Bitcoin investment vehicles beware – the SEC is watching

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USA
June 24 2014

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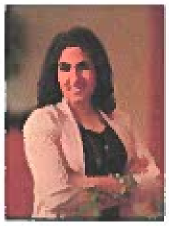

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The Securities and Exchange Commission (SEC) recently charged the co-owner of two Bitcoin-related websites for publicly offering shares in the ventures without registering the securities under the Securities Act of 1933 (the Securities Act).[1][1] *In the Matter of Erik. T. Voorhees* (Voorhees) is the most recent effort by the SEC to exercise regulatory authority over virtual currencies, including Bitcoin. The Voorhees case and an earlier case, *SEC v. Trendon T. Shavers and Bitcoin Savings and Trust* (Shavers) provide valuable insights into the scope of the SEC's authority to regulate virtual currencies.[2]

Bitcoin has been described as a "techno tour de force"[3] by Bill Gates. Fred Wilson of Union Square Ventures believes Bitcoin is a technology with "world changing" promise.[4]The virtual currency has been derided by others as a "shady online currency" and as "a virtual Wild West for narcotraffickers and other criminals."[5]

While there is disagreement over the potential economic and legal impact of the virtual currency, Bitcoin has been described as the "internet's favorite virtual currency."[6] The expanding acceptance of Bitcoin appears to signal that the virtual currency may be entering the mainstream. Despite this enthusiasm and acceptance, the SEC's role in regulating virtual currencies remains unclear.

Bitcoin 101

Bitcoin is a digital, private crypto-currency that can be "mined" by anyone. Mining requires the ability to solve a complicated mathematical algorithm. Bitcoin originated as a single source code by an anonymous creator, but is now continuously distributed on an open-source, non-proprietary, peer-to-peer network. Once mined, Bitcoins can be exchanged and traded on online exchanges for conventional currencies, such as U.S. dollars, or used to purchase goods and services from vendors accepting Bitcoins. Bitcoins are identified by a public "key" – like an account number – and protected by a private "key." Transactions are recorded on a "block chain," a universal public ledger which can be viewed by any computer on the Bitcoin network.

Created in 2008, Bitcoin was the first major crypto-currency on the market. It remains the most recognized and successful of the over 100 virtual currencies in existence. Today, over 12 million Bitcoins are currently in circulation and are worth an estimated $7 billion. While Bitcoins may not be held in ones hands, this has not slowed the use of Bitcoins in the digital currency market. Currently, Bitcoin ATMs have been installed in Austin, Boston, Las Vegas, Seattle, and Vancouver, with New York City next in line.

Bitcoin allows users to access the network anonymously which attracts users with nefarious intentions such as drug trafficking and money laundering. Bitcoin exchangers are required to comply with the Bank Secrecy Act[7] and sellers of interests in collective Bitcoin investment vehicles are subject to SEC regulations. The continued growth of Bitcoin and the failure of some of its exchanges, including the $550 million failure of the Bitcoin exchange Mt. Gox, have spurred the SEC to address the regulation of virtual currencies.

For virtual currencies to be regulated by the SEC, the offering must be deemed a "sale of a security." Like other federal agencies including the Commodity Futures Trading Commission (CFTC) and the U.S. Treasury through the Financial Crimes Enforcement Network (FinCEN), the SEC is currently exploring its ability to regulate Bitcoin. To date, the SEC has exercised its authority over parties that have sold unregistered securities in companies that invest in Bitcoins or collective investment schemes that invest in virtual currencies.

SEC Actions Against Bitcoin Investment Schemes

The SEC has initiated two enforcement actions against parties allegedly selling unregistered securities in collective investment schemes focusing on Bitcoin.

In the Matter of Erik. T. Voorhees

The SEC most recently initiated an enforcement action earlier this month against the operator of a purported Bitcoin investment scheme in Voorhees.[8] The SEC action was based on the unregistered offerings of shares of FeedZeBirds and SatoshiDICE, two separate entities co-owned by *Voorhees* and others. In May 2012, FeedZeBirds offered and sold 30,000 shares, and raised 2,600 Bitcoins in connection with that unregistered offer and sale. At the time of the FeedZeBirds offering, the value of the Bitcoins raised was approximately $15,000. From August 2012 through February 2013, in two separate offerings, SatoshiDICE offered and sold 13 million shares, and raised 50,600 Bitcoins in connection with those unregistered offers and sales. At the time of the SatoshiDICE offerings, the value of the total Bitcoins raised was approximately $722,659. In July 2013, SatoshiDICE bought back all outstanding SatoshiDICE shares from investors at a price of 0.0035 Bitcoins per share, for a total of 45,500 Bitcoins. Due to the significant rise in the exchange rate of Bitcoin, the total amount paid to investors in the SatoshiDICE buy-back transaction (approximately $3.8 million) exceeded the total USD amount raised.

The SEC investigation found that Voorhees published prospectuses on the Internet and actively solicited investors to buy shares in FeedZeBirds and SatoshiDICE. The SEC alleged Voorhees violated Sections 5(a) and 5(c) of the Securities Act, which prohibit the direct or indirect sale of securities, offer to sell or offer to buy securities through the mail or interstate commerce unless a registration statement has been filed or is in effect.

Voorhees agreed to settle the SEC's charges by disgorging $15,843.98 in profits plus a $35,000 penalty for a total of more than $50,000. The SEC stated: "[a]ll issuers selling securities to the public must comply with the registration provisions of the securities laws, including issuers who seek to raise funds using Bitcoin"[9] and that the agency "will continue to focus on enforcing our rules and regulations as they apply to digital currencies."[10]

However, the SEC did not address the issue of whether Bitcoins or other virtual currencies are securities. The SEC focused on the unregistered offerings of shares of FeedZeBirds and SatoshiDICE that were priced in Bitcoins as the basis for the enforcement against. This approach appears to be an extension of the rationale articulated in the Shavers case which dealt with the regulation of Bitcoin investment vehicles.

SEC v. Trendon T. Shavers and Bitcoin Savings and Trust (BST)

In Shavers, a well-publicized case involving the SEC's regulation of Bitcoin investment schemes, the SEC alleged that Shavers and BST engaged in the fraudulent offer and sale of securities without registration under the Securities Act. The SEC claimed that, during the relevant period, Shavers obtained at least 700,467 Bitcoins in principal investments from BST investors, or $4,592,806 in U.S. dollars, based on the daily average price of Bitcoin when the BST investors purchased their investments. In Shavers, the alleged organizer of a Ponzi scheme advertised a Bitcoin "investment opportunity" in an online Bitcoin forum. The SEC claimed investors were promised up to 7 percent (7%) interest per week and that the invested funds would be used for Bitcoin arbitrage activities in order to generate the returns. Instead, the invested Bitcoins were allegedly used to pay existing investors and exchanged into U.S. dollars to pay the organizer's personal expenses.

In a memorandum regarding the court's subject matter jurisdiction, the court analyzed whether, as a matter of law, BST's solicitations to entice persons to invest in Bitcoin-related investments opportunities constituted the "sale of securities." In addressing the issue, the court analyzed whether the investment opportunities fell within the scope of the term "security."

Citing Section 2(a)(1) of the Securities Act, the court noted that the term "security" is defined as "any note, stock, treasury stock, security future, security-based swap, bond . . . [or] investment contract . . . "[11] The court applied the three-part test articulated by the U.S. Supreme Court in *SEC v. W.J. Howey Co.*[12], to determine whether an offering, contract, transaction, or scheme constitutes an investment contract.[13] Under the Howey test, a contract, transaction, or scheme is an "investment contract" if it involves: (i) the investment of money; (ii) in a common enterprise; and (iii) with the expectation of profits to come solely from the efforts of others.

The court in *Shavers* held that all three prongs of the Howey test were satisfied and, thereby, the sale of interests in the trust constituted the sale of securities.[14] In its analysis, the court found:

- That because Bitcoin can be used as money to purchase goods or services and also can be exchanged for conventional currencies, that Bitcoin was in fact a currency or form of money;
- That the investors and the promoter were interdependent because the investors were dependent on Shavers's expertise in Bitcoin markets and his local connections; in addition,

- Shavers allegedly promised a substantial return on their investments as a result of his trading and exchanging Bitcoin; and
- Investors participating in the BST investments were expecting profits from the efforts of Shavers.

Based on these findings, the court concluded that the BST investments met the definition of "investment contract," and as such, were *securities*. It should be noted that the court did not address the issue of whether Bitcoins constitute securities, but rather focused on the system or scheme through which the investments in Bitcoins were being made.

The definition of "security" under the Securities Act does not include currencies. However, the SEC has argued that investments in Bitcoin-related schemes are investment contracts – a contract, transaction, or scheme involving: (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party.

Conclusion

Media reports have mistakenly claimed the SEC and courts have concluded that Bitcoins are securities. In reality, the SEC has stated that the sale of shares in collective investment schemes that focuses on virtual currencies, or parties that sell shares in companies that invest in virtual currencies, will be deemed a sale of securities. However, the sale of virtual currencies does not appear to fall within the scope of the definition of securities set forth in Section 2(a)(1) of the Securities Act. Given our view that the SEC does not have the authority to regulate virtual currencies, investors should be aware that the CFTC, FinCEN and state regulators continue to explore their authority to regulate the sale and use of virtual currencies.

Any firm that is planning to trade in or develop a platform to facilitate the trading of virtual currencies should proceed with caution. Similarly, anyone looking to invest in a collective investment vehicle that focuses on virtual currencies should make sure the vehicle is properly structured to comply with the securities laws. Due to the lack of clearly defined guidance with respect to the authority of the SEC, the CFTC, FinCEN and state regulators to supervise virtual currencies, it is important that you engage experienced counsel to assist you in navigating the regulatory requirements that may apply to any business you are building.

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