PROQUEST®
A DIVISION OF ALLIANT

CRYPTOCURRENCY: KEY AREAS OF CONCERN FOR ATTORNEYS

By: **Jennifer Wolak**, Partner, Fields Howell | **Samantha Rowles**, Partner, Fields Howell | **Adam Adler**, Associate, Fields Howell
Jennifer Groszek, Vice President–Claims Advocate Lead, ProQuest

Cryptocurrency is a rapidly evolving area and certainly will impact attorneys in the E&O space. Attorneys must understand what cryptocurrency is and how it works. Current law does not provide any federal agency with plenary authority over cryptocurrency. Various agencies (the SEC, CFTC, IRS, and DOJ) are promulgating guidance and engaging in enforcement actions. This patchwork approach creates uncertainty and can be a minefield for attorneys offering advice in this space. The increasing popularity of cryptocurrency combined with its regulatory uncertainty has also created a situation in which attorneys may feel pressure to accept digital coins as a form of payment, but face increased risks and ethical pitfalls when doing so.

Areas of concern involve whether initial coin offerings (ICOs) could be classified as a securities, fraud, tax implications and potential ethical issues with attorneys accepting payment in bitcoin and other cryptocurrencies.

WHEN IS A DIGITAL TOKEN A SECURITY?

In June 2018, SEC Chairman Jay Clayton indicated in a media interview that the SEC would not seek to alter the traditional *Howey* Test[1] to determine what constitutes a security, even in the realm of cryptocurrency. Thus, if a digital token meets the criteria set forth in *Howey*, then it will constitute a security. Chairman Clayton suggested that the SEC views tokens or coins offered via ICOs as securities that need to follow applicable rules regarding private placement or public offerings. On the other hand, Chairman Clayton suggested that cryptocurrencies that function as replacements for sovereign currencies are not securities.

Lawyers who are assisting clients in ICOs should be aware that the SEC is investigating these transactions, and we are starting to see litigation. For example, in October 2017, publicly-traded Overstock.com announced plans for a $250M cryptocurrency offering through its subsidiary, tZero. The offering prompted an SEC investigation and a shareholder suit alleging that the coin offering was problematic and potentially illegal and that the company's block chain venture was hemorrhaging money.

We anticipate that the SEC will become increasingly focused on cryptocurrency and ICOs. In December 2017, it issued a statement warning "main street investors" and market professionals. The SEC noted that at that point, no ICOs had been registered with the SEC and that by their nature and international platforms, these markets present less potential for investor protection and great opportunity for fraud. The SEC warned market professionals to assess carefully whether the particular product could be classified as a security. While a token that represents an interest in a book-of-the-month club might not implicate securities laws, an interest in a yet-to-be-built publishing house could be different, particularly if promoters are emphasizing a secondary market for trading the tokens.

Additionally, the SEC urges securities lawyers, accountants, and consultants to focus on the principal motivation of SEC registration, offering process and disclosure requirements—investor protection. In its December 2017 statement warning "main street investors" and market professionals, the SEC cautions that calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security. Significantly, the SEC advises that tokens and offerings incorporating features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. Law. In other words, is the prospective buyer being sold on the potential for the tokens to increase in value, either through reselling the tokens on the secondary market, or otherwise profit from the tokens due to the efforts of others? If so, it is likely the tokens could be classified as a security and subject to U.S. securities laws.

REGULATORS ADDRESS CONCERNS ABOUT FRAUD

Lawyers assisting clients in ICOs or investment in the same should be aware that the cryptocurrency arena is rife with fraud, and regulatory agencies have begun cracking down, such as in the CFTC's suit against Patrick McDonnell and his company, Coin Drop Markets, alleging he misappropriated investor funds via a deceptive cryptocurrency scheme. The CFTC alleges McDonnell violated the Commodity Exchange Act. In a preliminary order granting injunctive relief, the Court concluded that virtual currency may constitute a "commodity" and the CFTC may exercise enforcement power over fraud related to virtual currencies sold in interstate commerce.

In February 2018, FinCEN stated in a letter to Senator Ron Wyden (Ranking Member of the Senate Committee on Finance) that virtual currency exchangers and administrators are money transmitters and must comply with the Bank Secrecy Act (including registering with FinCEN as a money services business and preparing a written anti-money laundering compliance program). FinCEN's letter suggests that a company engaging in an ICO will have to comply with the Bank Secrecy Act. It is possible that failure to comply with these requirements could create criminal culpability.

The SEC recently halted two schemes involving an unregistered ICO and fraudulent coin offering. In April 2018, the SEC filed a Complaint in the Southern District of New York against two co-founders of a purported financial services start-up, Centra Tech, Inc. (Centra). The SEC alleges that the co-founders orchestrated a fraudulent ICO that raised more than $32 million from investors last year in which Centra offered and sold unregistered investments through a CTR Token. The SEC's Complaint is followed by a criminal action filed by the U.S. Attorney's Office for the Southern District of New York.

On May 29, 2018, the SEC issued a press release advising that it obtained a court order halting an ongoing fraud

[1] Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes "an investment contract." In *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946), the U.S. Supreme Court interpreted the term "investment contract" to mean a contract, transaction, or scheme involving (1) investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) from the efforts of the promotor or a third party. Id. at 298-99. Chairman Clayton, the SEC, and other commentators have utilized the *Howey* Test in analyzing whether digital tokens are or should be considered securities.

involving an ICO that raised approximately $21 million from investors perpetrated by Titanium Blockchain Infrastructure Services, Inc. (Titanium). According to the Complaint, Titanium fraudulently claimed to have relationships with numerous corporate clients, and the ICO was based on a social marketing campaign that allegedly deceived investors with purely fictional claims of business prospects.

THE TAX IMPLICATIONS OF DIGITAL CURRENCY

There are also serious tax law implications surrounding cryptocurrency. Media reports indicate the IRS has created a team to investigate whether cryptocurrencies are being used as tax evasion mechanisms. This has implications for attorneys advising cryptocurrency service providers, whose clients may come under IRS scrutiny. For instance, the IRS has required Coinbase (a cryptocurrency exchange) to report details of individuals who traded over $20,000 in a single year (roughly 13,000 persons). This might mean that companies providing cryptocurrency-based financial services will have to start creating programs to prevent or mitigate potential for tax evasion. According to a research note published by Fundstrat Global Advisors, U.S. investors will be on the hook for approximately $25 billion worth of cryptocurrency-related taxes, which is based on approximately $92 million of taxable gains for U.S. cryptocurrency investors. The IRS considers bitcoin as property and therefore subject to capital gains tax.

ETHICAL ISSUES FOR LAWYERS ACCEPTING DIGITAL CURRENCY AS PAYMENT

Lawyers accepting cryptocurrency as a form of payment for legal services rendered should consider whether or not the cryptocurrency is derived from a legitimate activity as well as whether accepting that form of payment is in line with applicable ethical rules. A conflict of interest may be a concern if a lawyer accepts payment in cryptocurrency for an ICO start-up or other business as the lawyer would have a financial interest in the company. The potential for conflict of interest in this situation may be mitigated if the lawyer immediately converts the digital currency to U.S. dollars.

Whether accepting digital currency is ever permissible is a new question that is largely unanswered, and attorneys should tread carefully in this arena. A recent Nebraska Supreme Court ethics opinion addresses lawyers accepting payments in digital currencies as payment for services. The ethics opinion noted that lawyers must be careful that the payment is not contraband, does not reveal client secrets, and is not used in a money-laundering or tax avoidance scheme. Additionally, lawyers should be aware of ethical rules as they relate to unreasonable fees as the value of digital currencies can fluctuate dramatically. The Nebraska opinion recommends converting bitcoins and other digital currencies into U.S. dollars immediately upon receipt to avoid overpayment. To mitigate the risk of volatility and potential for unconscionable overpayment for services, the Nebraska ethics opinion recommends that lawyers notify the client that they will not keep the digital currency units but instead will convert them into U.S. dollars immediately upon receipt; convert the digital currencies into U.S. dollars at objective market rates immediately upon receipt through the use of a payment processor; and properly credit the client's account at the time of payment. The Nebraska ethics opinion also states that it is permissible to hold bitcoins and other digital currencies in escrow or trust for clients; however, unless converted to U.S. dollars, bitcoins cannot be deposited in a client trust account.

Though the Nebraska Supreme Court's guidance is helpful, there are still open questions that could complicate any payment to an attorney involving digital currency. In particular, identifying an objective market rate could be challenging because the value of a particular digital currency can vary from exchange to exchange. Additionally, converting digital currency to fiat currency typically entails conversion costs. Attorneys have to consider who in the transaction will be responsible for those costs. With these uncertainties, attorneys should carefully analyze whether mitigating the risks associated with accepting digital currency is feasible at all in a given situation.

References:

https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-wont-change-definition-of-a-security.html
https://www.sec.gov/litigation/investreport/34-81207.pdf
https://www.sec.gov/ICO
https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11
https://www.ethnews.com/us-cryptocurrency-tax-liabilities-estimated-at-25-billion-after-2017-mania
https://www.sec.gov/news/press-release/2018-53
https://www.sec/gov/news/press-release/2018-94
https://supremecourt.nebraska.gov/sites/default/files/ethics-opinions/Lawyer/17-03.pdf
http://alawyershandbook.com/can-lawyers-accept-bitcoin-payments-from-clients/
https://www.law.cornell.edu/supremecourt/text/328/293
https://www.cnbc.com/2017/12/12/why-bitcoin-prices-are-different-on-each-exchange.html