



COUNSEL TO GREAT COMPANIES

Blockchain and the Law

Overview of token sales and bitcoin property rights

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Roadmap

- Overview of two cutting-edge legal issues in blockchain space today
 - 1) Blockchain token sales
 - 2) Treatment of bitcoin under property law
- Other topics of interest?
- Q&A

Issue 1 - Blockchain Token Sales

- **Overview -**
 - Securities, money transmitter, commodity law are most often critical
 - But aiding and abetting, sanctions, consumer protection and taxation should not be ignored
 - Cross-border issues frequently come into play

Why token sales are a timely topic

- Substantial funds are being raised very quickly using blockchain technology without public securities registration
- In 2016: ~65 major (over \$40K) token sales
 - Over \$235m raised in total (including the DAO)
 - Average amount raised: ~\$1.6m
 - Median amount raised ~\$500K
- Blurred line between *tokenized goods and services* and *tokenized financial returns*
- Regulators, law enforcement and lawmakers are paying attention

Securities law issues

- **Investment contract test**
 - *Howey* test for “investment contracts” typically the relevant test for blockchain tokens
 - Requires (1) investment of money, (2) in a common enterprise, (3) with expectation of profits, (4) from the efforts of others
- **Results in broad reach of U.S. securities law**
 - Difficult to “contract around” *Howey*
 - *Howey* is very dependent on specific facts
 - Substantial compliance obligations if a security

Securities law issues (cont'd)

- In token sales, “investment of money” and “common enterprise” prongs often satisfied
 - Token sale generally an investment of money
 - Common enterprise prong is easily met in most cases where there is promise of financial return
- The “expectation of profits” and “efforts of others” prongs often pivotal in token context
 - Ideally, token purchasers incentivized to use tokens as active contributors in the network

Securities law issues (cont'd)

- **Securities considerations beyond *Howey***
 - States have own definitions of “security”
 - *Reves* “family resemblance” test for “notes”
- **Conservative approach by SEC in recent blockchain-related actions**
 - Denial of ETF applications from Bats and NYSE in March 2017
 - Emphasis on “unregulated” nature of bitcoin
 - Implications for blockchain tokens?

Money transmitter law issues

- **FinCEN's virtual currency guidance**
 - Tokens often “convertible” virtual currency
 - Token sellers often an “administrator” of convertible virtual currency
- **Enforcement under the Bank Secrecy Act**
 - Criminal penalties for unregistered MSBs
 - Ripple Labs (2015), U.S. v. Ulbricht (2014), U.S. v. Shrem (2014), Liberty Reserve (2013)

Money transmitter law issues (cont'd)

- **Nearly all states regulate MT**
 - Can be one of three forms: money transmission, payment instrument or stored value
 - Some states have virtual currency-specific laws
 - Costly and difficult to obtain licenses in all states
- **Formal and informal exemptions are available from federal and state MT regulation**
 - Requires careful design of token sale to maximize chances of qualifying for exemption

Commodity law issues

- **CFTC rules have unexpectedly broad reach**
 - “Swap” risk may arise from unknown payouts or benefits from holding tokens
 - Financing of token sales can create risk that token may be a “retail commodity transaction”
- **Implications and enforcement**
 - CFTC-regulated transactions with public generally must be on authorized exchanges
 - Bitfinex (2016), TeraExchange & Coinflip (2015)

Other issues

- Consumer protection
- Aiding and abetting
- Taxation
- Sanctions
- Banking
- Cross-border

Key takeaways

- Develop compelling, non-investment business case for platform that is connected to tokens
- Ensure that marketing and description of tokens and network is disciplined across organization
- When designing token sale mechanism, think from perspective of a buyer
- Where possible, aim for simplicity and clarity

Issue 2 - Bitcoin and property law

- **Overview -**
 - California law – used for illustrative purposes – should recognize property rights in bitcoin
 - Persuasive support under other U.S. legal regimes
 - Consideration of possible challenges
 - Implications for bitcoin custody
 - For more details, see our white paper at www.virtualcurrencyreport.com

Overview of key facts

- **Bitcoin basics**
 - Unspent transaction outputs (“UTXOs”) are fundamental “units” for property analysis
 - Unlocking script necessary to transfer UTXOs (or portion thereof) to another public address
- **Where are ownership rights rooted?**
 - In ability to control disposition of UTXOs that are recorded on the bitcoin blockchain
 - Need sufficient credentials (i.e., private key(s))

California law – illustrative analysis

- *Kremen test*
 - Capable of precise definition
 - Capable of exclusive possession or control
 - Legitimate claim to exclusivity
- **Applied to bitcoin**
 - Units of UTXOs associated with public address on blockchain, locked with locking script
 - Public policy goals in protecting property interests in UTXOs – investment and innovation

Other U.S. legal regimes

- **Federal BSA/AML laws**
 - *In rem* proceedings against unregistered MSBs
- **Commodity laws**
 - Coinflip (2015) – bitcoin akin to precious metal
 - Bitfinex (2016) – focused on possession and control of bitcoin
- **Taxation laws**
 - Guidance (2014) – bitcoin expressly treated as “property” for federal tax purposes

Other U.S. legal regimes (cont'd)

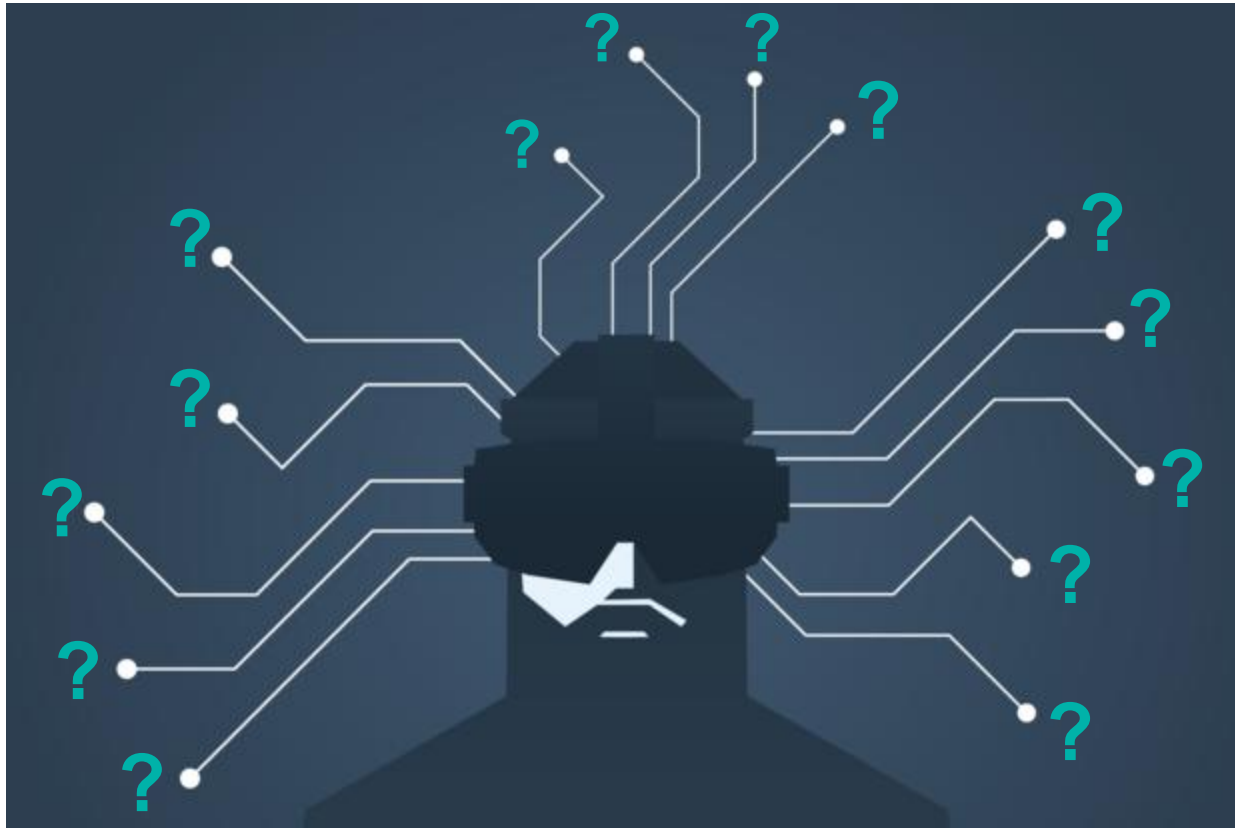
- **Bankruptcy laws**
 - *In re Hashfast* (2016) – bitcoin treated as property for fraudulent transfer purposes
- **NY BitLicense**
 - Assumes proprietary interest – abandoned property, bar on encumbrances
- **Uniform state laws**
 - Uniform Fiduciary Access to Digital Assets Act
 - Uniform Commercial Code – Art. 9 practices

Possible challenges

- **Pseudoanonymity**
 - Compare with ownership through trusts
- **“Numerus clausus” doctrine**
 - Compare with other intangibles
- **Multi-signature arrangements**
 - Query if no single entity has (a) sufficient keys or (b) necessary keys (or unilateral control)
 - Problems can likely be addressed by contract
- **Traceability limitations**

Property interest in bitcoins held in custody

- **Determine “specific” or “general” deposit**
 - Bailment or contract law
 - Agreement often controls
 - Implications of pooled v. segregated custody
- **Key steps for depositor to be deemed owner**
 - Look to FDIC rules as analogue
 - Disclose custody relationship and actual owners in account records
 - Carefully craft and execute contract with depositor so ownership rights are clear



Thank You! Any questions?

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