SEC Needs To Better Understand Cryptocurrency Industry

By **Harvey Kesner** (May 7, 2018, 5:17 PM EDT)

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Educating the U.S. Securities and Exchange Commission staff is expected when dealing with comments issued by the commission. While we are accustomed to some level of education with any issuer, when it comes to blockchain or cryptocurrency companies, there is an entirely new dimension to that effort. While subpoenas fly and much confusion surrounds unregistered initial coin offering sales, the SEC staff struggles to grasp the evolving businesses around blockchain. The staff is grinding out ill-fitted comments to issuers relying on assumptions incompatible with this brand-new industry, often to comical ends. What is clear is that the staff is struggling with the issues and public companies are paying the price with delays and added costs.

The first comment makes you wonder if some agency other than the premier securities regulatory authority is actually reviewing your filing. Since January, the staff has been issuing some form of the following comment:

It is unclear whether the digital assets you intend to hold are securities. Please provide a detailed analysis explaining why you believe Bitcoin, Ether and any other digital assets that are likely to be held by the company are not securities as defined in Section 2(a)(1) of the Securities Act. Your analysis should address substantive differences between each form of digital asset and how those differences affect your conclusions.

What? I'm just representing a company who has a barn full of computers that perform billions of calculations a second in order to earn rewards in the form of payments for solving successful math problems, which creates assets on its balance sheet (cryptocurrencies) for its business. The SEC has a $1.6 billion budget supporting 4,534 employees responsible for 26,000 companies and oversees the Public Company Accounting Oversight Board, the Financial Industry Regulatory Authority, the Municipal Securities Rulemaking Board, the Securities Investor Protection Corporation and the Financial Accounting Standards Board, 21 national securities exchanges and 10 credit rating agencies[1], but I am supposed to tell the staff that this new "thing" is or is not a security — even though nowhere in the filing did we actually say it is or isn't? What exactly is going on here? Are we being set up to fail?

So, we patiently explain to the staff that there is a difference between offering ICO tokens to the public and what our client is doing. Our clients are just miners.

Cryptocurrency mining is indistinguishable from gold or other resource mining. There are various inputs and outputs. Computer servers interact with other computers over a network through internet connections, electricity and software, which are consumed and can be seen as the equivalent of mines, excavation tools, machinery, roads, trucks, water, transportation and waste. Different extraction efforts and costs are measured against the yield, quality and value of the different outputs to determine the economic viability of the business. The activities yield outputs and the blockchain-based network issues cryptocurrency — as in a traditional mine, gold, silver or uranium discovery is the reward.

When the costs of extraction (mining versus hashing power) are less than the value of the outputs the business is profitable. In neither crypto-mining nor physical resource mining are the resulting outputs required to be sold or is an issuer obligated to assure unlawful actors don't employ unlawful means in order for the miner public company to be able to register, offer or sell its own securities. The regulated or unregulated nature of the output (consider pharmaceuticals or uranium) has never been a factor the SEC would use to restrict an entire industry from the public markets (with the notable exception perhaps of cannabis) or to lawfully offer its securities to finance and pursue such activity. The mere fact that drugs or uranium are highly regulated in their use or possession does not allow the SEC, in the discharge of its statutory authority, to pick and choose from businesses they like or don't like and restrict them from participating in the public markets.

What is going on is that the SEC, the U.S. Commodity Futures Trading Commission, the IRS, the Treasury Department, state banking authorities, the Financial Action Task Force and foreign counterparts don't agree on and can't agree on what a bunch of code running on a computer server in a data center generating cryptocurrency is. With good reason, since there is no precedent and there is plenty of reason to fear this new paradigm of value apart from any national government and independent of any fiat currency. For example, the Financial Action Task Force has classed bitcoin a "virtual currency," the IRS considers it an asset or property and not a security, and as far back as 2016, the American Institute of Certified Public Accountants asked the IRS for additional guidance on whether, under existing tax principles, cryptocurrency was property, currency or a commodity.[2] The accounting industry does not take a position formally.

We know that for the SEC, the cornerstone U.S. Supreme Court decision in SEC v. W.J. Howey Co.[3] established the test for determining if a contract is a security. But what of a peer-to-peer computer network running an uncurated algorithm to solve problems without human intervention, decision or efforts? Can that be a security?

The "touchstone" law defines an investment contract. According to the Supreme Court, the presence of a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others is controlling. This definition embodies a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[4] The test "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of the many types of instruments that in our commercial world fall within the ordinary concept of a security." In analyzing whether something is a security "form should be disregarded for substance,"[5] and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto."[6]

But bitcoin? The SEC had no problem establishing that "The DAO" is a security under the Howey test. The offer and sale of DAO tokens, the SEC argued, brought the federal securities laws into play over a distributed ledger technology in stopping the offer and sale of tokens.[7] In 2016, an entity called The DAO raised $160 million selling tokens to over 15,000 people worldwide.

In early 2018, professor Randolph Robinson of the University of Denver Sturm College of Law published a paper and noted, correctly, that there is little, if any, legal scholarship addressing initial coin offerings and how, or if, such offerings should be regulated, serving as the only legal scholarly treatment addressing the legal issues facing the blockchain/cryptocurrency industry. The paper has not been given much notice but deserves to be considered in any serious review of the legal issues faced. The paper provides a nontechnical road map, understandable by anyone, of the birth, emergence and evolution of bitcoin and the subsequent introduction of cryptocurrencies such as bitcoin, ethereum and tokens and their place in the ecosystem, and concludes that the SEC got it wrong in applying Howey to The DAO.

Disassembling the Howey test over horizontal and vertical commonality and other elements to their roots, Robinson illustrated how the SEC missed the shot. SEC comment letters have gone so far as to ask issuers to dissect horizontal and vertical commonality against the peer-to-peer networks generating cryptocurrency (again, just software) and explain bitcoin, etherium, bitcoin cash, litecoin, etc. In other words, an impossible task since it "assumes," incorrectly, that peer-to-peer software solving math problems somehow equates to an investor who invests money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. Loosely interpreted, that the investor expects a return and relies on the efforts of others — a key Howey component — is hard to overlay on crypto-mining even more so than token sales.

Concluding that the SEC's analysis has been widely accepted, without criticism, Robinson states that there are simply not many attorneys working in the blockchain space, that there is not a deep pool of knowledge as to how the technology operates and intersects with the law, and that lawyers (and the SEC) have a tendency to reflexively place new technology into old legal frameworks, whether appropriate or not.

The token/DAO analysis has had spillover effects, and the staff, in the exercise of their oversight of regulatory filings by issuers, is using the same analytics to ask the wrong question. Putting aside whether a "token" is a security, to ask an issuer if their own mining would be a security extends the thinking from one set of risks to another without reason. Even if it were true that tokens equate to securities satisfying the Howey test, merely mining a security has no bearing on whether the company doing the mining should be able to readily clear SEC hurdles, access the public markets, or trade on a national securities exchange. The initial comment is emblematic of the choice the SEC makes between displaying a deep misunderstanding and a conscious effort to delay public companies from participating in this new and evolving industry. Based on the comment letters issued by the Division of Corporation Finance and repetition of these questions in slightly modified form in subsequent comment letters, the very nature of the business continues to confound the regulators.

The staff has mixed feelings when it comes to its disclosure mandate if it doesn't like or understand the business. Rather than taking on the difficult task of writing rules and formulating policy to guide practitioners, the staff is imposing delays, costing companies time and opportunity, by, in effect, legislating by comment letter when and where it chooses. It is high time for the regulators to get on the same page with the industry, stop overreacting and overreaching, and state informed views on these important issues in order for the rule of law to prevail and investor protection to be assured.

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[1] https://www.sec.gov/files/secfy18congbudgjust.pdf

[2] FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks, Financial Action Task Force (June 2014), http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-andpotentialaml-cft-risks.pdf. The Financial Action Task Force is an independent intergovernmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction. The FATF Recommendations are recognized as the global anti-money laundering and counterterrorist financing standard; IR-2014-36 (March 25, 2014); https://www.irs.gov/newsroom/irs-virtual-currency-guidance; https://www.aicpa.org/advocacy/cpaadvocate/2016/virtual-currency-guidance-needed.html.

[3] SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946); see also United Housing Found. Inc. v. Forman, 421 U.S. 837, 852-53 (1975).

[4] Howey, 328 U.S. at 299.

[5] Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

[6] United Housing Fund, 421 U.S. 837 at 849.

[7] Release No. 81207 (July 25, 2017). Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO.