DREHER TOMKIES LLP

ALERT

FOR CLIENTS AND FRIENDS OF DREHER TOMKIES LLP

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SENATE COMMITTEE INITIATES INQUIRY INTO VIRUTAL CURRENCIES; FBI SHUTTERS SILK ROAD

The Senate Committee on Homeland Security and Governmental Affairs ("Committee") has begun an inquiry into virtual currencies. The Committee's inquiry will focus on the threats and risks of virtual currencies as well as "the promise it holds." The Committee indicated it will seek comments from individuals in government and the private sector. The Committee has not yet scheduled a hearing.

Committee Chairman Thomas Carper and Ranking Member Tom Coburn have expressed concern about the "anonymous and decentralized nature" of virtual currencies that makes them attractive vehicle for criminal activity. The senators called for a "holistic and whole-government approach" to understand virtual currencies and to "provide a sensible regulatory framework" for their existence. While the federal government must swiftly address potential risks posed by emerging technologies, the senators cautioned that the government must avoid "rash or uninformed" actions that would "stifle a potentially valuable technology."

On August 12, 2013, the Committee sent a letter to the Secretary of the U.S. Department of Homeland Security ("Department") requesting any information, plans and strategies that the Department has or plans to develop relating to virtual currencies. The Committee asked the Department to submit requested materials by August 30th.

The Committee's inquiry comes in the midst of a number of developments in recent months relating to virtual currencies. These developments include:

- On October 1, 2013, the Federal Bureau of Investigations ("FBI") reportedly shut down Silk Road, an online marketplace for illegal drugs and products. The FBI seized nearly $3.6 million worth of bitcoins held in Silk Road's virtual wallets and arrested the reported owner and operator of Silk Road on allegations of money laundering, drug trafficking and hacking. In a seizure order issued by the U.S. District Court for the Southern District of New York, the U.S. government alleges Silk Road was designed to "facilitate illicit commerce on the site by providing anonymity to it users" by operating on "The Onion Router" or "Tor" network and requiring transactions to be paid in bitcoins. The FBI confiscated Silk Road's bitcoins pursuant to 18 U.S.C. § 981(a)(1)(A), which authorizes the forfeiture of property used in money laundering transactions or attempted money laundering transactions.
- In July, Congress directed the FBI through an offered appropriations bill to provide a briefing on virtual currencies and money laundering no later that than 120 days after the enactment of the act.
- On July 23, 2013, the Securities and Exchange Commission ("SEC") charged a Texas man and his company with allegedly running a Ponzi scheme involving bitcoins worth nearly $60 million. The defendant challenged the U.S. District Court's jurisdiction over the case arguing that no securities were involved in his enterprise because bitcoins are not money and there are no other laws that regulate bitcoins. *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013). The U.S. District Court held that bitcoins are a currency or form of money and the bitcoin-backed investments offered by the defendant satisfy all the elements of an "investment contract." Therefore, the defendant's investment offerings qualify as securities and the SEC may regulate them. In connection with this case, the SEC also issued an investor alert, warning investors that "fraudsters may be attracted to using virtual currencies to perpetrate their frauds because transactions in virtual currencies supposedly have greater privacy benefits and less regulatory oversight than transactions in conventional currencies."
- In May 2013, the Government Accountability Office issued Report No. 13-516 that discussed virtual economies and currencies. Specifically, the report establishes tax reporting requirements for virtual economies and currencies, identifies associated tax compliance risks and sets forth recommendations on how the Internal Revenue Service can address those compliance risks.
- On July 29, 2013, Thailand declared that bitcoins are illegal because Thailand has no law that governs the virtual currency. This announcement came as a change to Thailand's former position that virtual currency exchanges could avoid money exchange licenses because bitcoins are not a currency. The

Darrell L. Dreher
ddreher@dltlaw.com

Judith M. Scheiderer
jscheiderer@dltlaw.com

Elizabeth L. Anstaett
eanstaett@dltlaw.com

Charles V. Gall
cgall@dltlaw.com

2750 HUNTINGTON CENTER
41 S. HIGH STREET
COLUMBUS, OHIO 43215
TELEPHONE: (614) 628-8000 FACSIMILE: (614) 628-1600
WWW.DLTLAW.COM

To see all previously sent ALERTS, visit our website at www.dltlaw.com

Michael C. Tomkies
mtomkies@dltlaw.com

Margaret M. Stolar
mstolar@dltlaw.com

Robin R. De Leo
robin@dreher-la.com

Susan L. Ostrander
sostrander@dltlaw.com

Susan M. Manship
smanship@dltlaw.com

Bank of Thailand indicated that it will continue to consider the issue of virtual currencies.

- The U.S. Department of Homeland Security seized U.S. accounts totaling over $ 5 million from Mt. Gox, the largest virtual currency exchange. The U.S. District Court for the District of Maryland issued seizure warrants on June 19 and August 19. In the affidavit supporting the seizure warrant, the U.S. government alleged that Mt. Gox's founder mislead U.S. authorities about the nature of the virtual currency exchange, and Mutum Sigillum LLC (Mt. Gox's U.S. subsidiary) engaged in a money transmitting business without registering as a Money Service Business with the Financial Crimes Enforcement Network ("FinCEN").

State regulators also have sharpened their focus on virtual currencies. Florida and Illinois imposed sanctions against Square, Inc. for operating as a money transmitter without a license. Square, Inc. offers mobile card-reading attachments for smart phones and tablets that use a cloud-based mobile wallet and operates a person-to-person payment system. Similarly, Idaho's Department of Finance announced that Idaho's Money Transmitter Act applies to virtual currencies and now requires entities engaging in virtual currency transactions to obtain a license. *See* our ALERT of Sept. 11, 2013. In September, the California legislature passed a bill amending California's Money Transmission Act to ease licensing requirement for money transmitters. *See* our ALERT of Sept. 11, 2013. At the same time, the New York State Department of Financial Services subpoenaed 22 payment providers to give information regarding the provider's anti-money laundering and consumer protection practices, in an effort to determine whether New York should use its existing money transmitter law to regulate virtual currencies or issue guidelines specifically for virtual currencies.

All of this follows FinCEN's publication of some interpretative guidance on virtual currencies and the Bank Secrecy Act. *See* our ALERT of Mar. 22, 2013.

These developments represent a mix for bitcoin participants. Closing Silk Road, for example, like the earlier action against Liberty Reserve S.A., removes a major critique and reputational challenge to legitimate bitcoin use. On the other hand, it also removes a purportedly large merchant user. Public interest in bitcoin has grown and a number of investors, including the Winklevosses, have made significant investments and started equity funds to provide capital to a diverse group of innovative companies serving the bitcoin world. Further scrutiny and regulation is expected on the state, federal and international levels. ☐

✧ *Mike Tomkies and Susan Manship*