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What is the Legal Status of Cryptocurrency in the U.S.?

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With the recent explosion of public interest and media attention on cryptocurrencies such as Bitcoin and Ethereum, many have been left with questions such as: what is the legal status of cryptocurrencies, or cryptocurrency-based investment products? What are the legal implications of buying and trading them?

From a taxation perspective, the IRS has stated unmistakably that cryptocurrencies are treated as property—they are not, as some might argue, currency. This means that gains or losses on cryptocurrency transactions should be reported as short-term or long-term capital gains, depending on the length of time the asset was held. The IRS guidance on this subject can be found here.

Contrary to the concerns of some cryptocurrency enthusiasts that governments would increasingly "crack down" on the use of cryptocurrencies, there has been no effort by any U.S. regulatory agency to prohibit or restrict the buying or trading of cryptocurrencies themselves. In fact, in December 2017, two regulated U.S. futures exchanges were cleared by the Commodity Futures Trading Commission ("CFTC") to begin trading Bitcoin futures. There are also multiple exchanges based in the U.S. where customers can buy and trade cryptocurrencies, subject to identity verification and financial reporting under U.S. law.

Rather than restricting access to cryptocurrencies, agencies appear to be focused on developing regulatory frameworks that recognize the existence of cryptocurrencies while addressing the traditional concerns of the securities laws: things like investor fraud, market manipulation, and money laundering. Jay Clayton, the chairman of the Securities and Exchange Commission ("SEC"), said at a meeting at the Federal Reserve Bank of New York in November 2017: "where we see fraud, and where we see people engaging in offerings that are not registered, we are going to pursue them because these types of things have a destabilizing effect on the market."

Toward that end, we have already seen significant enforcement activity around initial coin

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offerings ("ICOs"), a recently popular effort by some startup companies to solicit funds from investors (usually in the form of Bitcoin, Ethereum, or other cryptocurrencies) in exchange for cryptocurrency "tokens." The tokens may represent a participation interest in the company, similar to stock, or may confer other promised benefits on these early investors. In a series of enforcement actions, various state and federal regulators have made clear that structuring a financing as an ICO does not take it out from under the securities laws. Even if a token is not company stock in the traditional sense, regulators will examine whether the transaction is an "investment contract"—that is, a transaction whereby one: (1) invests money, (2) in a common enterprise, (3) with a reasonable expectation of profits, (4) derived from the managerial efforts of others. The interpretation and analysis of these factors is complex and varies somewhat by jurisdiction. The takeaway is that any company considering raising funds through an ICO will need to undertake a thorough analysis to determine how the offering needs to be structured and/or registered.

The silver lining for companies is that the presence of cryptocurrency in the transaction does not change the analysis—regulators are simply applying securities law principles that have been developed and well understood for decades. That said, some regulations may begin to change or new regulations be implemented in response to the entry of cryptocurrencies onto the world financial stage.

On January 18, 2018, the SEC issued a staff letter to two industry groups representing various investment and securities firms. In the letter, the SEC solicited input on questions relating to the regulation of cryptocurrency-based funds such as ETFs and money market funds. The areas of inquiry included:

- How would cryptocurrencies be valued to determine a Net Asset Value at the end of each day?
- Would a cryptocurrency fund have sufficient liquidity to provide daily redemptions?
- How would a fund maintain custody of cryptocurrencies?
- How would an ETF provide fair treatment of investors in light of the volatility of cryptocurrencies?
- How would potential manipulation and other risks be mitigated?

To date, the SEC has not approved any exchange-traded product holding cryptocurrencies, and the staff letter stated in its conclusion: "Until the questions identified above can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products, and we have asked sponsors that have registration statements filed for such products to withdraw them."

In his testimony before the Senate Banking Committee on February 6, 2018, the chairman of the CFTC, Christopher Giancarlo stated:

> We are entering a new digital era in world financial markets. As we saw with

> the development of the Internet, we cannot put the technology genie back in the bottle. Virtual currencies mark a paradigm shift in how we think about payments, traditional financial processes, and engaging in economic activity. Ignoring these developments will not make them go away, nor is it a responsible regulatory response. The evolution of these assets, their volatility, and the interest they attract from a rising global millennial population demand serious examination. With the proper balance of sound policy, regulatory oversight and private sector innovation, new technologies will allow American markets to evolve in responsible ways and continue to grow our economy and increase prosperity. Giancarlo's testimony suggested that such regulations may include, in the case of cryptocurrency trading platforms: data reporting, capital requirements, cyber security standards, measures to prevent fraud and price manipulation and anti-money laundering and "know your customer" protections.

The precise scope of the above-described new regulations, and the interplay between the regulatory approaches of various state and federal agencies, largely remains to be seen. Anyone with questions regarding the structure or registration of ICOs, cryptocurrency investment products, or the regulatory framework surrounding cryptocurrencies may contact Rich May attorney David Glod.

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