BLOCKCHAIN & CRYPTO CURRENCIES EXPLAINED:
Understanding the Technology and Regulatory Issues Behind Bitcoin

Presentation by:
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- Presentation
- Questions

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Biography:
- Found Bitcoin in 2011.
- 7 years of experience within the cryptocurrency and blockchain space.
- CEO of a Crypto Mining Company and Digital Asset Fund.
- Founder of Blockchain Law Firm.
Agenda:

1. An Overview of Blockchain & Cryptocurrencies
   a. Blockchain 101
   b. Cryptocurrencies, Digital Payments, and Tokens

2. Blockchain & Distributed Ledger Legal Issues
   a. Regulatory Overview
   b. Recent Determinations

3. SEC
   a. Howey Test
   b. Enforcement Actions:
      i. DAO
      ii. Munchee

4. Compliance & Avoidance Strategies

5. Exchange Regulation - EtherDelta Ruling

6. "Smart Contracts"

7. Questions & Answers
Blockchain 101

- Bitcoin and the creation of Blockchain technology
  - The Anonymous Satoshi Nakamoto first published a white paper in 2008 = decentralized infrastructure that could process transactions efficiently, anonymously, and securely.

- A Blockchain can be open to all or can be proprietary and limited to a designated universe of participants, i.e., public or private.

- Bitcoin - the first decentralized cryptocurrency that resides on a Blockchain ledger.

Regulatory Beginnings

- Early Law Enforcement Focus:
  - 2013 – Mt. Gox hack & seizure: >$5M in U.S. Accounts seized by DHS for operating an unlicensed MSB.
What is a Token?

• A token is a secondary asset or application within a Blockchain ecosystem, e.g., Ether (the digital token used on the Ethereum Blockchain)
  • A token runs the secondary application
  • Tokens can represent basically any assets that are fungible and tradeable, from commodities to loyalty points to even other cryptocurrencies
  • Utility Tokens vs. Security Tokens
Initial Coin Offerings (ICOs)

- Investor Participation Model for fundraising whereby individuals transfer fiat currencies or Cryptos to the issuer in exchange for digital tokens ("Tokens").
  - Filecoin - $257 million; Tezos - $232 million; EOS - $180 million.
  - 2016 – more than $100 million raised through ICOs globally.
  - 2017 – global issuance volume exceeding $3 billion.
Security vs. Utility Tokens

• **DAO, Munchee & Giga Watt Cases:**

  • **DAO** – Decentralized Autonomous Organization – raised $150 million
    • Security b/c it failed the “Howey Test”
      • (1) whether participants invested money,
      • (2) in a common enterprise;
      • (3) from which they expected to profit;
        • **MOST IMPORTANT!**
        • (4) due to the efforts of others.

  • **Munchee** – Restaurant Review Blockchain Platform – raised $15 million
    • Promised a “rise in value” to investors.
    • Promised the token would be listed on exchanges.

  • **Giga Watt** – mining operation ICO – offered tokens in exchange for mining services.
    • Failed to provide tokens to investors.
SEC—Beginnings

Initially the SEC brought an enforcement action alleging a failure to register the interests being sold as securities:

• In the *Matter of Erik T. Voorhees, Adm. Proc. File No. 3-15902 (June 3, 2014)* (settled administrative proceeding involving unregistered shares valued in bitcoin)
• Debate whether Bitcoin could be a security raged on
• Subsequently, the SEC brought enforcement actions which allege fraud in addition to failure to register
SEC—The DAO Report


- A company called Slock.it created a DAO, and sold tokens as interests in the enterprise. Investors were told the coins would increase in value, and would be listed for trading on an exchange.
  - Based on these facts the SEC concluded the interests were securities.

- The critical test (Howey Test) here is two fold:
  - SEC v. H.J. Howey Co., 328 U.S. 293 (1946) which considers:
    - An investment of money
    - In a common enterprise
    - With the expectation of profits
    - From the efforts of others
Administrative Rulings and Settlements

2014 Software and Investment Administrative Ruling:

• FinCEN determined that the production and distribution of software, in and of itself, does not constitute acceptance and transmission of value, even if the purpose of the software is to facilitate the sale of virtual currency.

• However, this ruling was for a “company,” not an individual. A business investing in virtual currencies is an unregulated user. A business helping others buy, sell, or send virtual currency is a regulated exchanger, and needs to register with FinCEN.

Ripple Labs Settlement:

• In 2015, FinCEN fined Ripple Labs, the company who builds products utilizing the decentralized cryptocurrency XRP, for selling XRP for fiat currency without registering with FinCEN as a Money Service Business.

• To be clear, Ripple Labs was selling tokens (XRP) it, the company, owned. Ripple Labs was not an intermediary selling on behalf of someone else.

• Ripple Labs previously described itself in court filings and in a sworn affidavit as “a currency exchange service.”

  • Only a settlement agreement.
State Regulation

- Pennsylvania’s Department of Banking and Securities (DoBS) has clarified that crypto exchanges and service providers do not require a money transmission license to operate in the state.

- New York: BitLicense for virtual currency businesses.

- Nevada: prevents local governments from taxing or regulating blockchain. Senate Bill 398

- Arizona: Signatures and records secured through blockchain technology; smart contracts. A.R.S. § 44-7061 (eff. Aug. 9, 2017)

- Vermont: Blockchain enabling (authentication and admissibility). V.S.A. Title 12, § 1913


Survey of Litigation:

- Ponzi schemes—defendants allegedly solicit investments in Bitcoin, overpromise returns, use new investor money to pay old investors.

- Virtual currencies for precious gems and metals.
  - See, e.g., Hussein v. Coinabul, LLC (14-C-5735, N.D. Ill.)

- Securities fraud in connection with Initial Coin Offerings.
  - See, e.g., SEC v. REcoin Group Foundation, LLC (CV17-5725, E. D.N.Y.)
Exchange Regulation

• Traditional AML and KYC Approach
  • Exchanges required to prove identity of users
    • Coinbase user-log subpoenaed by the IRS.

• Self-Regulated
  • Exchanges are expected to implement their own best practices, but no federal regulation exists.

• New York State – Bit-license
  • Requires a license from an independent board.

• Wyoming – State Senate Bill: SF0111
  • that "virtual currencies … shall be exempt from property taxation."

• Security – Off-exchange vs. Exchange storage
Ether Delta Ruling

SEC charges Zachary Coburn, founder of decentralized crypto trading platform EtherDelta for operating an unregistered securities exchange.

- EtherDelta users conducted more than 3.6 million trades over an 18-month period “for ERC-20 tokens, including tokens that are securities under the federal securities law,” according to the release.

- SEC Division of Enforcement co-director Stephanie Avakian said in a statement that “EtherDelta had both the user interface and underlying functionality of an online national securities exchange and was required to register with the SEC or qualify for an exemption.”

- Coburn settled the charges, paying $300,000 in disgorgement, $13,000 in pre-judgement interest and a $75,000 penalty.
What is a Smart Contract?

A smart contract is a set of promises, specified in digital form, including protocols within which the parties perform on these promises.
Questions?

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