SEC v. Shavers, et. al.

2013 U.S. Dist. LEXIS 130781 (E.D. Tex., Sept. 18, 2014)

A federal judge ruled that the operator of Bitcoin Savings and Trust had operated a Ponzi scheme that defrauded investors and awarded $40.7 million in damages following Securities and Exchange Commission charges of investment fraud.

On 6 August 2013, the US District Court for the Eastern District of Texas (the 'Court') found subject matter jurisdiction was properly held over a case brought by the Securities and Exchange Commission ('SEC') against a Texas based Bitcoin business, Bitcoin Savings and Trust ('BS&T'), and its owner, Trendon T. Shavers. (*SEC v. Trendon T. Shavers and Bitcoin Savings and Trust*, 2013 U.S. Dist. LEXIS 110018 (E.D. Tex. 2013)). The defendants in this case maintained a fund which invested in Bitcoin. The Court found that it had subject matter jurisdiction over the matter pursuant to the Securities Act of 1933 (the '33 Act') because the investments offered by BS&T were securities as they met the definition of 'investment contract.'

The Court noted that the term 'security' as defined in the 33 Act includes investment contracts, and held that investments in Bitcoin may, and in that case did, 'meet the definition of [an] investment contract, and as such, are securities.' In finding that bitcoins qualify as an 'investment contract,' the Court applied the Supreme Court's test from *SEC v. W. J. Howey Co.*, (328 U.S. 293) (1946).

The Howey test provides that an 'investment contract' is any contract, transaction or scheme involving: (i) an investment of money; (ii) in a common enterprise; and (iii) with the expectation that profits will be derived from the efforts of a third party. The *Shavers* court easily concluded that Bitcoin is money because it can be used to purchase goods or services. The Court found that prongs (ii) and (iii) were met because, in that case, in an apparent Bitcoin Ponzi scheme, the defendant had engaged investors to invest in Bitcoin, under his collective management, with the promise of interest returns upon redemption of an investor's Bitcoin investment. The Court found that Shavers and BS&T were selling a security, and was therefore able to find subject matter jurisdiction.

On 18 September 2014 the Court considered the underlying facts of the case. (*SEC v. Shavers, et. al.* 2013 U.S. Dist. LEXIS 130781 (E.D. Tex., Sept. 18, 2014)). During the period of February 2011 through to August 2012, approximately 80 individual investors suffered a collective net loss of 265,687 bitcoins or more than $87.4 million. Defendants noted a significant increase in the number of withdrawal requests from BS&T investors in July 2012. These requests were so significant that the amounts maintained by Shavers and BS&T were not sufficient to cover the requests. Unable to pay BS&T investors, in August 2012 BS&T was shut down. The Court granted the SEC's Motion for Summary Judgment against Shavers and BS&T, and found the defendants guilty of securities violations including engaging in a Ponzi scheme. The Court ordered the defendants to disgorge $38.6 million of illegal profits plus approximately $1.8 million in interest, imparted civil penalties of $150,000 against each of Shavers and BS&T, and issued permanent injunctions pursuant to the Securities Exchange Act of 1934 and the 33 Act.

Although the circumstances of this case are unique, the underlying holdings of the Court regarding the classification of Bitcoin have broad potential applicability. While the threshold question 'are Bitcoin legal?' has been answered by this Court, which noted that Bitcoin 'can be used as money' because it possesses attributes of a 'currency or form of money,' the larger question, 'how will the continued use and growing adoption of cybercurrency be assimilated into existing laws and regulatory schemes?' remains. Internal Revenue Guidance classifies cybercurrency as property for tax purposes, the US Treasury's Financial Crimes Enforcement Network ('FinCEN') guidance indicates that persons who exchange or administer the transmission, purchase or sale of virtual currency are considered 'money transmitters' under its regulations and are likely subject to the Bank Secrecy Act requirements. The New York Department of Finance has proposed regulations that would require special purpose 'BitLicenses,' and many other regulators have indicated their consideration of guidance or regulation regarding virtual currency. The outcome of this regulation remains to be seen, but what seems to be certain is that those engaged in Bitcoin trading, mining, and related business, whether with nefarious intent or not, must be mindful of the impact of new and existing regulatory requirements applicable to Bitcoin.

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