

The Legal Nature of Cryptocurrencies in the US and the Applicable Rules

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Key Points:

- In the US, cryptocurrencies are treated differently by the US courts and the Internal Revenue Service.
- Several broadly drafted US legislations can encompass cryptocurrencies, why several regulators will have jurisdiction.
- Many further contradictions may arise in the future, why parties must take proper legal advice in all specific cases.

ABSTRACT*

In this article, the authors examine the legal nature of cryptocurrencies from a US perspective. The article concludes that several rules with different regulators may apply to cryptocurrencies in the context of an initial coin offering ('ICO'), why it is unclear which regulator has jurisdiction.

1. GENERAL ASPECTS OF THE APPLICABLE US RULES

Given the fact that cryptocurrencies cannot be said to be real property, we shall here focus on cryptocurrencies as personal property in the US, specifically money and securities. The division is relative to the purpose of highlighting the special legal circumstances of each subdivision.

The following analysis is made from the perspective of which rules might be applicable to cryptocurrencies in relation to an initial coin offering ('ICO').

1.1. Cryptocurrencies as Money

In the US, several court rulings have found bitcoin to be money in a legal sense. Noteworthy cases are: *SEC v. Trendon T. Shavers and Bitcoin Savings and Trust*, 416 (E.D. Tex. 2013) and *United States v Ross William Ulbricht*, 14-cr-68 (KBF) (S.D.N.Y. Oct. 10, 2014) (under appeal)¹, and *United States v Murgio* 15-cr-769 (AJN) (SDNY, 12 January 2017).

In the *SEC case*, Judge Mazzant noted that:

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¹ See <<https://regmedia.co.uk/2016/01/13/ulbrichtjan12appeal.pdf>> accessed 20 February 2017

*"[bitcoin] can be used to purchase goods or services, and as Shavers stated, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the US dollar, Euro, Yen and Yuan. Therefore, Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money."*²

In the *Ulbricht* case, Judge Forrest noted:

*"The money laundering statute is broad enough to encompass use of Bitcoins in financial transactions. Any other reading would – in light of Bitcoins' sole raison d'être – be nonsensical. Congress intended to prevent criminals from finding ways to wash the proceeds of criminal activity by transferring proceeds to other similar or different items that store significant value. ... One can money launder using Bitcoin."*³

Finally, in the *Murgio* case, Judge Nathan found that:

"[Bitcoins] can be accepted as payment for goods and services or bought directly from an exchange with a bank account. They, therefore, function as pecuniary resources and are used as a medium of exchange and a means of payment".

In contrast to these, as a seemingly lone example, stands *Florida v Espinoza* F14-2923 (Fla 11th Cir, 22 July 2016). Judge Pooler noted that "[w]hile Bitcoin can be exchanged for items of value, they are not a commonly used means of exchange." with "... a limited ability to act as a store of value ...".

Although it seems that the general view of the US courts is that bitcoin amount to 'money' legally, the general approach in the US is still unclear. It seems that only New York State have final rules on bitcoin as the state has created a *BitLicense* issued by New York State Department of Financial Services ('NYSDFS').⁴ Indeed, the Internal Revenue Service ('IRS') treats bitcoin as property for US tax purposes.⁵ To this end, it is noted that it is not given that any other cryptocurrency would receive similar treatment, as the individual cryptocurrency may differ materially from bitcoin. This is due to the many possible features a cryptocurrency may be embedded with. Which may apply to both metacoins and altcoins.⁶

² See

<<https://ia600904.us.archive.org/35/items/gov.uscourts.txed.146063/gov.uscourts.txed.146063.23.0.pdf>> accessed 20 February 2017

³ At p. 50, see <<http://www.nysd.uscourts.gov/cases/show.php?db=special&id=416>> accessed 20 February 2017

⁴ NYSDFS, 'BitLicense Regulatory Framework' (24 June, 2015)

<http://www.dfs.ny.gov/legal/regulations/bitlicense_reg_framework.htm> accessed 20 February 2017

⁵ IRS, 'IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply' (IR-2014-36, 25 March 2014), <<https://www.irs.gov/uac/newsroom/irs-virtual-currency-guidance>> accessed 20 February 2017. This view is shared by the Australian Taxation Office which notes that: "Transaction with bitcoins is akin to a barter arrangement, with similar tax consequences.", see ATO, 'Tax treatment of crypto-currencies in Australia – specifically bitcoin' (18 December 2014), <<https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin/>> accessed 20 February 2017

⁶ 'Metacoins' are cryptocurrencies built on bitcoin, and 'altcoins' are alternative cryptocurrencies.

1.2. Cryptocurrencies as Securities

In the US, the Jumpstart Our Business ('JOBS') Act exemptions allows crowdfunding platforms to offer and sell securities. The Securities Act of 1933 ('SA1933') § 2(a)(1) defines a security sufficiently broad to "... encompass virtually any financial instruments that constitute an investment, and able to enact securities laws regardless of the name given ...".⁷ The broad US definition of a security includes investment contracts.⁸ To qualify as an investment contract, the *Howey Test* must be met. In *SEC v. Howey Co.*⁹ the US Supreme Court stated that:

"The test of whether there is an "investment contract" under the Securities Act is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others; and, if that test be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative, or whether there is a sale of property with or without intrinsic value."

This was reinforced in *SEC v. Edwards*.¹⁰ Accordingly, if all four criteria of the test are fulfilled, can be considered as an investment contract, and this "... regardless of whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the physical assets used by the enterprise."¹¹ Regardless of whether the *Howey Test* for investment contracts is fulfilled, given the broad definition of a security, cryptocurrencies are covered by the definition in SA1933.

With the JOBS Act the US Congress has sought to ease access to funding and assist job creation.¹² In comparison to the UK, the US has less restrictive rules with its exemption in Regulation Crowdfunding 2015 § 227.100. The rule allows an issuer to offer or sell securities in reliance on § 4(a)(6) of the SA1933 (15 U.S.C. 77d(a)(6)), provided that:

- i) The aggregate amount of securities sold to all investors by the issuer during the 12-month period preceding the date of such offer or sale, including the securities offered in such transaction, does not exceed \$1m;
- ii) The aggregate amount of securities sold to any investor across all issuers during the 12-month period does not exceed either:
 - a) The greater of \$2,000 or 5 percent of the lesser of the investor's annual income or net worth if either the investor's annual income or net worth is less than \$100,000; or
 - b) 10 percent of the lesser of the investor's annual income or net worth, not to exceed an amount sold of \$100,000, if both the investor's annual income and net worth are equal to or more than \$100,000;
- iii) The transaction is conducted through an intermediary that complies with the requirements in § 4A(a) of the SA1933 (15 U.S.C. 77d-1(a)) and the related requirements in this part, and the transaction is conducted exclusively through the intermediary's platform; and

⁷ G G Castellano, 'Towards a General Framework for a Common Definition of "Securities": Financial Markets Regulation in Multilingual Contexts' (Uniform Law Review - Revue De Droit Uniforme, Vol. 17, No. 3, 2012), p. 462ff. Cf. A R Bromberg, 'Commodities Law in Securities Law-Overlaps and Preemptions' (J. Corp. L., Vol. 1, No. 2, 1976), p. 242

⁸ SA1933 § 2(a)(1)

⁹ 328 U.S. 293 (1946)

¹⁰ 540 U.S. 398 (2004)

¹¹ *SEC v. Howey Co.* 328 U.S. 293 (1946) at 298-99

¹² C Clifford, Symposium with K Wales et al [Transcript] (Fordham University School of Law, 24 March 2014), p. 326

- iv) The issuer complies with the requirements in § 4A(b) of the SA1933 (15 U.S.C. 77d-1(b)) and the related requirements in this part; provided, however, that the failure to comply with §§ 227.202, 227.203(a)(3) and 227.203(b) shall not prevent an issuer from relying on the exemption provided by § 4(a)(6) of the SA1933 (15 U.S.C. 77d(a)(6)).

Moreover, persons acting as an intermediate in a transaction involving the offer or sale of securities for the account of others, such as funding portals, must register with the SEC.¹³

1.3. Commodities Futures

Bromberg notes that:

"There are many differences between a commodity future and a traditional security, of which the most obvious is that the future represents specific tangible assets while the security typically represents an interest in (or claim against) an operating business."¹⁴

A commodity is defined by the Commodity Exchange Act ('CEA')¹⁵, 7 U.S.C., § 1a(9) as:

"... wheat, cotton, rice, ... and all other goods and articles, except onions ... and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in."¹⁶

In *Dunn v. Commodity Futures Trading Commission*¹⁷, the U.S. Supreme Court defined future contracts as *"... agreements to buy or sell a specified quantity of a commodity at a particular price for delivery at a set future date ..."*.

Levin, O'Brien, and Zuberi notes that bitcoin can qualify as a commodity, as *"... they are articles that can be made subject to futures contracts."*¹⁸ This will apply to most, if not all, cryptocurrencies. If an ICO's underlying cryptocurrency is qualified as a commodity, the ICO would be regulated by the CFTC. Bromberg notes that *"[a commodity futures contract] is not a security except when expressly so classified by statute."*¹⁹ However, in the case of cryptocurrencies and ICOs, given the broad definitions given by both the SA1933 and the CEA, it would seem that both regimes are applicable. Indeed, the broad scope of the definition of a commodity has been reiterated in the cases of both Coinflip, Inc²⁰, a bitcoin options trading platform, and TeraExchange LLC²¹, a bitcoin swap-exchange. In both cases, the U.S. Commodity Futures Trading Commission ('CFTC') ordered the exchanges to

¹³ JOBS Act § 302(b)

¹⁴ A R Bromberg, 'Commodities Law in Securities Law-Overlaps and Preemptions' (J. Corp. L., Vol. 1, No. 2, 1976), p. 242

¹⁵ As amended through P.L. 114-113, enacted 18 December 2015

¹⁶ See also *Board of Trade of City of Chicago v. SEC* 677 F.2d 1137, 1142 (7th Cir. 1982)

¹⁷ (95-1181), 519 U.S. 465 (1997)

¹⁸ R B Levin et al, *Handbook of Digital Currency* (Academic Press, 29 April 2015), p. 349

¹⁹ A R Bromberg, 'Commodities Law in Securities Law-Overlaps and Preemptions' (J. Corp. L., Vol. 1, No. 2, 1976), p. 242

²⁰ *Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29, 2015 WL 5535736, (CFTC, 17 September 2015)

²¹ *TeraExchange LLC*, CFTC Docket No. 15-33, 2015 WL 5658082, (CFTC, 24 September 2015)

cease operating their unregistered facilities for trading or processing swaps. In the former case, the CFTC noted that "*Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.*"²² Accordingly, the CFTC will apply the same principles applicable to other derivatives when considering whether or not to allow trading of a bitcoin swap-exchange. In particular, as noted by CFTC Chairman Timothy Massad, the CFTC will not object to a bitcoin swap being traded, provided that (i) the contract is (a) based on an index of bitcoin exchanges, and (b) not susceptible to manipulation; and (ii) the platform has been duly registered.²³

2. CONCLUSION

With cryptocurrencies, there is typically no issuer to which a claim can be made against. On the same note, however, a cryptocurrency cannot be said to typically represent a tangible asset. It is, therefore, unclear which set of rules should have precedence, or if all the rules are equally applicable. In case of the latter, it would be a matter of which regulator is preferred or takes action first. In any case, the result would depend on the actual features and relations of the underlying cryptocurrency of an ICO.

In the US, most case law have treated bitcoin as money for securities law purposes with many of the general requirements for securities, including investment contracts, and commodities futures being applicable. However, that is not to say that any cryptocurrency would receive similar treatment, as the individual cryptocurrency may differ materially from bitcoin. Indeed, the IRS treats bitcoin, and likely cryptocurrencies with similar features, as property for tax law purposes. To this end, it would seem that both the SEC and CFTC have jurisdiction with regard to ICOs, and it is unclear which set of rules should have precedence, or if all rules are equally applicable. Many further contradictions may arise in the future, and parties must take legal advice in all specific cases.

²² *Coinjlip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29, 2015 WL 5535736, (CFTC, 17 September 2015), section Legal Discussion (A)

²³ T Massad, 'Keynote Address of Chairman Timothy Massad before the World Federation of Exchanges Annual Meeting, Doha, Qatar' (CFTC, 19 October 2015), <<http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-29>> accessed 18 March 2017