

# Cryptocurrency 101

April 9, 2018

If you do not currently own Bitcoin, the odds are in the last few months you have thought about the merits (or lack thereof) of owning Bitcoin. Bitcoin is a cryptocurrency, which is a digital or virtual currency (commonly referred to as "tokens" or "coins") or, in its most elemental sense, a piece of software. Although Bitcoin is the oldest and most well-known cryptocurrency, it is only one of over 1,300 different cryptocurrencies that exist in the world today. The fast increase in the value of cryptocurrencies like Bitcoin (and the equally quick fall in values, and subsequent volatility) have made cryptocurrencies and the technology upon which they exist all the rage in social media, financial press and, yes, the eyes of US and foreign regulators.

**Tokens & Coins** Cryptocurrencies usually are designed to facilitate financial transactions of one sort or another - just like the US Dollar and other government-backed (fiat) currencies. It is believed that cryptocurrencies will enable quicker, safer and cheaper transactions worldwide because they generally involve no intermediaries (like banks), are not limited to particular markets (like some fiat currencies) and their underlying technology - blockchain - is believed to offer security features that greatly minimize fraud and other problems with current payment systems. Indeed, many argue blockchain technology holds great promise for many applications throughout our society. Some have likened blockchain to the smartphone - for which thousands of "apps" have been written, making it very useful - or "internet 2.0", which we will explore in future Alerts.

**ICOs** In the last few years, there has been an explosion of initial coin offerings or initial token offerings ("ICOs") around the world. ICOs are used to promote the sale and issuance of new cryptocurrencies, usually for the purpose of raising money for a new business venture. Purchasers of tokens in ICOs usually "pay" for the tokens with either another cryptocurrency or US Dollars (or other fiat currency like Euros). The attributes of tokens that have been sold, as well as the terms on which they have been sold, vary widely.

**Problems with Cryptocurrencies** To some degree, most (if not all) of the purported benefits of cryptocurrencies remain elusive. There are technical problems to be worked out in processing cryptocurrency transactions (problems that likely will be solved, given that we're talking about software). And, the near anonymity of cryptocurrency transactions lends itself to criminal activity like illegal drug trade, money laundering and illegal arms transactions. So the "early" spotlight on cryptocurrencies has not been all

that rosy.

Another problem is that many purchasers of tokens are unhappy because they purchased tokens in an ICO that promised the development of a specific business enterprise or useful thing, which never materialized. Others bought tokens without fully understanding what they were buying, what "return" or utility they would get from their tokens, or whether they could sell their tokens later when they needed funds. Some bought tokens only to discover that they could not remember the "code" or "key" to access their electronic vault, account or wallet where they stored their tokens and, therefore, the token is now inaccessible to them. Some actually had their vault, account or wallet hacked and lost their tokens.

A third problem is that most token transactions after an ICO occur on one of many cryptocurrency exchanges that have popped up throughout the world. Users don't always know where an exchange is located. These exchanges generally are not licensed and are unregulated (compared to your local bank where you can conduct financial business with some comfort and assurance). Even tokens whose issuers truly intended a limited utility (and not a security) often

become tradeable on such cryptocurrency exchanges, without the involvement of the issuing company.

**Regulatory Response** Governments throughout the world are responding to the rise of cryptocurrencies and the problems outlined above - often in conflicting ways. We focus in this Alert on the recent actions of the United States Securities and Exchange Commission ("SEC").<sup>1</sup>

One of the key legal issues is whether a particular token is, in fact, a "security" and thus subject to regulation under the securities laws of the United States, its 50 states and various foreign nations. Simply put, a security cannot be sold in the United States unless it is registered or the subject of one of several exemptions from registration. These laws exist to protect investors by helping them know what they are buying and the related risks.

There are two main legal constructs for tokens: security tokens and utility tokens:

(a) A token is a **security** if it is (1) an investment of money; (2) in a common enterprise; and purchased (3) with an expectation of profits to be derived predominantly from the efforts of others. With a security, the investor is attracted by the prospects of a return on his or her investment. "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."<sup>2</sup>

(b) A token is a **utility** if the purchaser is motivated by a desire to use or consume the item purchased, with no expectation of an increase in value. Utility tokens serve as access (or future access) to a product or service and are analogous to a gift card or a software license.

The problem is that most tokens have characteristics of both a security and a utility. On February 6, 2018, SEC Chairman Jay Clayton testified before Congress on the role of the SEC in monitoring virtual currencies. One of Chairman Clayton's most significant statements was that a token having a use-value does not automatically prevent it from also being a security. If a token has characteristics of a security, Chairman Clayton's position is that the token sale was required to have been registered under U.S. securities laws. In fact, Chairman Clayton said that all the ICOs he has seen occur in the United States thus far are probably securities.

The SEC recently weighed in on the use of unlicensed cryptocurrency exchanges to buy and sell tokens. On March 7, 2018, the SEC released a Public Statement titled "*Statement on Potentially Unlawful Online Platforms for Trading Digital Assets*" warning investors and market participants about "unregistered" online platforms (exchanges) that are used to buy, sell and trade tokens that were sold in an ICO. The SEC warned that these exchanges often falsely appear to be registered in compliance with government regulatory standards. To combat the false perception that these exchanges are regulated, the SEC provided a detailed



list of questions and considerations to assist investors considering trading tokens (or other digital assets) through an online exchange. Consequently, there is little doubt the SEC enforcement division will continue to closely monitor activity related to online exchanges and secondary markets that buy, sell and trade ICO-issued tokens. Put simply, if a token is a security, any party providing a "system or platform" for exchanging such token for other cryptocurrencies or fiat currency must be registered with the government.

It will take time for regulatory schemes to "catch up" with the transformative technology that blockchain (distributive ledger) and its related cryptocurrencies. Until then, both the government and aggrieved individuals (through private lawsuits, including class action lawsuits) will pursue remedies fashioned under existing laws for a (perhaps) simpler time.

### **About Our Practice**

Blockchain is the next precedent-setting technology disruptor of our time. This distributed and immutable digital platform of transactions and records has the potential to revolutionize countless industries over the next decade. Our ranks include not only experienced practitioners, but industry thought leaders, frequent speakers, and authors on emerging and transformative technologies. As a nationwide full-service law firm, we draw upon the expertise of attorneys from a wide host of practice areas to ensure our clients are well-supported and advised in all aspects of their business.

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<sup>1</sup> Action has also been taken, and statements made, by the Commodities Futures Trading Commission, the Internal Revenue Service, the Financial Crimes Enforcement Network ("FinCen"), the Secretary of the Treasury Department, the Federal Reserve and various state governments and state attorneys general.

<sup>2</sup> SEC Chairman Jay Clayton's testimony before Congress, February 6, 2018 available at <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission>