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BITCOINERS IN THE COURT ROOM PART I: GOVERNMENT OVERSIGHT

By William B. Fleming and Joseph Evans

Bitcoiners beware, in [SEC v. Shavers](#), No. 4:13-cv-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013) the Eastern District of Texas ruled that investments in Bitcoin are “investment contracts” and, thus, “securities” covered by the Federal Securities Laws.

This series discusses recent private and government actions concerning Bitcoin which reveal that Bitcoin-related litigation and regulation is on the rise and lawyers are well-served to learn about the legal impact of this virtual currency phenomenon. Part I describes recent government actions and their impact on Bitcoin. Part II explores private actions involving Bitcoin.

The Eastern District of Texas ruled that investments in Bitcoin are securities.

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A. BITCOIN PRIMER

For the uninitiated, the first question: what is Bitcoin? Bitcoin is a virtual currency which is tradeable and is used to purchase goods and services. Indeed, according to a [Bloomberg](#) article, Bitcoin “can be used to buy and sell a broad range of items – from cupcakes to electronics to illegal narcotics.”

Bitcoin was created in 2009 by a person or group using the name [Satoshi Nakamoto](#). It is entered into circulation electronically through a process called “mining.” Members of the Bitcoin network, typically referred to as “miners,” are the ones who “mine” Bitcoin. Miners download free software and dedicate their computer server power to solve complex Bitcoin equations. If the miner’s computer is the fastest and most powerful for a particular equation the miner is rewarded with Bitcoin. [Videos](#) and [images](#) are available online displaying massive super computers dedicated to maximizing Bitcoin production. Miners’ computers are shown stuffed into basements with cooling systems employed to prevent the hard working computers from overheating.

Mining is not the only way for people to get their hands on Bitcoin; a huge secondary market has developed for Bitcoin trading on decentralized exchanges. Miners harvest Bitcoin supply and subsequently sell it over the exchanges structured by its founder, a process which fuels the secondary market in the virtual currency and enables the general public to own it.

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Bitcoin is limited in supply. There are 21 million minable Bitcoins projected to be mined and circulated by 2140. The United States Government Accountability Office (“USGAO”) [reports](#) that “[a]ccording to Bitcoin’s peer-to-peer network generated statistics, as of May 1, 2013, approximately 11 million Bitcoins were in circulation.”

Trading in the currency has resulted in wild swings in its price. The USGAO [reports](#) that, while from May 2012 through February 2013 prices ranged between \$5 and \$20 per Bitcoin, prices in the ensuing three months reached as high as \$237. In that same time period, the number of transactions per day ranged from approximately 8,000 to 70,000. On August 20, 2013, [Mt. Gox](#), a Japanese corporation and the largest Bitcoin exchange in the world, shows one Bitcoin to be worth roughly \$120.

A controversial feature of Bitcoin usage is that users can easily remain anonymous. Bitcoin is stored in Bitcoin wallets, a series of numbers and letters linked to an IP address. Savvy internet users – the vast majority of Bitcoiners – have found relatively simple ways to hide their IP addresses making it quite difficult to trace a Bitcoin to its owner. As for [Bitcoin millionaires](#), by April 2, 2013, 250 wallets existed that were each worth over \$1 million. Since the owners’ identities are not public, however, the number of \$1 million wallets has no sure bearing on the actual number of Bitcoin millionaires since a solitary end user can hold multiple wallets.

Thus, Bitcoin is a highly volatile, hard to trace, wholly digital currency, that can be earned, bought, sold and used to purchase goods and services.

From May 2012 to August 20, 2013 Bitcoin prices have ranged from \$5 to \$237.

B. GOVERNMENT: BITCOIN REGULATION AND ENFORCEMENT

Since *Shavers* ruled that Bitcoin investments are securities, the SEC and private litigants may be able to sue Bitcoiners under federal securities laws. Furthermore, Bitcoin regulation and litigation is heating up as indicated by the [Shavers](#) ruling, [subpoenas](#) and [cease and desist letters](#) from state regulators, a [2014 House of Representatives Appropriations Bill](#), a [USGAO report](#), the [seizure](#) of bank accounts and online payment processor accounts of the largest Bitcoin exchange in the world, a [U.S. Treasury Financial Crimes Enforcement \("FinCEN"\) Guidance](#) and a supposed leaked [FBI report](#).

1. *Shavers*: Bitcoin Investments Are Securities

In the Eastern District of Texas, the SEC brought an [enforcement action](#) alleging fraud in connection with an alleged Bitcoin ponzi scheme under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 17(a) of the Securities Act as well as under Section 5(a) and 5(c) of the Securities Act.

According to the SEC, Shavers and Bitcoins Savings and Trust (“BTCST”) solicited investors to invest in Bitcoin in return for interest payments of up to 7% weekly. The SEC alleged that Shavers told investors that his high margins and returns for investors were because of his ability to arbitrage the Bitcoin market, capitalizing on the different exchange rates offered by different exchanges in this nascent and still inefficient market.¹

¹ Since Bitcoin is bought and sold on decentralized exchanges the conversion rate to “real” money is not always the same on each exchange because of exchange fees, degree of automation, funding methods and other factors. One [website](#) explains that “these differences occur because of inefficient markets . . . Bitcoins trade against a number of different currencies and price moves between those currencies are one reason why these market inefficiencies occur . . . arbitrage opportunities do exist and will usually persist long enough that even traders working with no trade automation can still take advantage of the price differences.”

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The SEC alleged that defendants were engaged in a fraudulent ponzi scheme and paid certain investors interest and redeemed their underlying Bitcoin investment out of the investments of subsequent investors. In particular the SEC alleged the defendant Shavers acquired Bitcoin for “his personal use” and gave “preferential redemptions to friends and longtime BTCST investors.” The Complaint claimed Shavers used Bitcoin message boards to solicit investors: “I don’t move a single coin until the cash is in hand and I’m out of harms [sic] way (just incase ☺). So risk is almost 0 . . . anything not covered is hedged or I take the risk personally . . . in the event there was a huge change in the market and I needed to personally cover the difference I am more than willing to do . . . if my business is illegal then anyone trading coins for cash and back to coins is doing something illegal. ☺.”

Defendants moved to dismiss for lack of subject matter jurisdiction because “Bitcoins [are] not money, and [are] not part of anything regulated by the United States” and therefore were not covered by the federal securities laws. The Eastern District of Texas did not agree.

The federal securities laws strictly regulate “securities.” A “[security](#)” is “any note, stock, treasury stock, security future, security-based swap, bond . . . [or] investment contract . . .” In the case in the Eastern District of Texas, the issue was whether BTCST investments were “investment contracts.” The court applied the Supreme Court’s [Howey](#) test: an investment contract is any contract, transaction, or scheme involving (1) an investment of money, (2) in a common enterprise, (3) with the expectation that profits will be derived from the efforts of the promoter of a third party.

In *Shavers* the SEC alleged a Bitcoin ponzi scheme.

The court found that the second and third prongs of the *Howey* test were satisfied because the SEC alleged a collective reliance on Shavers' expertise in Bitcoin markets to provide a promised daily interest which shows a common enterprise and an expectation of profit from his efforts.

As to the first prong, the inquiry focused on the question whether Bitcoins were "money." The Eastern District of Texas answered a resounding yes. "It can be used to purchase goods or services, and as Shavers stated, used to pay for individual living expenses." The Court recognized that Bitcoin is limited to places that accept it but that it can be exchanged for conventional currencies, so under the first prong – the investment of *money* – "Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money." The Court concluded, "BTCST investments meet the definition of [an] investment contract, and as such, are securities. For these reasons, the Court finds that it has subject matter jurisdiction over this matter."

2. Governmental Bodies Take Aggressive Steps Towards Regulating Bitcoin

Various Government agencies have made efforts to regulate Bitcoin. For instance, while the trading and use of Bitcoins has an obvious tax dimension, such transactions may be the subject of a growing tax enforcement focus. In May 2013, the USGAO issued a report to the U.S. Senate Committee on Finance, titled "Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks." In it, the recommendation was made that the IRS should keep an eye on Bitcoin.

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The report concluded that the “IRS has not provided taxpayers with information specific to virtual currencies” and that “by not issuing guidance, IRS may be missing an opportunity to address virtual currency tax compliance risks.” The USGAO recommended that the “IRS find relatively low-cost ways to provide information to taxpayers, such as on its website, on the basic tax reporting requirement for virtual currencies” and noted the “IRS agreed with our recommendation.”

As well, discussion about the possibilities for criminal abuse of Bitcoin, and law enforcement’s interest in directing attention to the field, has populated the internet. A purported April 24, 2012 unclassified FBI report on Bitcoin has been circulating online. The memorandum was cited by [Forbes](#) magazine and, according to one online [article](#), an FBI representative has confirmed that the report “is legitimate, but it was not leaked by the government.” The twenty-page report noted that Bitcoin could be “an increasingly useful tool for various illegal activities” citing drugs, theft and money laundering. The report also discussed anonymity. It observed that Bitcoin transactions are published online and are connected to distinct IP addresses, but that if users route Bitcoin traffic through an IP anonymizer, it can become very difficult for the FBI to trace the source.

**The USGAO
and FBI are
taking a close
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Furthermore, market participants need to be aware of other regulatory focus on Bitcoin. FinCEN has issued a guidance titled: “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using, Virtual Currencies.” The guidance, issued March 18, 2013, sought to “clarify the applicability of the regulations implementing the Bank Secrecy Act (“BSA”) to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies.” The BSA and corresponding regulations subject financial institutions and Money Services Businesses (“MSBs”) to anti-money laundering obligations. According to FinCEN, “administrators” and “exchangers” are MSBs subject to federal registration, reporting, and recordkeeping regulations. The guidance defines an “administrator” as “a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.” It defines an “exchanger” as “a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.” Notably, according to the guidance, “users” are not subject to these registration requirements. “A ‘user’ is a person that obtains virtual currency to purchase goods or services.” Miners, too, are not subject to these registration requirements since “a person that creates units of this convertible virtual currency and uses it to purchase real or virtual goods and services is a user of the convertible virtual currency and not subject to regulation as a money transmitter.” On June 13, 2013, Jennifer Calvery, a FinCEN director, issued the cautionary [comment](#) that her agency is not working against Bitcoiners so long as they comport with the rules that other financial institutions have to follow.

**A FinCEN
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Recently, referencing the FinCEN guidance, the United States Homeland Security Investigations (“HIS”) obtained court intervention against Mt. Gox, the Japan-based Bitcoin exchange. On May 14, 2013 HIS got a federal court judge in Maryland to sign off on a seizure [warrant](#) to foreclose a [Dwolla](#) account used by a subsidiary of Mt. Gox, [Mutum Sigillum LLC](#). The warrant found probable cause to believe that the contents of Mt. Gox’s and Mutum Sigillum’s Dwolla account was “involved in transactions and attempted violations of [18 U.S.C. § 1960](#) (the unlawful operation of a money transmitting service) and that the contents of that account are subject to seizure and forfeiture pursuant to [18 U.S.C. § 981\(a\)\(1\)\(A\)](#).” According to the warrant, Mutum Sigillum represented to Wells Fargo that it was not a business engaged in money services because it did not deal in or exchange currency for its customers or accept and send customer currency. HIS claimed that despite FinCEN’s guidance, neither Bitcoin company registered with FinCEN as an MSB. The warrant cited a confidential informant who explained that Mt. Gox, through its subsidiary Mutum Sigillum, used Dwolla – an online payment processor – and Wells Fargo accounts to funnel U.S. consumer funds to and from their Bitcoin exchange accounts at Mt. Gox. The warrant application stated that a Wells Fargo account used by Mutum Sigillum had already been seized pursuant to a May 9, 2013 seizure warrant predicated on the same facts. Dwolla responded with the following [statement](#) on May 14, 2013: “Dwolla has ceased all account activities associated with Dwolla services for Mutum Sigillum while Dwolla’s holding partner transferred Mutum Sigillum’s balance, per the warrant.”

Bitcoin-related accounts have been seized.

On May 30, 2013 the California State Department of Financial institutions issued a [cease and desist letter](#) to the [Bitcoin Foundation](#) for its possible “engage[ment] in the business of money transmission without having obtained a license or proper authorization required by the California Financial Code.” On July 1, 2013 the Bitcoin Foundation issued a [response](#) that stated: “the Bitcoin Foundation believes it does not require licensure as a money transmitter under California law . . . the sale of Bitcoin is not regulated under the California Money Transmission Act.” The response gives four reasons why California regulators should not pursue the cease and desist, including: (1) it does not maintain business operations in California; (2) it does not sell or issue payment instruments; (3) it does not sell or issue stored value; and (4) it does not receive money for transmission.

Increased regulatory interest in Bitcoin is hard to miss. On May 7, 2013 CFTC commissioner Bart Chilton [stated](#) that Bitcoin “is for sure something we need to explore . . . it’s not monopoly money we’re talking about here – real people can have real risk in these instruments, and we need to ensure that we protect markets and consumers, even in what at first blush appear to be ‘out there’ transactions.”

**State
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Bitcoin-related
cease and
desist letters.**

Additionally, on August 12, 2013 twenty-two² digital currency companies were slapped with [subpoenas](#) from the New York Department of Financial Services (“DFS”). At that time, Superintendent Benjamin Lawsky stated “we believe that – for a number of reasons – putting in place appropriate regulatory safeguards for virtual currencies will be beneficial to the long-term strength of the virtual currency industry.” DFS issued a [release](#) regarding the subpoenas. DFS noted that the “cloak of anonymity provided by virtual currencies has helped support dangerous criminal activity, such as drug smuggling, money laundering, gun running, and child pornography.” DFS also expressed its concern that New York Bitcoin companies were not complying with appropriate regulations:

“we are concerned that – at a minimum – virtual currency exchangers may be engaging in money transmission as defined in New York law, which is an activity that is licensed and regulated by DFS . . . under current DFS regulations firms engaging in money transmission are required to post collateral in order to better safeguard customer account funds. Additionally, they are required to undergo periodic safety and soundness examinations, as well as comply with applicable anti-money laundering laws”

² [Forbes](#) published a list of the subpoenaed Bitcoin companies: BitInstant, BitPay, Coinabul, Coinbase Inc., CoinLab, Coinsetter, Dwolla, eCoin Cashier, Payward, Inc., TrustCash Holdings Inc., ZipZap, Butterfly Labs, Andreessen Horowitz, Bitcoin Opportunity Fund, Boost VC Bitcoin Fund, Founders Fund, Google Ventures, Lightspeed Venture Partners, Tribeca Venture Partners, Tropos Funds, Union Square Ventures and Winklevoss Capital Management.

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DFS' effort was designed to bolster customer confidence by making "safety and soundness requirements" so customers could know that money given to Bitcoin companies "will not get stuck in a digital black hole." Lastly, DFS stated that since Bitcoin is a "money changer of choice for terrorists, drug smugglers, illegal weapons dealers, money launderers, and human traffickers [it] could expose the virtual currency industry to extraordinarily serious criminal penalties." Accordingly, DFS stated that it intends to "put in place appropriate regulatory guardrails to protect consumers and our national security."

Even the U.S. Congress has indicated its interest in the ramifications of the growing Bitcoin market. The House of Representatives' 2014 Appropriations Bill requested Bitcoin guidance from the FBI citing the potential for crime, terrorism and money laundering. The House requested a briefing within 120 days of the bill's passing that describes the FBI's efforts towards a coordinated response to the potential for the unlawful use of Bitcoin.

Bitcoin's inherent secrecy potential has even provided flavor for a federal [indictment](#). On June 26, 2013, a Tennessee man was [indicted](#) for attempting to extort Mitt Romney seeking payment in Bitcoin. According to the indictment, the defendant demanded the payment of \$1 million in converted Bitcoin to prevent the public release of certain documents. Purportedly, the defendant demanded that Bitcoin be deposited in Bitcoin account number 1HeF89wMjC48bWNgWvVo7Wu3RaLW8XVsE8. A jury trial is set for September 3, 2013.

**Congress
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C. CONCLUSION

It is becoming apparent that the Government wants to regulate Bitcoin. Stay posted for Part II of this series which discusses private Bitcoin actions and further solidifies the primary focus of this series: lawyers should know about Bitcoin.

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