



# Financial Fraud Law Report

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# Recent Developments in the Regulation of Bitcoin Under State and Federal Securities Laws

SCOTT H. KIMPEL

*As the author explains, regulators in the U.S. are increasingly not shy about applying old-fashioned regulations to the modern innovation known as “Bitcoin.”*

The advent of Bitcoin and other virtual currency in recent years is the latest example of a new technology emerging with the potential to disrupt traditional ways of doing business. As with other technological innovations that initially outpace regulation, the regulatory environment around the treatment of Bitcoin has been rapidly evolving. And like other regulators who have begun to interpret existing regulations in the context of virtual currency, the Securities and Exchange Commission (“SEC”) and state securities regulators have begun to apply traditional securities regulations to Bitcoin.

## WHAT IS BITCOIN?

Bitcoin is a peer-to-peer, network-based virtual currency introduced as open source software in 2009 by an unknown person or persons using the

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pseudonym Satoshi Nakamoto. By using third-party services, users of Bitcoin are able to buy, sell or accept bitcoins from anywhere in the world. These users can purchase goods or services using Bitcoin, they can buy and sell Bitcoin like a commodity, and they can convert Bitcoin into traditional currencies like the U.S. dollar.

## **HOW DOES BITCOIN WORK?**

Unlike traditional fiat currencies issued by central banks, Bitcoin has no central monetary authority. Instead, users rely on peer-to-peer networking of their computers to support the Bitcoin ecosystem.

Acquiring bitcoins is accomplished through a process known as “mining,” which is meant to mimic the process of mining for physical commodities. But instead of pick axes and shovels, Bitcoin miners must use supercomputers to solve complicated mathematical problems. Solving these problems, known as “blocks,” leads to a “block reward” for the user in the form of new bitcoins. The size of the block reward diminishes over time, halving every four years, and is currently set at 25 bitcoins. Theoretically, no new bitcoins will be issued after the year 2140 and approximately 21 million bitcoins will be in existence at that time.

Users store their bitcoins in a “digital wallet,” and each transaction in the virtual currency is logged in a so-called “block chain,” a kind of universal ledger. In theory, all transactions in Bitcoin — past and present — are permanently inventoried in the block chain, and various forms of cryptography minimize the risk of theft or double counting. The block chain identifies users by Bitcoin addresses rather than name, affording users a high degree of anonymity. Users of Bitcoin who do not mine their own currency may also buy and sell it on one of the many Bitcoin exchanges that have emerged in recent years.

Various merchants and service providers — particularly those that operate online — have begun accepting payment in Bitcoin. In late March 2014, one bitcoin was worth approximately \$570. The value of bitcoins has fluctuated significantly (and sometimes unpredictably) since 2009. At one point in late 2013, the virtual currency traded for over \$1,100 per bitcoin before dropping precipitously.

## **WHAT IS THE REGULATORY ENVIRONMENT FOR BITCOIN IN THE UNITED STATES?**

Most U.S. laws and regulations were not drafted with virtual currency in mind. Accordingly, many U.S. regulators have begun analyzing existing statutes and rules to determine whether they are sufficiently broad to capture commercial activity in Bitcoin and other virtual currency. To that end, the FBI published a white paper in April 2012 identifying many of the criminal risks and investigative challenges inherent in Bitcoin.<sup>1</sup> The Financial Crimes Enforcement Network published guidance in March 2013 clarifying the applicability of the Bank Secrecy Act and related regulations concerning money service businesses to persons exchanging and accepting virtual currencies.<sup>2</sup> Additionally, media reports indicate that the Commodity Futures Trading Commission is currently studying whether Bitcoin and other virtual currency should be deemed a commodity under the Commodity Exchange Act or otherwise be subject to CFTC jurisdiction. Furthermore, on March 25, 2014, the Internal Revenue Service published guidance describing the federal income tax treatment of virtual currency, finding that virtual currency will be deemed property (and not currency) for federal tax purposes.<sup>3</sup> Other agencies continue to analyze the regulatory environment for Bitcoin.

## **HOW DO THE SEC AND STATE SECURITIES REGULATORS VIEW BITCOIN?**

Bitcoin is clearly not one of the enumerated financial instruments within the statutory definition of “security” under Section 2(a)(1) of the Securities Act of 1933 or parallel provisions of the other federal securities statutes. Likewise, Bitcoin is not mentioned in any version of the Uniform Securities Act, upon which many state securities laws are based. Although the Supreme Court has ruled that an FDIC-ensured certificate of deposit is not a security,<sup>4</sup> its rationale would clearly not apply in the case of Bitcoin or other virtual currency. Instead, the SEC would likely examine whether an investment in Bitcoin would be deemed an “investment contract” (and thus be a security) under the Supreme Court’s classic *Howey* test.<sup>5</sup> Under *Howey*, an instrument is deemed a security if it entails:

- an investment of money
- due to an expectation of profits arising from
- a common enterprise
- which depends solely on the efforts of a promoter or third party.

Indeed, in responding to an inquiry from the Senate Committee on Homeland Security and Government Affairs, SEC Chair Mary Jo White made the following observations in August 2013:

Whether a virtual currency is a security under the federal securities laws, and therefore subject to our regulation, is dependent on the particular facts and circumstances at issue. Regardless of whether an underlying virtual currency is itself a security, interests issued by entities owning virtual currencies or providing returns based on assets such as virtual currencies likely would be securities and therefore subject to our regulation.

In this letter, Chair White also noted that the SEC's Division of Enforcement has been in communication with representatives of several state and federal agencies, including the Department of Justice, Department of Treasury, New York Attorney General and New York State Department of Financial Services, concerning potentially fraudulent activity.

Several asset managers have begun offering investment products that are linked to underlying portfolios of Bitcoin. The Winklevoss brothers also filed a registration statement with the SEC in July 2013 seeking to make a public offering of an exchange-traded fund that will invest exclusively in Bitcoin. That registration statement remains in registration while the SEC staff continues its review. Amendments made to the Winklevoss registration statement since its original filing have significantly expanded the discussion around how Bitcoin works and the risks attendant in Bitcoin investments.

The SEC brought its first Bitcoin-related enforcement action in July 2013 when it sued Trendon T. Shavers and his Bitcoin Savings and Trust ("BST"), formerly known as "First Pirate Savings and Trust." Shavers allegedly ran a Ponzi scheme by selling bitcoin-denominated investments online that promised annual returns in excess of 300 percent.<sup>6</sup> According to the SEC's com-

plaint, Shavers promised investors a return based on a proprietary strategy for trading in Bitcoin. In reality, the SEC asserts that Shavers lost money on his Bitcoin trading, and instead used new investor payments to pay returns to prior investors. Shavers is also alleged to have diverted investment proceeds to the payment of his own personal expenses and for casino gambling.

As part of his defense, Shavers argued that his BST investments were not securities and thus the SEC (and the courts) lacked subject matter jurisdiction.<sup>7</sup> In reply, the SEC argued that the BST investments were both investment contracts and notes and, thus, were securities. After conducting a thorough analysis of the investments under the *Howey* test, a federal magistrate judge concluded that the investments were in fact securities.<sup>8</sup>

Contemporaneously with the commencement of the case against Shavers, the SEC's Office of Investor Education and Advocacy released an investor alert warning about the risks of Bitcoin and other virtual currency investments.<sup>9</sup> OIEA cautioned that:

We are concerned that the rising use of virtual currencies in the global marketplace may entice fraudsters to lure investors into Ponzi and other schemes in which these currencies are used to facilitate fraudulent, or simply fabricated, investments or transactions. The fraud may also involve an unregistered offering or trading platform. These schemes often promise high returns for getting in on the ground floor of a growing Internet phenomenon.

Fraudsters may also be attracted to using virtual currencies to perpetrate their frauds because transactions in virtual currencies supposedly have greater privacy benefits and less regulatory oversight than transactions in conventional currencies. Any investment in securities in the United States remains subject to the jurisdiction of the SEC regardless of whether the investment is made in U.S. dollars or a virtual currency.

Media reports indicate that the SEC is monitoring other Bitcoin platforms for compliance with the federal securities laws as well. During a speech in January 2014, Andrew Ceresney, director of the SEC's Division of Enforcement, said the agency is "very focused" on whether bitcoin-denominated stock exchanges are complying with SEC regulations, or instead if they are

“unregistered exchanges or broker dealers operating in violation of the securities laws.” Shortly thereafter, on February 19, 2014, the SEC suspended trading in the stock of Imogo Mobile Technologies Corp., which purportedly operated a new mobile Bitcoin platform, due to questions about the accuracy and adequacy of publicly disseminated information concerning its business, revenue and assets.<sup>10</sup> Moreover, the operator of Bitcoin exchange MPEX has released the text of an SEC investigative demand into his dealings with on-line gambling site SatoshiDice dated as of March 3, 2014, and in doing so revealed that the SEC’s Division of Enforcement has begun a formal investigation into the matter. In the meantime, the collapse of Tokyo-based Mt. Gox, previously one of the largest Bitcoin exchanges, continues to play out in courts around the world.<sup>11</sup>

State securities regulators have also taken a keen interest in Bitcoin investments. On March 10, 2014, the Texas State Securities Board issued an emergency cease and desist order against Kirk Johnson and his company, Balanced Energy LLC,<sup>12</sup> in what appears to be the first blue sky enforcement action involving Bitcoin. According to the Securities Board’s order, Johnson offered investments in working interests in various oil and gas prospects located in Runnels County, Texas. In lieu of cash, Johnson also accepted payment through Bitcoin with the intention of converting Bitcoin to traditional currency to pay for business operations. In alleging violations of the registration and antifraud provisions of the Texas Securities Act, the Securities Board highlighted Johnson’s alleged failure to disclose the “nature of the risks associated with the use of Bitcoin to purchase working interests, including the risks inherent to the use of Bitcoin and the risk that fluctuation in the price of the digital currency may affect business operations.” The Texas State Securities Board and the Alabama Securities Commission have each also issued investor alerts warning about the risks of investing in Bitcoin enterprises. Additionally, the New York State Department of Financial Services commenced a broad investigative inquiry into virtual currency in August 2013.

## **TAKEAWAYS**

Regulators in the U.S. have begun to focus on Bitcoin, with the SEC and its counterparts at the state level among them. Investing in Bitcoin is not

inherently illegal, nor is offering a platform for its exchange, and many legitimate businesses transact Bitcoin commerce. But despite the hopeful claims of some Bitcoin promoters who believe Bitcoin has ushered in a brave new world of commerce outside the bounds of traditional commercial regulation, regulators in the U.S. are increasingly not shy about applying old-fashioned regulations to this modern innovation. Users of Bitcoin should in particular be attuned to the speculative nature of Bitcoin and the potential implications of the federal securities laws on their operations. Traditional securities-law concepts such as registration (or exemption) of an offering, as well as the use of full and fair disclosure in offering materials, will continue to apply to investment opportunities involving Bitcoin.

## NOTES

<sup>1</sup> FBI Directorate of Intelligence, *Bitcoin Virtual Currency: Unique Features Present Distinct Challenges for Deterring Illicit Activity* (Apr. 24, 2012).

<sup>2</sup> FinCEN Guidance FIN-2013-G001, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar. 18, 2013).

<sup>3</sup> IRS Notice 2014-21 (Mar. 25, 2014).

<sup>4</sup> *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

<sup>5</sup> *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

<sup>6</sup> Complaint, *S.E.C. v. Shavers*, Case No. 4:13-CV-416 (E.D. Tex. July 23, 2013).

<sup>7</sup> *SEC v. Shavers*, Case No. 4:13-CV-416 (E.D. Tex. Aug. 6, 2013).

<sup>8</sup> *Id.*

<sup>9</sup> SEC Pub. No. 153, *Ponzi Schemes Using Virtual Currencies* (July 2013). FINRA has also issued its own investor alert on the risks of Bitcoin investments. FINRA, *Bitcoin: More than a Bit Risky* (Mar. 11, 2014).

<sup>10</sup> Exchange Act Release No. 71568 (Feb. 19, 2014).

<sup>11</sup> The Department of Homeland Security previously sanctioned Mt. Gox for operating an unlicensed money service business in the United States.

<sup>12</sup> Texas State Securities Board, *In the Matter of Balanced Energy, LLC*, Order No. ENF-14-CDO-1731 (Mar. 10, 2014).