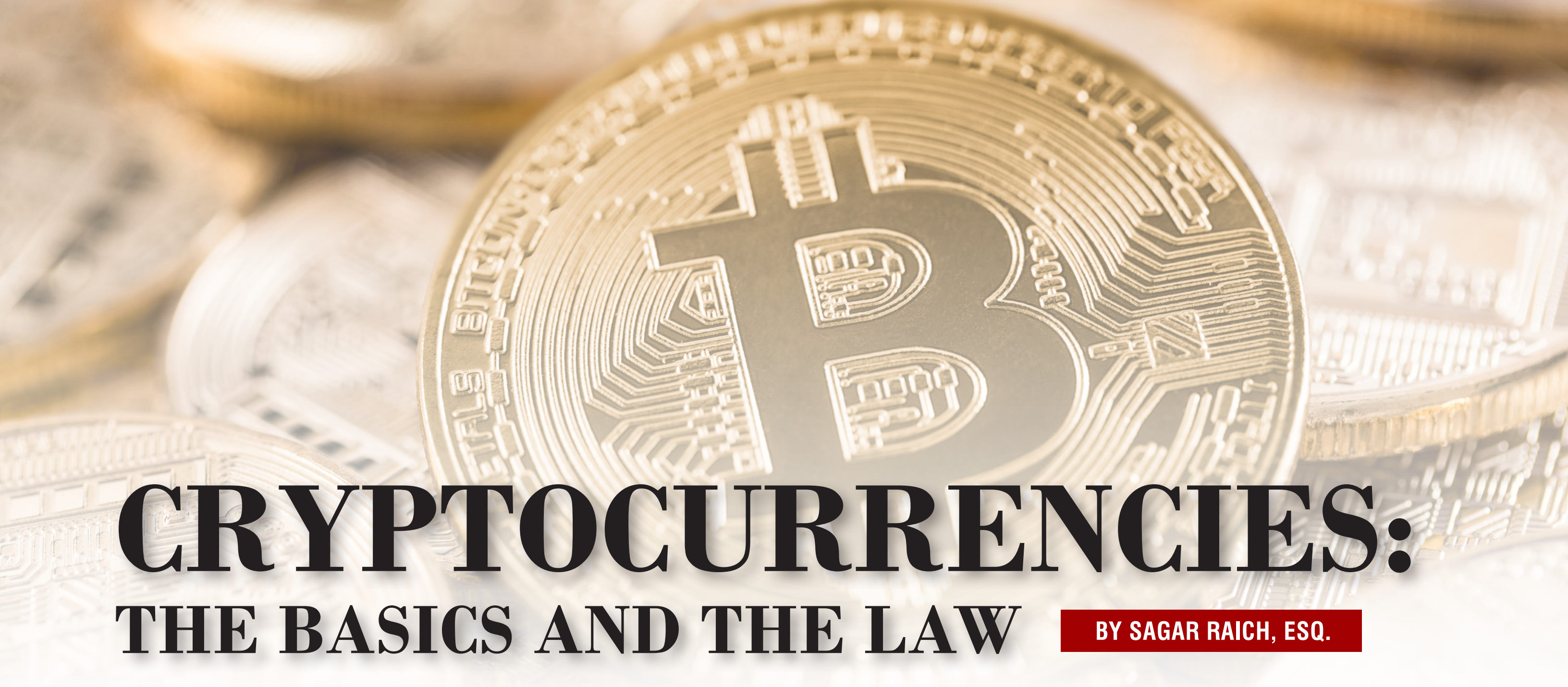

CRYPTOCURRENCIES: THE BASICS AND THE LAW

BY SAGAR RAICH, ESQ.

Everyone is talking about it – this thing called Bitcoin – that has made some people ridiculously wealthy. They talk about "mining" it and how it is going to replace all currency. But what is a cryptocurrency, and why should we care?

Decrypting the Cryptocurrency

A cryptocurrency is a type of digital currency that is based on computer code, such that the currency is digital in nature, is not controlled or guaranteed by a central government, and is self-contained in keeping track of its ownership. So, each type of cryptocurrency (Bitcoin and Ethereum being the more popular ones) has a system that defines:

1. How the currency can be created,
2. How to determine who owns the currency, and
3. How to keep track of transactions so that the currency can be exchanged for other assets.

The backbone of every cryptocurrency is its blockchain; this is the actual record of the transactions of each unit of a cryptocurrency, such that the network – the aggregate of the currency – knows what transactions took place and who is the rightful owner of each such unit of currency.

A New Kind of Mining

One of the most common terms used when it comes to cryptocurrencies is "mining." As stated above, a key feature of cryptocurrencies is that they can keep track of their ownership and maintain records in a blockchain. However, the actual process of validating cryptocurrency transactions in order to update the blockchain is one that requires significant computing power. After all, the currency is digital and processing the encrypted code for the currency is complex. The reward for such mining is – you guessed it – the cryptocurrency itself. Thus, the network rewards miners by giving them a piece of the action for helping validate the network.

Baseball and Apple Pie, or Bell Bottoms and Flip Phones?

Lots of fads have come and gone, but is cryptocurrency one of them? When most of us think of money, we think of bills and coins. This kind of currency, fiat in nature, is guaranteed by the federal government. Cryptocurrencies, on the other hand, are decentralized: no one person or government controls it, guarantees it or determines changes in its price. The network itself gives value to the cryptocurrency—the more people who use the currency, the more it is validated; the more it is validated, the more it is mined; the more it is mined, the more of it is introduced in the system; and the cycle continues. There are now exchanges through which a unit of a cryptocurrency can be exchanged for U.S. dollars. These exchanges give the general public an idea as to the value of certain cryptocurrencies and are voraciously tracked by amateurs and professionals alike. Once in use, cryptocurrencies serve a purpose as a medium of exchange and are elevated beyond just a passing fad.

Initial Coin Offerings

Most of us have heard of Initial Public Offerings: how companies raise capital by bringing their equity (shares) to the market. Cryptocurrencies are brought to the market through a process called an Initial Coin Offering (ICO). A group, usually including programmers and those wanting to raise funds for a project, issue their new cryptocurrency to investors in their project. The new currency is usually also related to the project; investors and others can usually use it and redeem it for the goods and/or services related to the project. One of the most recent and famous examples is an ICO involving a cryptocurrency called the "Petro," a cryptocurrency issued by the government of Venezeula; one token (unit) of this cryptocurrency represents one barrel of crude oil.[1]

Uncle Sam's Viewpoint

We can't discuss raising money, investors, currencies, markets, etc. without talking about the Securities and Exchange Commission (SEC). The SEC was formed by the Securities Exchange Act of 1934, which also defined what it meant for an asset to be a security and therefore fall under the regulatory purview of the SEC. Under the 1934 act, a "security" can be a "note, stock, ... bond, …[or an] investment contract…"[2] It is the investment contract aspect of a security's definition that is most relevant when discussing cryptocurrencies.

Cryptocurrencies fall under the purview of regulatory agencies under the precedent established by *SEC v. Howey*. In *Howey*, the U.S. Supreme Court held that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."[3]

So, if there is an investment of money in a common enterprise that might yield profits from the efforts of another, such a scheme would be considered an investment contract and therefore be security. Cryptocurrencies do require an investment of money – the network by its nature yields a common enterprise – and miners and third parties do lead to an increase in value and profits for holders of such currencies. As such, it is widely accepted that the SEC has purview over the security that is cryptocurrency.

Since their introduction, cryptocurrencies have been gaining traction and have recently entered the limelight of the broader market. When there are profits to be made, greed may attract those trying to make a quick buck in an illegal manner. There are many examples of Initial Coin Offerings of cryptocurrencies that raised money for the founders/promoters of such currencies but didn't serve any other real purpose, leading to the failure of such currencies. Due to the potential for fraud and negative impact on the public, regulatory agencies, based on the authority of the 1934 act and *Howey,* have begun to enter the cryptocurrency space in a regulatory/overseeing role. In fact, in recent months, the SEC has started to regulate the space and has launched probes targeting cryptocurrency promoters and firms.[4]

Our Clients

As attorneys, we sometimes read materials through the prism of utility to our clients; we consider how we can apply what we read to benefit our current and future clients. Cryptocurrencies may impact our clients in two main ways:

1. Our clients might want to buy/sell/exchange a cryptocurrency for goods or services; or
2. They might want to partake in the actual network of the cryptocurrency: form a cryptocurrency, undertake an ICO, mine for cryptocurrencies, etc.

If a client asks an attorney for advice on buying or selling any security, it is important to realize that while the Rules of Professional Conduct allow attorneys to provide legal and general guidance, attorneys are not investment advisors and should defer giving direct investment advice to such professionals. However, the more likely scenario regarding clients will probably be that a client wants to exchange his/her cryptocurrency for your legal services or for the goods/services of a third party. The client might even want to accept cryptocurrency for the goods/services they provide. While certain companies can assist a client in setting up merchant processing to accept cryptocurrencies, the constantly changing dollar value of each unit of a cryptocurrency is a risk that clients need to understand and be willing and able to accept.

A client might also come into your office asking you to help them with an Initial Coin Offering to fund a project, to help with a business to mine for cryptocurrencies, to market existing cryptocurrencies to potential investors, etc. As discussed earlier, existing SEC regulations regarding investment contracts will likely guide these discussions with clients. Thus, an Initial Coin Offering, marketing or advertising of cryptocurrencies should be undertaken in accordance with existing federal and state (Blue Sky Laws) regulations that govern the formation, marketing and advertising of securities, in order to minimize the risk of an SEC probe/investigation.

The Future

Today, more and more cryptocurrencies are being introduced into the market. Some are designed to assist with products or to help companies, while others are meant to assist entire countries. The more cryptocurrencies mature as an asset class, the more regulations, guidelines and advisory papers will come into being to assist with the management of the cryptocurrency space. For now, it is an exciting realm of possibilities best approached with curiosity and caution. NL

1. https://www.forbes.com/sites/jonmarkman/2018/03/20/this-is-why-the-venezuela-cryptocurrency-matters/#dec0f6f4a564.
2. 15 U.S.C.A. § 78c (West).
3. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298–99, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244 (1946).
4. https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266.

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