

In the Realm of Bitcoin, Exercise Caution

The rules are still evolving in this brave new digital world

By Brad Rosen / Wolters Kluwer Legal & Regulatory U.S.

During 2017, the realm of bitcoin, the blockchain, cryptocurrencies and distributed ledger technology (DLT) has been expanding at a rapid pace. All signs point to the continuation of this phenomenon. The implications for the legal community, and corporate law departments in particular, are enormous. Counsel will have to help companies determine when newly popular initial coin offerings (ICOs), an innovative means of raising capital using DLT, must be registered with the SEC under new ICO guidance from the commission.

As a preliminary matter, a brief discussion of some nomenclature is useful. The distributed ledger refers to a digital record that is shared instantaneously across a network of participants. Blockchain is often

used synonymously for DLT, but it is actually one type of distributed ledger. Within a blockchain, every transaction is digitally signed, chained together and replicated on hundreds of computers around the world. As a result, there are not multiple competing sets of records that need to be reconciled. Rather, there is just one record which represents a golden source of data.

A cryptocurrency is typically defined as a digital representation of value that can be digitally traded and functions as a medium of exchange, a unit of account and/or store of value, but which does not have legal tender status in any jurisdiction. Bitcoin is a widely recognized cryptocurrency maintained on the blockchain. Digital tokens (also known as coins) are a type of digital currency created by a company and sold in exchange for more established cryptocurrencies like bitcoin. The sale of digital tokens is often used as a

Digital tokens may be securities that have to be registered with the SEC.

means to raise capital and is referred to as an initial coin offering or ICO.

ICOs and the SEC's Response

In July 2017, the SEC published a Report of Investigation that concluded that digital tokens in an ICO may be deemed to be securities under federal law where the tokens were issued by an entity for the purpose of raising funds for a project. At the time of the report, hundreds of ICO projects had raised in excess of \$1 billion.

If tokens are judged to be securities, they must be registered with the SEC or be eligible for an exemption from registration requirements. Moreover, the SEC concluded that any trading facility, like an exchange for digital tokens that are deemed to be securities, must be registered as a national securities exchange or otherwise be exempt from registration.

The SEC's report related to its enforcement investigation of DAO, an unincorporated virtual organization that had created and sold digital tokens via the blockchain. Those transactions

were valued at approximately \$150 million at the time. In finding that the DAO digital tokens were subject to the commission's registration requirements, the SEC looked to the landmark 1946 U.S. Supreme Court decision, *SEC v. W.J. Howey Co.*, which holds that a security exists when something sold for value represents an ownership interest in a common enterprise and the purchasers have a reasonable expectation of profits from the managerial efforts of others.

Notwithstanding its finding, the SEC elected not to pursue enforcement action against the DAO entity, but rather chose to provide further guidance to the ICO community. Carol Van Cleef, a partner and FinTech specialist at BakerHostetler, found cause for optimism in the SEC's action, noting "[f]or those who are looking at issuing a token solely to raise money for a business venture – the SEC has made clear that the offering must comply with federal securities laws. For those that have never intended it for these purposes, they can feel more comfortable with a clear roadmap."

In August, the SEC issued an Investor Alert, again expressing concerns involving public companies making ICO-related claims. While ICOs have become an increasingly popular means to raise capital, companies would be well advised to proceed with caution so as not to end up on the wrong side of an enforcement action.



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