

BITCOIN – IS ANYONE IN CHARGE?

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Bitcoin, one of the best-known virtual currencies, has experienced some growing pains recently. Once hailed by Bill Gates as a “techno tour de force,” 2014 has been less kind to this digital alternative to fiat currency. Earlier this year, Mt. Gox, one of the largest Bitcoin exchanges in the world, collapsed and filed for bankruptcy both in Japan, where it was based, and the United States. Allegations of fraud, mismanagement and outright theft of Bitcoins then worth more than \$450 million have arisen in connection with the exchange platform’s collapse. More recently, the SEC filed a settled administrative action against Erik T. Voorhees, one of Bitcoin’s most outspoken proponents, for violating Section 5 of the Securities Act for publicly offering unregistered interests in two Bitcoin-related websites in exchange for Bitcoins. But perhaps most interesting is the fight currently being waged in Ft. Worth, Texas, federal court over whether or not the SEC has jurisdiction over Bitcoin transactions and, specifically, whether an investment using Bitcoins (or in Bitcoin) can be regulated under the federal securities laws. *Background information:* According to the SEC, Bitcoin has been described as a decentralized, peer-to-peer virtual currency that can be used like money (*i.e.*, it can be exchanged for traditional currencies or used to purchase goods and services). It is based on a computer algorithm created in 2008 by the pseudonymous Satoshi Nakamoto. Pursuant to the algorithm, there will never be more than twenty-one million Bitcoins. Bitcoins consist of two parts – a public “key” and a private “key.” Transactions in Bitcoins are recorded on an electronic public ledger called a “block chain,” which is viewable by any computer user that can access the Bitcoin network. As with any other currency, a Bitcoin’s exchange rate varies against other currencies. Currently, one Bitcoin is worth approximately \$624. See [bitcoinwatch.com](#). The exchange rate has varied from about \$5 to almost \$1,200 per Bitcoin. Based on the thirteen million Bitcoins currently in existence, the total dollar value of Bitcoins in circulation tops \$8 billion. However, unlike traditional currencies, Bitcoin does not operate under the supervision of any central bank, is not legal tender in any country and otherwise is not backed by any government. It acts as a currency mostly because its users treat it that way. The IRS recently issued guidance that treats virtual currencies, like Bitcoin, as property for federal tax purposes. Therefore, tax principles that apply to property transactions apply to transactions using virtual currency. The service has also explained that, in some instances, Bitcoin could be viewed as a capital asset (like stocks, bonds, or other investment property) whereas in other instances it is not. What Bitcoins “are” and what federal regulatory agency(ies) can regulate them, if any, remains open to question. The SEC has issued “investor alerts” to those who use Bitcoins warning that Bitcoins pose unique risks. According to the Commission, some of the currency’s principal selling-points (*i.e.*, it is difficult to trace, there is no central authority that

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collects information on its users and many of its transactions occur cross-border) also make it more difficult for Bitcoin users that are defrauded to recover those funds. Moreover, since Bitcoin has no regulatory body, like the FDIC, SIPC or Federal Reserve behind it, its exchange rate can fluctuate significantly, it is not legal tender, and it comes with a host of unanswered legal and practical questions. The SEC has only begun gingerly to take enforcement action in cases involving Bitcoins. Its actions against Erik Voorhees and Trendon Shavers highlight some unanswered regulatory questions. Last month, the Commission announced that it brought a settled administrative proceeding against Erik Voorhees. Mr. Voorhees was one of the owners of FeedZeBirds, a website that pays Twitter users in Bitcoins in exchange for forwarding sponsored text messages and SatoshiDICE, an online gambling site that uses Bitcoins as currency. In 2012, FeedZeBirds offered and sold 30,000 of its shares and received 2,600 Bitcoins in return without registering with the SEC. The Bitcoins received were valued then at about \$15,000. Then, in 2012 and 2013, SatoshiDICE offered and sold 13 million shares without registering them, raising 50,600 Bitcoins in the process. The Bitcoins received were valued then at more than \$700,000. Later in 2013, SatoshiDICE bought back all outstanding SatoshiDICE shares; because the exchange rate for Bitcoins changed dramatically during that time, the approximate value of the SatoshiDICE buy-back transaction substantially exceeded the amount raised (by more than \$3 million). Shares in FeedZeBirds and SatoshiDICE were listed on what purported to be Bitcoin stock exchanges. Voorhees published prospectuses for each offering on the Internet but never filed them with the Commission. Voorhees also solicited investments through postings on various Bitcoin-related websites. Voorhees never filed a registration statement in connection with either offering, nor did any exemption from registration apparently apply. Following an investigation by the SEC, the SEC concluded that Voorhees' conduct violated Sections 5(a) and 5(c) of the Securities Act, which prohibits the direct or indirect offering or sale of securities without filing a registration statement. While refusing to admit or deny any of the SEC's findings, Voorhees agreed to disgorge the value of the Bitcoins received in the FeedZeBirds offering, plus interest (\$15,844), pay a \$35,000 penalty, and cease and desist from committing any other violations of Sections 5(a) and 5(c). This settlement avoids important questions about Bitcoin. First, the SEC did not allege that Bitcoins themselves were securities or subject to the SEC's regulation; instead, it was the offering of "shares" in the websites that gave rise to the alleged Securities Act violations. Second, the settlement seems to have focused exclusively on the FeedZeBirds transaction. Nothing in the SEC Order says that the fine relates to the SatoshiDICE transaction. Finally, the settlement itself means that no facts or legal theories were ever adjudicated. Of greater interest may be the SEC's lawsuit against Trendon Shavers and his investment vehicle, Bitcoin Savings and Trust (BCST). The SEC filed suit last year in Texas federal court, and litigation is ongoing. The SEC has alleged that Shavers offered and sold various Bitcoin-denominated investments, raising more than 700,000 Bitcoins (which amounted to at least \$4.5 million when invested and now would be more than \$400 million). According to the SEC, BCST was essentially a Ponzi scheme that did not generate the 7 percent per week return Shavers promised investors. In addition, the SEC has alleged that Shavers used investors' Bitcoins to pay his personal expenses. Defendants and the SEC are now litigating whether the federal court has subject matter jurisdiction over the case because, according to Defendants, Bitcoins are neither money nor securities subject to regulation under the federal securities laws. According to Shavers, "for the first time in

apparent history, [the SEC] seeks to impose its will on a transaction that at no point in time involved the actual exchange of legal tender.” Relying on statements by the IRS, the State of Texas and the SEC, along with the federal definition of “legal tender,” Shavers has argued that Bitcoin is property, not money; and because an investment contract as defined by the Supreme Court in *SEC v. Howey* requires “an investment of money” to be regulated by the federal securities laws, the transactions at issue are beyond the reach of the SEC and therefore the federal court. The SEC has responded that the “investment of money” requirement is satisfied because Bitcoins function as money and because, according to the SEC, valuable consideration other than money has satisfied this condition in the past. Defendants also made the alternative argument that, if Bitcoin is money, it cannot be a security because Section 3(a)(1) of the Exchange Act states that a security “shall not include currency.” The Commission carefully sidestepped this issue by pointing out that it had not argued that Bitcoins themselves were securities. The court heard argument on the jurisdictional issue last week. What seems clear at this point is the SEC has skirted around attempting to regulate Bitcoins directly and instead chosen to regulate transactions involving vehicles that invest in, or use, Bitcoins. How this approach fares as the \$8 billion Bitcoin market continues to expand will undoubtedly be watched with interest.