TEXAS CRYPTOCURRENCY JURISPRUDENCE

Examining the current legal framework.

WRITTEN BY **NELSON S. EBAUGH**

Some cryptocurrencies have a high market value, but many are worthless and outright scams. Hence the need for vigorous enforcement actions. At the same time, cryptocurrency market participants need guidance on how to comply with preexisting regulatory schemes. And courts must decide whether there is a Fourth Amendment right to privacy in a cryptocurrency transaction. Recognizing these and other issues presented by cryptocurrencies, Texas regulators, Texas lawmakers, and the U.S. Court of Appeals for the 5th Circuit have acted. This article examines the current state of Texas' cryptocurrency jurisprudence.

Before delving into the law, it is essential to have a basic understanding of blockchain technology (the foundation for cryptocurrency) and some of the different types of cryptocurrencies. To be sure, there are myriad ways to structure a cryptocurrency. But this article focuses only on those types of cryptocurrencies that the law is concerned with. After a brief explanation of the technology and the identification of a few cryptocurrency categories, this article examines the legal framework that Texas and the 5th Circuit have developed so far.

Blockchain technology and basic types of cryptocurrencies

The first cryptocurrency, bitcoin, sprang from the financial crisis of 2008. After the financial crisis, many expressed dissatisfaction with the traditional banking system. An anonymous person or group under the pseudonym Satoshi Nakamoto suggested bitcoin as an alternative to government-issued legal tender. One of the defining characteristics of bitcoin is that it is a virtual currency existing only on computers and the internet. There are no physical coins or bills. Each transaction of bitcoin is recorded on a blockchain, a permanent online ledger that is publicly maintained on a network of computers throughout the world.

The details of how the blockchain is maintained are beyond the scope of this article. However, it is worth mentioning that Nakamoto intended the structure of this new system to separate the control of bitcoin from any one country or governing body. In other words, a key feature of this digital currency is that it is "decentralized." In short, "[d]ecentralized cryptocurrencies are not created or issued by a particular person or entity, have no administrator, and have no central repository."[1]

Inspired by bitcoin, other cryptocurrencies popped up. In fact, there are thousands of cryptocurrencies now. However, the cryptocurrency market is largely dominated by just two cryptocurrencies, bitcoin and ether. Just as Coke and Pepsi dominate the cola market, bitcoin and ether dominate the cryptocurrency market.

Bitcoin and ether also distinguish themselves as being decentralized vis a vis other cryptocurrencies. In contrast, some cryptocurrencies are "centralized." A centralized cryptocurrency is managed by just one entity, usually the creator of the cryptocurrency. For example, Russia is planning to issue its own state-sponsored cryptocurrency, the CryptoRuble, that would be a centralized cryptocurrency.

There is one more type of cryptocurrency, commonly referred to as a "stablecoin," that warrants attention. A stablecoin strives to solve the problem of wild fluctuations in value that most cryptocurrencies experience. For example, over the past three years, bitcoin has skyrocketed from a value of about $10,000 to over $60,000, before falling to less than $20,000. With such wild fluctuations in value, bitcoin hardly makes a suitable currency. A stablecoin is designed to guard against such volatility by pegging its value to a more stable currency, like the U.S. dollar. The most popular stablecoin, tether, is backed 1-to-1 by the U.S. dollar.

Having set the stage, attention can now be turned to how Texas regulators, the Texas Legislature, and the 5th Circuit have begun to form a legal framework for cryptocurrencies.

Texas Department of Banking guidance

In 2014, the Texas Department of Banking, or TDB, became the first state bank regulator in the nation to provide guidance on when a cryptocurrency transaction falls within the state's money transmission statute.[2] In Supervisory Memorandum 1037, the TDB interpreted the state's existing money transmission statute to generally require licensure of third-party exchangers, including automated teller machines, that exchange cryptocurrency for government-issued currency.[3]

In 2019, the TDB amended Supervisory Memorandum 1037 to provide that any transaction involving stablecoins qualifies as a money transmission too.[4] In making this interpretation, Texas became the first state in the nation to specifically include stablecoins within its definition of "money or monetary value" under its money transmission statute.[5]

In sum, unless a third-party exchanger or a stablecoin is involved, cryptocurrency transactions generally do not involve the transmission of money in Texas for purposes of the state's money transmission statute.

Texas State Securities Board, or TSSB, and U.S. Securities and Exchange Commission, or SEC, regulate by enforcement

According to its website, "[t]he Texas State Securities Board was the first state securities regulator to enter an enforcement order against a cryptocurrency firm. . . ."[6] In 2017, the TSSB initiated its first regulatory sweep of cryptocurrency investment offerings.[7] In 2019, the TSSB conducted a second sweep of cryptocurrency investment offerings.[8] To date, the TSSB has entered more than 50 administrative orders involving individuals and entities.[9] In 2022, the TSSB announced "that investments related to cryptocurrencies and digital assets are [the state's] top investor threat."[10]

The definition of a "security" under the Texas and federal securities statutes includes the term "investment contract," a general catch-all.[11] Under this catch-all provision, the TSSB regulates "investments that claim to use virtual currencies in an investment program," but the TSSB does not purport to "regulate the cryptocurrencies themselves."[12]

The SEC also regulates investments tied to cryptocurrencies as investment contracts. But the SEC has gone one step further, claiming that many cryptocurrencies themselves qualify as securities because they are investment contracts, too.[13]

Initially, the SEC stated that at least a couple of cryptocurrencies do not qualify as securities. The former SEC chairman noted that because "[b]itcoin is decentralized, not centrally distributed, and functions like a sovereign currency," it does not appear to be a security.[14] Further, the former director of the SEC's Division of Corporation Finance stated "that in his view bitcoin and ether, the two leading cryptocurrencies, are not securities because they are sufficiently decentralized from a price-controlling entity. . . ."[15] But due to a recent upgrade to ether's validation process, the current SEC chairman recently remarked that ether might now qualify as a security.[16] To the frustration of many, the SEC has not taken an official position on which cryptocurrencies qualify as securities.

Similarly, the TSSB has offered no clear guidance on when a cryptocurrency qualifies as a security. In fact, the TSSB acknowledges that whether a cryptocurrency qualifies as a security is an open question.[17] In any event, even though the TSSB does not "regulate the cryptocurrencies themselves," the TSSB routinely brings enforcement actions concluding that an investment tied to a cryptocurrency is a security.[18]

In sum, the TSSB is regulating by enforcement. So is the SEC. Perhaps sometime soon regulators will provide clear guidance on how investments tied to cryptocurrencies can avoid running afoul of the law and clarity on which cryptocurrencies qualify as securities.

The 5th Circuit holds that a search warrant is unnecessary to examine the bitcoin blockchain and obtain transaction records from a virtual currency exchange.

In *United States v. Gratkowski,* defendant Gratkowski argued that the government's blockchain tracing and grand jury subpoena to a virtual currency exchange violated his Fourth Amendment right to be free from unreasonable searches and seizures. The 5th Circuit observed that Gratkowski's challenge presented it with "the novel question of whether an individual has a Fourth Amendment privacy interest in the records of their Bitcoin transactions."[19] Further, the 5th Circuit noted that no other circuit court had even addressed the issue yet.[20] The 5th Circuit ultimately held that Gratkowski did not have a reasonable expectation of privacy in either the bitcoin blockchain or the records kept by the virtual currency exchange he voluntarily chose to employ.

In sum, according to the 5th Circuit, there is no Fourth Amendment right to privacy in either the bitcoin blockchain or the records kept by a virtual currency exchange.

Texas lawmakers define "virtual currency" and provide guidance on how to perfect a security interest in cryptocurrency.

In 2021, Texas became one of the first states to amend its version of the Uniform Commercial Code, or UCC, to define "virtual currency" and explicitly set forth how to perfect a security interest in cryptocurrency.[21] Further, Texas passed a law to create a "work group on blockchain matters" to "develop a master plan for the expansion of the blockchain industry in [Texas] and recommend policies and state investments in connection with blockchain technology."[22]

In sum, the Texas UCC now specifically defines "virtual currency" and allows a security interest in such to be perfected by filing. Further, Texas could see state investments in connection with blockchain technology.

Conclusion

Texas regulators, Texas legislators, and the 5th Circuit have been working hard to keep up with the ever-evolving cryptocurrency industry. But the law is always one step behind the development of new technology. It will be interesting to see how Texas' cryptocurrency jurisprudence continues to grow as the cryptocurrency industry further develops. **TBJ**

NOTES

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NELSON S. EBAUGH
is an attorney in Houston. He has an LL.M. in securities and financial regulation and is certified in criminal appellate law by the Texas Board of Legal Specialization.