

Romancing the Crypto

June 26, 2018

Ether and Bitcoin are not securities and not subject to the requirements of the U.S. securities laws, said William Hinman, Director of the U.S. Securities and Exchange Commission (SEC) Division of Corporate Finance during his June 14, 2018 speech¹ at the *Yahoo Finance All Market Summit: Crypto* event held in San Francisco, CA. A long anticipated and important development, the remarks of Director Hinman provided a sigh of relief for many in the cryptocurrency community.

In the speech titled *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Director Hinman explained the legal rationale for reaching this conclusion by applying the federal securities laws to digital asset transactions. With an obvious reference to the romantic comedy *When Harry Met Sally*, in which a couple navigate the twists and turns of love and romance for more than a decade, the title of the speech *When Howey Met Gary (Plastic)*, appears to refer to the twists and turns of the legal analysis in determining when a transaction amounts to an offer or a sale of a security, including whether it is an economic transaction, whether there is a third party expectation of a return/profit, whether an investment contract element exists, as first discussed in the U.S. Supreme Court case, known as the Howey case,² or, whether an instrument is a part of an investment contract that is itself a security, as discussed in a U.S. Court of Appeals for the Second Circuit case, known as the Gary Plastic case.³

How is this applied to digital assets transactions, you may wonder? Stay with me. I will not recap the legal analysis here or discuss the securities laws. To put it simply, if a determination is made that a transaction amounts to an offer or a sale of a security or that an instrument is part of an investment contract that is a security, a disclosure is ultimately required to prospective investors under the current regulatory framework. And that is not the case for Ether and Bitcoin...

As Director Hinman remarked, “[w]hen I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value. And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network

¹ https://www.sec.gov/news/speech/speech-hinman-061418#_ftn8.

² SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

³ Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985).



and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value.”

Great, You Cheer. Not Yet, I Caution.

Why? Because it appears that this is not a policy statement of the SEC and will not be applied across the board. As Director Hinman pointed out, “[t]he analysis of whether something is a security is not static and does not strictly inhere to the instrument. Even digital assets with utility that function solely as a means of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security.”

The analysis will depend on the facts and circumstances and there is an illustrative list of guidelines/questions to consider, such as, for example:

“Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?”

Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?

Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?”⁴

Striking the Right Balance: Innovation v. Regulation

Topics and developments like the one above is what I will discuss through a series of monthly articles. Broadly, the articles will focus on the growth and adoption of disruptive technologies and the challenges faced by regulators, including regulatory efforts not to stifle innovation.

In essence, the focus will be on hot button topics, such as:

- Disruptive technologies, such as cloud technology, blockchain and other distributed ledger technologies

⁴ See link to speech in Footnote 1 above for additional guidelines.

- Fiat currencies, digital currencies and cryptocurrencies
- Decentralized exchanges
- Initial coin offerings (ICOs)
- Artificial intelligence (AI)
- Cyber-crimes, cybersecurity, data breaches
- Privacy and data protection
- Digital advisers/robo-advisers
- Jurisdictional Matters: are FinTech firms choosing friendlier jurisdictions?

In upcoming articles, I will outline some of the challenges vis-à-vis the regulatory and compliance initiatives and frameworks, primarily in the U.S., but will also provide additional context for regulatory initiatives and frameworks abroad. I will highlight the perspectives of the various stakeholders in the ecosystem, including start-up FinTech innovators, established technology companies, financial institutions, management consultants, lawyers, and regulators, including the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), and state regulators, such as the New York State Department of Financial Services.

Internet 2.0 – Is Crypto the New Internet?

The rapid growth and continued adaptation of disruptive technologies in the last several years has been unprecedented. While, Gen Xers may share a more skeptical view, having witnessed the enthusiasm of the Information Age, the dot coms explosion in the late 90s and the Y2K bubble burst, the world of today is different.

The point here is not about generational differences or shifting societal values, but about witnessing shifts in technologies that are changing dramatically the way we live, work, and communicate in communities that are becoming more interconnected and more global. It is about learning lessons and finessing our ability to apply these lessons without compromising our drive for innovation and change. It is also about building on precedents, mitigating risks and finding an equilibrium.

Having said that, the ecosystem is undeniably exciting. Groundbreaking. Revolutionary even.

We are in the midst of Internet 2.0.

Stay Tuned!

Whether you are a FinTech Connector innovator, a FinTech Connector enabler, an enthusiast, a maven, a FinTech or blockchain evangelist (as many in the realm like to refer to themselves), I encourage you to join the community and the conversation. Reach out to me with questions, suggestions and comments regarding the topics that we discuss here.

Until next month...



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