under the [Investment Advisers Act of] 1940 Act will also be important to the ongoing analysis of filings for exchange-traded products and related changes to listing standards by the Division of Corporation Finance, the Division of Trading and Markets and the Office of the Chief Accountant." Until "the questions identified above can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products."

The SEC's approach to trading platforms is similar. It is reflected in a joint statement issued by the SEC's Divisions of Trading and Markets and Enforcement on March 7, 2018 ("Trading Markets Release").[5] That Release echoes in part the questions raised by Director Bass in her letter regarding funds and ETFs. In this regard the Trading Markets Release notes, for example, that many digital platforms refer to themselves as "exchanges" which can give "the misimpression to investors that they are regulated or meet the regulatory standards of a national securities exchange." While some platforms may be selective or have strict standards, they "should not be equated to the listing standards of national securities exchanges," according to the Release. Likewise, while some platforms may have trading protocols, "investors should not

5 Divisions of Enforcement and Trading and Markets, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (March 7, 2018), available at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

assume the trading protocols meet the standards of an SEC-registered national securities exchange." And, while some platforms create the impression that they have exchange functions such as order books and updated bid and ask pricing and data, the Release cautions investors that "there is no reason to believe that such information has the same integrity as that provided by a national securities exchange." In view of these cautionary statements and the key questions raised by the Director of the Division of Investment Management there is no reason to assume that any funds, ETFs or platforms will be authorized to deal in cryptocurrencies in the immediate future.

### 3. Testing the DAO Report: The *Munchee* Case

The SEC's approach to cryptocurrencies will be tested in an enforcement action heading for hearing, *In the Matter of Munchee Inc.*, Adm. Proc. File No. 3-18304 (Dec. 11, 2017). The central question in this case is whether the product involved is a security – the critical question on which the SEC's regulatory authority hinges and which the agency addressed in The DAO Report.

Munchee is a privately held firm based in San Francisco. In late 2015, it began developing an iPhone app that was launched two years later. The app allowed users to post photographs and reviews of restaurant meals on-line.

The firm created a plan to improve the app. In part the plan called for raising capital through the sale of tokens or MUN on the Ethereum blockchain. Munchee created 500 million MUN tokens. Overall the plan called for the creation of about $15 million in Ether by selling 225 million MUN tokens out of the 500 million MUN tokens created by the company. The firm marketed the coins through a website, a white paper and other means, promising that as others became involved and the tokens circulated the value would increase. A key part of the plan was the trading of MUN on an exchange. The firm represented that MUN tokens would be available for trading on at least one U.S. based exchange within thirty days of the initial coin offering closing.

The coins were sold to the public beginning on October 17, 2017. Investors were told that they could profit on the investment based on the potential development of the ecosystem, the efforts of the firm and the future exchange listing of the coins. As the ecosystem expanded the value of the coins would increase, according to the firm. Munchee stopped selling the coins on November 1, 2017 after being contacted by the staff.

Echoing The DAO Report, the Commission's Order initiating the proceeding states that under Section 2(a)(1) of the Securities Act, the MUN tokens are securities because they are investment contracts. Accordingly, in offering the tokens for sale in the absence of an effective registration statement, or an exemption from registration, Munchee violated Section 5(a) of the Securities Act.

*Munchee* is currently being litigated. The registration question, based on The DAO Report, is squarely presented since there is no fraud claim as in many cases. At the same time the application of the *Howey* test here may differ from that in other cases. Typically the focus in investment contract cases is on the pooling of investor funds and a potential investor profit from the efforts of the enterprise. Beyond putting in capital, the investors may be passive.

In *Munchee*, however, a key to the future success and profits for the investors is the ecosystem. While the company may promote that ecosystem, the increased value of the investment – the coins – may well be largely a function of other investors deciding to purchase a coin and thereby building out the ecosystem and trading in the coins. While it can be argued that these facts fit the *Howey* test, it differs from the more traditional model. Thus the outcome of *Munchee* may hinge on the development of the facts and their presentation at the hearing.

### 4. The SEC: Protecting Investors -- Gatekeepers

While the Commission evolves its approach to virtual currencies, the agency and its officials have repeatedly cautioned investors about the lack of protections in these new markets compared to those available in the securities markets while trying to enlist the aid of the market professionals or gatekeepers.[6] In one speech, for example, the Chairman stated flatly that "from what I have seen recently particularly in the initial coin offering ("ICO") space, they [gatekeepers] can do better" in fulfilling their professional obligations.[7]

The Chairman went on to offer two examples of the difficulties investors face in the virtual currency markets. First, while the processes in the markets may be similar to those in the securities markets, the protections are not. ICO, the Chairman stated, "sounds pretty close to an "IPO." Yet there are significant protections for an IPO investor under the securities laws but not necessarily for an ICO. Second, he called out those who would try to take advantage of the current exuberance for all things crypto noting "I doubt anyone in this audience [a group of securities lawyers] . . . would [find it] . . . acceptable for a public company . . . with no experience in virtual currencies to changed its name "to something like 'Blockchain-R-US' and immediately start selling securities without providing adequate protections for investors.

Chairman Clayton then delivered what he called a "simple and a bit stern" message to market professionals: "I have instructed the SEC staff to be on high alert for approaches to ICOs that may be contrary to the spirit of our securities laws and the professional obligations of the U.S. securities bar." Those market professionals and members of the securities bar "need to act responsibly and hold themselves to high standards." Indeed, the securities laws "assume that securities lawyers, accountants, underwriters, and dealers will act responsibly . . ." the Chairman stated. It is simply not acceptable for securities lawyers involved in these transactions to conclude that the ICO is "pretty close" to an IPO and let it go forward. Likewise, assessing the situation and taking an equivocal position is not acceptable. As gatekeepers the securities lawyers and other market professionals have obligations to step forward and ensure that investors are given proper protections.

While the issues posed by virtual currencies, and the hype created in part by social media about them is new, Chairman Clayton's approach is not. The call on gatekeepers – market professionals who can at times control access to such transactions – to act in the highest

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6 *See, e.g.*, SEC Chairman Jay Clayton, Testimony on Virtual Currencies: The Oversight Role of the U.S. SEC and U.S. CFTC, Senate Committee on Banking (Feb. 6, 2018), available at https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission; Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions (Jan. 19, 2018), available at https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors).

7 Chairman Jay Clayton, Opening Remarks at the Securities Regulation Institute, Washington, D.C. (Jan. 22, 2018), available at https://www.sec.gov/news/speech/clayton-opening-remarks-sec-speaks.

traditions of their professional obligations traces to the earliest days of the Division of Enforcement. The access theory, as it was known years ago, posits that securities lawyers and other market professionals can aid in the protection of the investors by faithfully implementing their professional obligations.[8] In view of the Chairman's invocation of it, the theory may well form at least part of the predicate for any investigation brought in this area.

### B. The CFTC: Virtual Currencies are Commodities

The CFTC's approach has been similar to that of the SEC, focusing first on its jurisdictional predicate and then on trading. The agency has sought to bolster its approach with repeated public statements – at times in conjunction with the SEC – about investor protections.

#### 1. The CFTC: Virtual Currency as a Commodity

In 2015, the regulator concluded that virtual currencies are a commodity within the meaning of the Commodity Exchange Act ("CEA"). Accordingly, they are subject to regulation by the agency. The position of the CFTC was recently confirmed in *CFTC v. McDonnell*, Civil Action No. 18-cv-361 (E.D.N.Y. Opinion March 6, 2018).

The action centered on fraud claims. The resolution of those claims hinged in the first instance on the jurisdiction of the agency which is a function of whether a commodity is involved. Named as Defendants in the action are Patrick McDonnell and his firm, Coin Drop Markets. The complaint alleges that the Defendants were marketing access to expert trading advice in virtual currencies that would permit investors to make huge profits. In fact the Defendants did not have the expertise as traders, contrary to their claims, and were misappropriating portions of the investor funds. The CFTC charged fraud in its action.

The Court upheld the jurisdiction of the CFTC, granting a request for a preliminary injunction to halt the transaction, in a memorandum and order per Senior Judge Jack Weinstein. In its opinion the Court stated that the Commodity Exchange Act defines commodity to include "wheat, cotton, rice, corn, oats . . . and all services, rights, and interests . . . in which contracts for future deliver are presently or in the future dealt in." In view of this definition the CFTC issued an order in 2015 stating that virtual currencies can be classified as commodities. *In the Matter of: Coinflip Inc.*, CFTC Docket No. 15-29. That order stated that "'Bitcoin and other virtual currencies are encompassed in the definition [of a commodity] and properly defined as commodities.'" The Court went on to hold that while the CFTC generally cannot regulate the spot market, under an expansion of its authority in the Dodd-Frank Act, the agency can bring an action under Section 9 of the CEA and Rule 180.1 prohibiting fraud involving any "'contract of sale of any commodity in interstate commerce.'"

The CFTC has also brought a number of enforcement actions involving virtual currencies centered on fraud charges and unregistered trading that are similar to those initiated by the SEC. *See, e.g., CFTC v. Gelfman Blueprint, Inc.*, Case No. 17-7181 (S.D.N.Y. Filed Sept. 21, 2017) (action against the firm and its CEO centered on a Bitcoin Ponzi scheme supposedly using a high-frequency, algorithmic trading strategy to trade; case is in litigation); *In the Matter of BFXNA Inc., d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016) (settled administrative

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8 The Division evolve its access theory in early cases such as *SEC v. National Student Marketing*, 430 F. Supp. 639 (D.D.C. 1977); *but see SEC v. Arthur Young*, 584 F. 2d 1018 (9th Cir. 1978) (refusing to apply access theory to outside auditors absent statutory authority).

proceeding centered on trading or exchanging cryptocurrencies, mainly bitcoins, on an unregistered platform).

### 2. The CFTC: Virtual Currencies and Trading

Unlike the securities markets, trading in the commodities markets involving virtual currency products has been permitted by the exchanges. Trading involving virtual currencies is a question initially addressed by the commodity exchanges, rather than the CFTC, a crucial difference from the securities markets.

On December 1, 2017, the Chicago Mercantile Exchange Inc. and the CBOE Futures Exchange self-certified new contracts for bitcoin future products. The Cantor Exchange self-certified a new contract for Bitcoin binary options. The product self-certification process was designed by Congress to "give the initiative to DCMs [Designated Contract Markets] to certify new products . . . [which] is consistent with a DCM's role as a self-regulatory organization . . ." according to the CFTC Backgrounder to Virtual Currency Markets.[9] The process does not allow for public comment. The CFTC has only limited input.

Nevertheless, the CFTC has taken an active role centered on investor protections. Within the limits of the self-certification process, the CFTC staff has engaged in what the Backgrounder calls "heightened review for virtual currency." That process, centers largely on strengthening oversight and monitoring, including: derivatives clearing organizations setting substantially high initial and maintenance margin for cash-settled Bitcoin futures; setting large trader reporting thresholds at five bitcoins or less; entering into information sharing agreements with spot market platforms; monitoring data from cash markets; and other, similar steps. The CFTC "expects that any registered entity seeking to list a virtual currency derivative product would follow the same process, terms and conditions" the Backgrounder notes. Accordingly, while there is currently trading involving virtual currencies in these markets, it is being carefully monitored by the CFTC which continues to focus on its investor protection rule.

## II. The Future

The SEC, CFTC, FinCEN, DOJ and the banking regulators continue to monitor the cryptocurrency markets and take action within their limited spheres. The SEC and the CFTC have been particularly aggressive. The SEC, for example, has issued guidance in The DAO Report on what constitutes a securities – the predicate to its jurisdiction – and is litigating the question in *Munchee*. The agency has also engaged in a dialogue with market participants about investment by funds and ETFs in virtual currencies and authorizing trading. Those discussions are continuing as the SEC tries to ensure that securities law type protections are available to investors in the virtual currency market. At the same time the Enforcement Division has not only brought a number of fraud cases, it is currently conducting a significant non-public investigation into cryptocurrencies which appears to be a sweep, gathering additional information to inform the processes of the agency and perhaps as the predicate for more enforcement actions.

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9 CFTC Backgrounder to Virtual Currency Future Markets (January 4, 2018)("Backgrounder"), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

The CFTC has taken a similar approach. The jurisdiction of the agency – predicated on determining that a virtual currency is a commodity – has been upheld by the first court to consider the question. The agency has also brought a series of fraud actions and is using its limited authority over the trading that has been initiated to bolster investor protections.

As the regulators debate various issues and investigate the market is moving forward. Praetorian Group, for example, announced an anticipated $75 million initial coin offering and filed a registration statement with the SEC which appears to be a first. The firm invests in residential and commercial real estate. Coin investors would have a right to profits but not an interest in the actual real estate under the terms of the offering.[10]

Cameron and Tyler Winklevoss, who were not able to secure approval for a trading platform from the SEC, have returned with a request that a self-regulatory organization be created to monitor virtual currencies.[11] The proposal follows remarks from a CFTC Commissioner who initially suggested that such an organization be created.[12] This may signal an effort to circumvent the limitations the two brothers encountered when trying to deal with the SEC.

In the end, the final word on virtual currencies may ultimately evolve from the markets and the investors who have fostered growth in the virtual markets to date. Recently Facebook banned advertisements for cryptocurrencies.[13] If social media continues on this path it could have a more significant impact on virtual currencies than all of the regulators.

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10 Law 360 (March 7, 2018), www.law360.com/articles/1019491/print?section=securities.

11 Law 360 article available at https://www.law360.com/articles/1021500/print?section%20=securities%20(March%2014,%202018).

12 CFTC Commissioner Brian Quintenz, Key Note Address before DC Blockchain Summit (March 7, 2018) (discussing possible SRO for virtual currency), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz8; *see also*, Statement of Commissioner Quintenz on Proposal vy Cameron and Tyler Winklevoss (March 13, 2018) (welcoming proposal), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement031318.

13 Sheera Frenkel, *The New York Times* (Jan. 30, 3018), https://www.nytimes.com/2018.01/30/technology/facebook-.

eUPDATE
A PUBLICATION OF DORSEY & WHITNEY LLP

**January 17, 2018**

# The SEC, CFTC and Virtual Currencies

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The public interest in anything relating to virtual currencies, blockchain technology or bitcoin is not just very high but reaching near hysteria. For example, the Long Island Iced Tea Corporation saw its share price jump as much as 289% after changing its name to Long Blockchain Corp. Kodak, Inc., the one-time film and camera giant, saw its share price triple after announcing the development of KodakCoin, a form of virtual currency, according to a recent CNBC report. Even the SEC is looking at jumping on board according to a tweet from its Fort Worth Texas office (in jest) stating that the agency is considering adding "Blockchain" to its name to improve its popularity, according to a Bloomberg report.

Regulators such as the SEC and CFTC have expressed repeated concern in the face of these and other public responses while monitoring the situation and at times struggled to craft the appropriate response. As the CFTC recently admitted, U.S. law does not provide for "direct, comprehensive U.S. regulation of virtual currencies. To the contrary a multi-regulatory approach is being used." CFTC Backgrounder on Oversight and Approach to Virtual Currency Futures Markets, dated January 4, 2018 ("Backgrounder"), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf. Those U.S. regulators include:

- Banking regulators,
- The Internal Revenue Service,
- Treasury's Financial Crimes Enforcement Network,
- The Securities and Exchange Commission, and
- The Commodity Futures Trading Commission.

While the SEC and CFTC have worked to develop a regulatory approach to the issues within their jurisdiction, each agency has repeatedly cautioned investors regarding the significant potential for fraud. *See, e.g.*, SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, Dec. 11, 2017 available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11; CFTC Chairman J. Christopher Ciancario, *Commending SEC Chairman Clayton on ICO Statement*, Dec. 11, 2017 available at http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement121117. At the same time, each has limited regulatory authority in the area.

## The SEC

The SEC's approach keys to the question of whether a security is involved, central to its jurisdiction under the federal securities laws. In a Report of an Investigation issued under

Exchange Act Section 21(a), The DAO, the agency detailed its approach to determining whether a security is involved. The report is available at https://www.sec.gov/litigation/investreport/34-81207.pdf. The investigation sought to determine if The DAO, an unincorporated organization, Slock.it UG, a German entity, Slock.it's co-founders and certain intermediaries violated the federal securities laws. The inquiry focused on the sale by The DAO, an autonomous organization that used blockchain technology to operate as a "virtual entity," of tokens. Those tokens represented interests in its enterprise and could be paid for with virtual currency. The tokens could also be held as investments and had certain voting and ownership rights. In addition, the tokens could be sold on web-based secondary platforms.

The Commission's analysis of the question centered on whether the tokens were an "investment contract," a form of a security under the definitions in the federal securities laws. The seminal decision in this regard is *SEC v. H.J. Howey Co*., 328 U.S. 293 (1946). There the Court used a multi-prong test centered on the question of whether the investors were pooling their money with the expectation of making a profit through the efforts of others. Utilizing this approach in view of the economic reality of the transactions, the Commission concluded that the tokens involved were in fact an investment contract and thus a security subject to the federal securities laws. Exchange Act Release No. 81207 (July 25, 2017) ("21(a) Report").

Most of the cases brought by the SEC in this area both before and after the 21(a) Report have been offering fraud actions, often involving a Ponzi scheme. For example, *SEC v. Plexcorps*, Civil Action No. 1:17-cv-07007 (E.D.N.Y. Filed Dec. 1, 2017) centers on the claimed sale of a cryptocurrency by individuals enjoined from such sales by a Canadian court before implementing their scheme in the U.S., according to the SEC's complaint.

The complaint names as defendants the company, an unincorporated entity, and Dominic Lacroix, a securities law recidivist who controlled the entity. Sabrina Paradis-Royer, believed to be a romantic interest of Mr. Lacroix, is also named as a defendant. The action centers on the sale of what the defendants call PlexCoin, claimed to be the next cryptocurrency. In the United States the defendants began their offering of unregistered interests in August 2017. It continues to the present.

Prior to the U.S. offering defendants initiated sales of the securities in Quebec, Canada. In July 2017, the Quebec Financial Markets Administrative Tribunal entered an injunction against Mr. Lacroix, prohibiting him from future violations of the Quebec Securities Act, based on his sales efforts. Subsequently, defendants began offering interests in Plexcorps' claimed cryptocurrency in this country.

Since August 2017, defendants have engaged in over 1,500 investor transactions, selling about 81 million PlexCoin Tokens for about $15 million. Investors were induced to enter into these transactions through a series of claims which included: a representation that a team of experts around the world were involved; that the firm's executives were hidden to avoid poaching by competitions; that new products were being developed; and that the potential returns were enormous.

The representations were false, according to the SEC. Defendants misappropriated much of the investor funds. The complaint alleges violations of Securities Act Sections 5(a), 5(c) and 17(a) and Exchange Act Section 10(b). This case is in litigation. *See also SEC v. Gara*, Civil Action No. 3:15-cv-01760 (D. Conn. Filed Dec. 1, 2015) (scheme offering opportunity to mine virtual currency attracted 10,000 investors and raised about $19 million in four months; it was a Ponzi

scheme); *In the Matter of Erik T. Voorhees*, Adm. Proc. File No. 3-15902 (June 3, 2014) (settled administrative proceeding involving the offering of unregistered shares valued in bitcoin).

The Commission's most recent case in this area centers on the failure to registered the interests offered as required by Section 5 of the Securities Act based on an analysis similar to the one in the 21(a) Report. I*n the Matter of Munchee Inc*., Adm. Proc. File No. 3-18304 (Dec. 11, 2017). Munchee is a privately held firm based in San Francisco. In late 2015, it began developing an iPhone app that was launched two years later. The app allowed users to post photographs and reviews of restaurant meals on-line.

Munchee created a plan to improve the app. Part of the plan called for raising capital through the sale of tokens or MUN on the Ethereum blockchain. Munchee created 500 million MUN tokens. The plan was to raise about $15 million in Ether by selling 225 million MUN tokens out of the 500 million MUN tokens created by the company. Munchee marketed the coins through a website, a white paper and other means, promising that as others became involved and the tokens circulated the value would increase. A key part of the plan was the trading of MUN on an exchange. Munchee represented that MUN tokens would be available for trading on at least one U.S. based exchange within thirty days of the close of the initial coin offering.

Munchee offered the coins to the public beginning on October 17, 2017. Potential investors were told that they could profit on the investment based on the potential development of the ecosystem, the efforts of the firm and the future exchange listing of the coins. As the ecosystem expanded, the value of the coins would increase, according to the firm. The firm stopped selling the coins on November 1, 2017 after being contacted by the staff.

Under Section 2(a)(1) of the Securities Act the MUN tokens are securities, according to the Order because they are investment contracts. Accordingly, in offering the tokens for sale in the absence of an effective registration statement, or an exemption from registration, Munchee violated Section 5(a) of the Securities Act. The case will be set for hearing.

The SEC has also received a number of applications related to the trading of virtual currency. For example, in March of last year the Commission denied such a request from Cameron and Tyler Winklevoss, owners of Gemini Bitcoin exchange. At present about 14 applications for bitcoin ETFs or related products are pending, according to a Reuters inquiry dated January 10, 2018. None have been approved.

### The CFTC

The CFTC concluded in 2015 that virtual currencies are a commodity within the meaning of the Commodity Exchange Act. Accordingly, they are subject to regulation by the agency. Since that date the CFTC has brought enforcement actions involving virtual currencies centered on fraud charges and for unregistered trading that are similar to those brought by the SEC. *See, e.g., CFTC v. Gelfman Blueprint, Inc*., Case No. 17-7181 (S.D.N.Y. Filed Sept. 21, 2017) (action against the firm and its CEO centered on a Bitcoin Ponzi scheme supposedly using a high-frequency, algorithmic trading strategy to trade; case is in litigation); *In the Matter of BFXNA Inc., d/b/a Bitfinex*, CFTC Docket No. 16-19 (June 2, 2016) (settled administrative proceeding centered on trading or exchanging cryptocurrencies, mainly bitcoins, on an unregistered platform).

The agency also granted a request by LedgerX, LLC for registration as a derivatives clearing organization under the Commodity Exchange Act on July 24, 2017. The order authorizes LedgerX to provide clearing services for fully-collateralized digital currency swaps. The CFTC also granted an order of registration for LedgerX under which it registered as a Swap Execution Facility in July 2017. The firm plans to clear bitcoin options, according to the CFTC announcement. Under the order LedgerX is required to comply with the applicable provisions of the Commodity Exchange Act and other undertakings presented in its application that relate to CFTC regulations. In issuing the order the CFTC disclaimed any endorsement of digital currencies.

Subsequently, the Chicago Mercantile Exchange Inc. and the CBOE Futures Exchange self-certified new contracts for bitcoin future products on December 1, 2017. The Cantor Exchange also self-certified a new contract for Bitcoin binary options. The product self-certification process was designed by Congress to "give the initiative to DCMs [Designated Contract Markets] to certify new products . . . [which] is consistent with a DCM's role as a self-regulatory organization . . ." according to the Backgrounder. The process does not allow for public comment. The CFTC has only limited input.

Within the limits of the self-certification process, the CFTC staff has engaged in what the Backgrounder calls "heightened review for virtual currency." That process, largely centered on strengthening oversight and monitoring, includes: derivatives clearing organizations setting substantially high initial and maintenance margin for cash-settled Bitcoin futures; setting large trader reporting thresholds at five bitcoins or less; entering into information sharing agreements with spot market platforms; monitoring data from cash markets; and other, similar steps. The CFTC "expects that any registered entity seeking to list a virtual currency derivative product would follow the same process, terms and conditions" the Backgrounder notes.

## Conclusion

Public and investor interest in blockchain technology, virtual currency, Bitcoin, and similar processes and products is at near fever pitch. The technology and products in this area are rapidly evolving while the depth of investor knowledge and sophistication in the area, in general, may not be keeping pace.

At the same time the regulatory approach is fragmented and evolving with a number of agencies working hard to get on top of this recent investment craze. Some think this is a bubble that will blow-up quickly and crash. Others believe this is the newest and greatest investment opportunity. Regardless of which view is correct, it is clear that the investment risks are high and the protections few as the market for these products rapidly evolves.

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# Blockchain & Digital Assets

**DORSEY'S BLOCKCHAIN & DIGITAL ASSETS PRACTICE LINKS MULTIPLE DISCIPLINES AND INDUSTRY FOCUSES TO COMBINE AN INNOVATIVE APPROACH TO LEGAL SOLUTIONS WITH HISTORICAL PERSPECTIVE.**

## Overview

Blockchain technology is both innovative and disruptive in nature—but Dorsey attorneys have been heavily involved in these emerging industry segments since their inception. Not only is it necessary to understand how Bitcoin and other crypto-currencies and digital assets function and are created, it is also critical to be able to advise clients how existing regulation and licensing impacts participants in this arena.

Dorsey has provided clients with critical counsel on numerous legal issues presented by blockchain technologies and digital assets, including:

- Establishment of Bitcoin mining operations
- Intellectual property concerns
- Investments and corporate structuring
- Contracting
- Regulatory compliance including SEC registration issues, anti-money laundering provisions and other state and federal regulatory matters.
- State and federal licensing and enforcement
- Cybersecurity issues
- Digital asset trading and exchanges
- Tax impacts

Importantly, while many existing regulatory structures may apply to blockchain operations, Dorsey works with regulatory officials to obtain the most favorable outcomes in legal areas where ambiguity exists. This includes monitoring on a daily basis the announced intention by the U.S. Department of the Treasury to review these issues in a comprehensive manner.

# FinTech

**HELPING CLIENTS NAVIGATE THE CRITICAL AND EVER-CHANGING BUSINESS, LEGAL AND REGULATORY ISSUES ASSOCIATED WITH TECHNOLOGICAL DISRUPTION IN THE FINANCIAL SERVICES INDUSTRY.**

## Overview

More than 250 Dorsey lawyers comprise the firm's Banking Industry Group, advising clients on banking and other financial services matters around the globe. Dorsey represents both FinTech companies and financial services companies engaging in transactions with FinTech companies, giving the firm a 360° view of the issues that impact the sector.

Drawing on deep expertise that applies to the financial services industry specifically as well as technology industries generally, Dorsey's suite of services available to FinTech companies includes:

## Litigation, Arbitration, Enforcement and Investigations

Dorsey's large team of trial attorneys helps clients prevail in matters ranging from commercial disputes in civil court to government enforcement actions involving criminal allegations. Our deep experience includes matters involving the SEC, DOJ, FINRA, CFTC, CFPB, the OCC and state regulators. Dorsey represents emerging or growth companies facing investigations, and applies the specialized skill to bridge information gaps (in fact and law) with regulators. In doing so, Dorsey advocates for clients in investigations or government probes, which are made more complex by the increased scrutiny of FinTech firms by a patchwork quilt of federal and state agencies. As outside counsel, we permit our clients to focus on developing pioneering technologies in the new economy, while ensuring that government agencies' investigations are resolved expeditiously and sensibly.

## Regulatory

Dorsey's Financial Services Regulatory team has significant experience advising clients on compliance matters and representing clients before regulatory bodies on consumer financial protection issues and other issues of relevance to the FinTech industry. For example, a Dorsey team member who served with the Consumer Financial Protection Bureau for several years starting with its inception has represented clients' interests in connection with CFPB rulemaking related to oversight of the FinTech industry.

## Cybersecurity and Privacy

In addition to advising on privacy compliance matters, Dorsey provides proactive planning for, and assessment of, cyber threats and incident response. We stay on the cutting edge of evolving technologies, regulatory requirements and industry best practices to provide clients with comprehensive and practical legal solutions.

## Intellectual Property

In addition to highly rated patent and trademark teams, Dorsey's Technology Commerce practice group advises a wide range of clients (including FinTech companies) engaged in developing and commercializing their products and services – from emerging companies needing strategies to secure appropriate rights to maximize value when developing intellectual property to Fortune 100 companies forging bet-the-company joint ventures and other complex commercial transactions.

## Corporate and M&A

Dorsey is highly rated for general corporate matters, including an M&A practice that has been ranked in the Top 25 among all law firms for the number of U.S. deals completed for 23 consecutive years by Thomson Reuters. Our representations include many financial services industry transactions, for companies including financial transaction and credit card processing services and other FinTech businesses.