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## Digital currency: Scam or not? Money or not? (Part I)

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It's not quite a scam just yet, at least for the Securities and Exchange Commission (SEC), but it's illegal if it doesn't have SEC's approval.

Cryptocurrencies, also known as virtual money, have become so popular that regulators around the world are trying their best to catch up.

But whether or not regulators are succeeding remains to be seen. What is clear is that cryptocurrencies have become the Wild, Wild West of the financial world. When it was starting, it was a concept very alien to regulators.

They are, after all, outside the realm of the usually regulated products like stocks and bonds. Now, regulators around the

world are trying to catch up after some investors around the world lost money.

The Philippine SEC, the corporate regulator, is no exception. It has recently issued an advisory against initial coin offerings (ICOs). To show that it means business, the SEC issued a cease and desist order (CDO) against the ICO of Krops, a mobile app founded by businessman Joseph Calata. It said that Krops must first register with the SEC its token offering which was launched last year.

SEC commissioner Emilio Aquino said the SEC would also soon issue bespoke rules that would govern ICOs.

"It has to be within the year. We will come up with regulations. We are really trying to

come up with bespoke regulations for ICOs," Aquino said in a recent briefing.

### What is digital money?

Virtual currency refers to a digital representation of value issued and controlled by its developers and accepted by users. An ICO is the first sale and issuance of a new virtual currency to the public, usually for the purpose of raising capital.

### Digital money is a security

The SEC, like its US counterpart, has ruled that cryptocurrencies are securities and that they should be registered with the SEC.

The SEC argues that cryptocurrencies become a security if it includes an investment contract, which in turn, is presumed to exist

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whenever a person seeks to use the money or property of others on the promise of profits.

### Howey Test

Aquino cited the Howey Test in determining whether a product or offering is a security or not. He said the same would apply to ICOs.

"The SEC has adopted the Howey Test. The concept of securities is really by way of definition. An investment contract is one that qualifies under the Howey Test, in which case they have to be registered," Aquino said.

The Howey Test is a test created by the US Supreme Court for determining whether certain transactions qualify as "investment contracts."

In 1946, the US Supreme Court heard a case against Howey Corp. Two corporate defendants offered real estate contracts for tracts of land with citrus groves.

The defendants offered buyers the option of leasing any purchased land back to the defendants, who would then tend to the land, and harvest, pool, and market the citrus. As most of the buyers were not farmers and did not have agricultural expertise, they were happy to lease the land back to the defendants, according to *consumer.findlaw.com*.

But the US SEC sued the defendants over the transactions, claiming they broke the law by not filing a securities registration statement.

Thus, the Howey Test was born. Under this test, it was determined that a transaction is a security if it is an investment of money; there is an expectation of profits from the investment; the investment of money is in a common enterprise and any profit comes from the efforts of a promoter or third party.

If it's a security, issuers then have to comply with the registration and disclosure

requirements, the SEC's Aquino said.

"There is a possibility the commission will grant them such an authority. The mindset of the commission has always been to foster innovation and allow beneficial means or ways to raise capital," he said.

### Not an outright ban

Aquino said the SEC is open-minded and recognizes the advancement in technology and how it can help Filipinos.

"It is not an outright ban like in China and South Korea," he said.

### Protecting Filipinos

But Aquino acknowledges, the SEC needs to protect Filipino investors.

"We're not trying to put a stop to technology. We're trying to address bad behavior," he said.

As such, he said, as far as the Philippine SEC is concerned, it needs to protect Filipinos everywhere.

"Issuers can put any disclaimer. But as regulators we have to scrutinize that," he said.

"These cryptocurrencies, ICOs - these are new frontiers. A lot of our *kababayans* don't know the risks involved, so we have to come in. As regulators, we have to ensure that certain safeguards are in place. We have to take steps. These are calculated steps," Aquino added.

### Krops

He said Krops is the first ICO in the Philippines and it's very pronounced.

"On our part we had to act accordingly," he said.

Calata, the man behind KROPs, said it would comply with the SEC's order but lamented the issuance of the CDO.

"While I would have wanted my fellow Filipinos to continuously be part of this major breakthrough in the world of agriculture, it is lamentable that the Philippine SEC is currently moving to unduly regulate the global ICO of Krops and has even hastily issued a CDO against our ongoing sale. To be clear, we understand that the CDO was just an order to stop the sale of Kropcoins

only to Filipino nationals.

The Philippine SEC cannot prohibit the sale to other nationalities because this is not under their jurisdiction. The CDO also does not stop the operation of the Krops application which serves as the daily virtual agricultural market place of all buyers and sellers of agricultural products," Calata said in a letter given to ICO participants.

But Aquino said that is the direction - to regulate ICOs - taken by regulators around the world.

"All our counterparts, that is the direction we're taking. As I said, it's not just in the Philippines, but all over the world," he said.

Asked why the SEC seemed to have reacted late in the day on the Krops ICO, Aquino said the commission had already issued a warning before it issued a CDO.

"Actually we're not really late. We are more or less on the same footing as the rest of our counterparts," he said.

Aquino acknowledges virtual currency is new thing, so regulators face the same dilemma.

But the bottomline is that for the SEC, ICOs are securities that should be registered with the SEC.

### Security versus utility

Sought for comment, John Lilib, director for enterprise business technology development strategy and operations at ConsenSys, a blockchain software technology company, gave this statement to **The STAR**:

"In very simple terms this boils down to whether a token has utility and is necessary to the functionality of the system it is issued against. For example, Ether is not a security because it is the fuel that pays the Ethereum network miners to run the computational steps required for decentralized applications and smart contracts to execute within the full security of the network. The utility of Ether is something similar to needing a token to play an arcade game back in the day. You need the token in order to run your software on the network and this dynamic is very different from a purely financial instrument that might otherwise not pass the Howey Test, in which case it would both need to be registered with the SEC and fall under the jurisdiction of the SEC."

He said Ether itself has been interpreted to pass the Howey Test, which is why the SEC is okay with it.