



SUMMER 2018 E-NEWSLETTER

At Digital Mountain we assist our clients with their computer forensics, e-discovery, and cybersecurity needs. For this E-Newsletter, we discuss cryptocurrency hacking events, as well as the regulatory and legal climate for blockchain and cryptocurrency technologies.

Hyperventilating Over Cryptocurrency Regulation News

On June 14, 2018, the Securities and Exchange Commission (SEC) Director of Corporation Finance, William Hinman, spoke at the Yahoo Finance All Markets Summit: Crypto regarding “whether a digital asset offered as a security can, over time, become something other than a security.” Within twenty-four hours of Director Hinman’s remarks, cryptocurrency-focused media outlets splashed headlines across the internet touting the speech as everything from a proclamation that cryptocurrencies are free from SEC regulation, to a mild suggestion that certain cryptocurrencies, in certain circumstances, at various times, might not be securities, but something else. Considering the recent bear market mood of the New York Stock Exchange Bitcoin Index, cryptocurrency investors are probably seriously considering the question of digital assets and their status as securities. In this article, we’ll try to shed a little light on both the legal precedent of Director Hinman’s remarks and attempt to clarify the position advanced by the Director without the hyperbolic headlines.



Comparing Oranges to Cryptocoins

In 1946, a lot farther back than we usually look for precedent on current technology issues, the US Supreme Court adjudicated *SEC v. Howey Co.*, (328 U.S. 293 1946), a matter in which the SEC sued over the offering of land sales and service contracts in a Florida orange grove. The SEC maintained, and the Court concurred, that the offer constituted an offer of securities because the terms of the offering met the following criteria for an investment contract:

“...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.”

Two of the critical details of the Howey offering were (1) the sales of parcels which, while transferring title to a piece of real estate, were in fact being offered to help the Howey Company finance additional development, and, (2) the inducement of profits that could be realized by entering into a service contract with Howey Company for the grove maintenance, along with the harvesting and sale of the fruit from said parcels.

As Director Hinman did in his remarks at the Yahoo summit, drawing an analogy between *Howey* and some initial coin offerings isn't difficult. When investors are lured to purchase digital assets or cryptocurrency within a framework that supports other development, commonly a blockchain project, and with the expectation that there will be profits derived from the development of such project (be they an increase in the value of the cryptocurrency or the delivery of additional coins to investors), the coin offering meets the *Howey* definition of an investment contract and is covered accordingly by SEC regulations. Whether the offering is named an initial coin offering or a token sale is irrelevant to whether the offering falls under SEC regulations – what matters is the function of the sale, not the name of game.

Hearing What They Want to Hear

The comment by Director Hinman that garnered the most attention was, "...current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value." This remark was the genesis for the range of headlines cheering deregulated cryptocurrency. Declaring that Bitcoin and Ether are not securities, however, did not come without some previous qualification.

Prior to making the above statement, Director Hinman specifically pointed to the manner in which cryptocurrency is sold as a crucial determinant of SEC regulation. "The digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract. And regulating these transactions as securities transactions makes sense." This concept is underpinned by *Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, (756 F.2d 230 (2d Cir. 1985), in which the Court found that depending on the structure of the sale, an item which does not normally meet the definition of a security, in this case a Certificate of Deposit, may qualify as a security. What Director Hinman's comments do is specify that two specific cryptocurrency products, Bitcoin and Ethereum, appear not to require SEC regulatory oversight – he did not, as many would like to believe, state that cryptocurrency as a whole is exempt from SEC regulation.

Changing the Leopard's Spots

So, if it's possible for cryptocurrencies to change their proverbial spots, when are cryptocurrency sales unregulated transactions as far as the SEC is concerned? Boiling down the director's statements to their essential points, the critical juncture appears to be when (a) the underlying blockchain reaches decentralization; (b) when the function of the coin is predominantly a utility; and (c) when the sale of the token or coin is no longer marketed as an investment.

Therefore, Director Hinman's comments make sense with regard to Bitcoin and Ethereum:

- A. Both cryptocurrencies operate on decentralized ledger systems that are not dependent on a single, third-party entity to set and regulate the value, add value through management, and set rules for the use of the product.

B. Bitcoin and Ethereum are widely accepted as utility tokens, meaning they can be exchanged as payment for goods and services much like fiat currency.

C. While there can be profit in buying Bitcoin and Ethereum with the hope that at some future date the tokens will increase in value, neither the Bitcoin nor Ethereum blockchains are actively marketing their cryptocurrencies as investments which provide any ownership stake in the blockchain operation.

As we enter what may now be the regulatory clarification phase of cryptocurrency's evolution, we should expect to see additional, and potentially conflicting, but definitely clarifying statements from the SEC, and other regulatory agencies, with regard to which laws and regulations apply to cryptocurrency transactions, and under what circumstances do they apply. What we should not expect is that this phase will be an easy, painless growth process for digital assets. There will be opportunities to cheer, and some to jeer, but no doubt, it will be a fascinating time with plenty of headlines.

Please direct questions and inquiries about cybersecurity, computer forensics and electronic discovery to info@digitalmountain.com.

UPCOMING INDUSTRY EVENTS

MASTERS CONFERENCE

New York, NY: July 24, 2018

BLACK HAT USA

Las Vegas, NV: August 04-09, 2018

ILTACON 2018

Washington, DC: August 19-23, 2018

HTCIA INTERNATIONAL 2018 CONFERENCE AND TRAINING EXPO

Washington, DC: August 19-22, 2018

TODAY'S GENERAL COUNSEL, "THE EXCHANGE" EDISCOVERY

Seattle, WA: September 1, 2018

[Click here to see more upcoming events and links](#)



Digital Mountain, Inc. Founder and CEO, Julie Lewis, will be presenting at various upcoming industry events. Please send requests for speaker or panel participation for her to marketing@digitalmountain.com.

DIGITAL MOUNTAIN, INC.

4633 Old Ironsides Drive, Suite 401
Santa Clara, CA 95054
866.DIG.DOCS

Contact us today!

www.digitalmountain.com

FOLLOW US AT:

