



REGULATION OF VIRTUAL CURRENCIES

Cryptocurrencies as Payment Instruments and global regulatory responses

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INTRODUCTION

What is a cryptocurrency?

- European Banking Authority defined a virtual currency as "a digital representation of value that is neither issued by a central bank or public authority nor necessarily attached to a fiat currency, but is used by natural or legal persons as a means of exchange and can be transferred, stored or traded electronically".
- Cryptocurrencies often take the form of a cryptographically secured virtual currency and are almost always decentralised.
- There are currently several thousand different cryptocurrencies (sometimes interchangeably referred to as tokens or coins), constituting a significant asset class. In this area, the technological innovation and the rate of adoption far outpaced the development of legal and regulatory frameworks.



Types of crypto assets

- There is a great variety of crypto assets and there can be many ways to classify them. A Swiss financial regulator FINMA, for example, broke them down into three not mutually exclusive categories:
 - **Payment tokens:** Bitcoin and similar cryptocurrencies that are intended to be used as a means of payment for goods or services. Cryptocurrencies do not entail any claims on their issuers.
 - **Utility tokens:** Utility tokens are designed to give their holders access to blockchain powered services or platforms. They also create no claims on the issuers.
 - **Asset tokens:** Tokens that represent debt or equity claim on the issuer come under this category. Asset tokens are very similar to traditional securities by promising a share in the growth, development or profitability of the project. Tokens that allow physical assets to be traded are also included in this category.
- The regulators across the globe expressed the most interest in the latter category as the asset tokens most closely resemble the financial instrument currently regulated and may be captured by existing legislative frameworks.



Payment tokens = money?

- Do cryptocurrencies fare any better in economic terms? According to Mark Carney, the Governor of the Bank of England, the answer is no. In a recent speech, Mr Carney argued that cryptocurrencies perform poorly under the three classical criteria describing what "money" should be able to do. In Mr Carney's opinion:
 1. Cryptocurrencies do not function well as a **store of value**. Very high volatility and wild swings in the price of one of the more stable cryptocurrencies, bitcoin, disqualify them on this measure. What is more, although the supply of some tokens may be limited, frequent "forking" might be akin to bad old currency debasement;
 2. As a **means of payment**, crypto assets currently do not offer a great deal. Even bitcoin, the most popular cryptocurrency can only be used to pay in a very small proportion businesses. The speed and the cost of transacting in bitcoin competes very unfavourably with the established payment methods.
 3. There is very little evidence of cryptocurrencies being used as a **unit of account**. Even the businesses that accept cryptocurrencies as payment frequently update the price to reflect a constant fiat value of goods or services. The Bank of England is also "not aware of any business that accepts Bitcoins in payments that also maintains its accounts in Bitcoin".

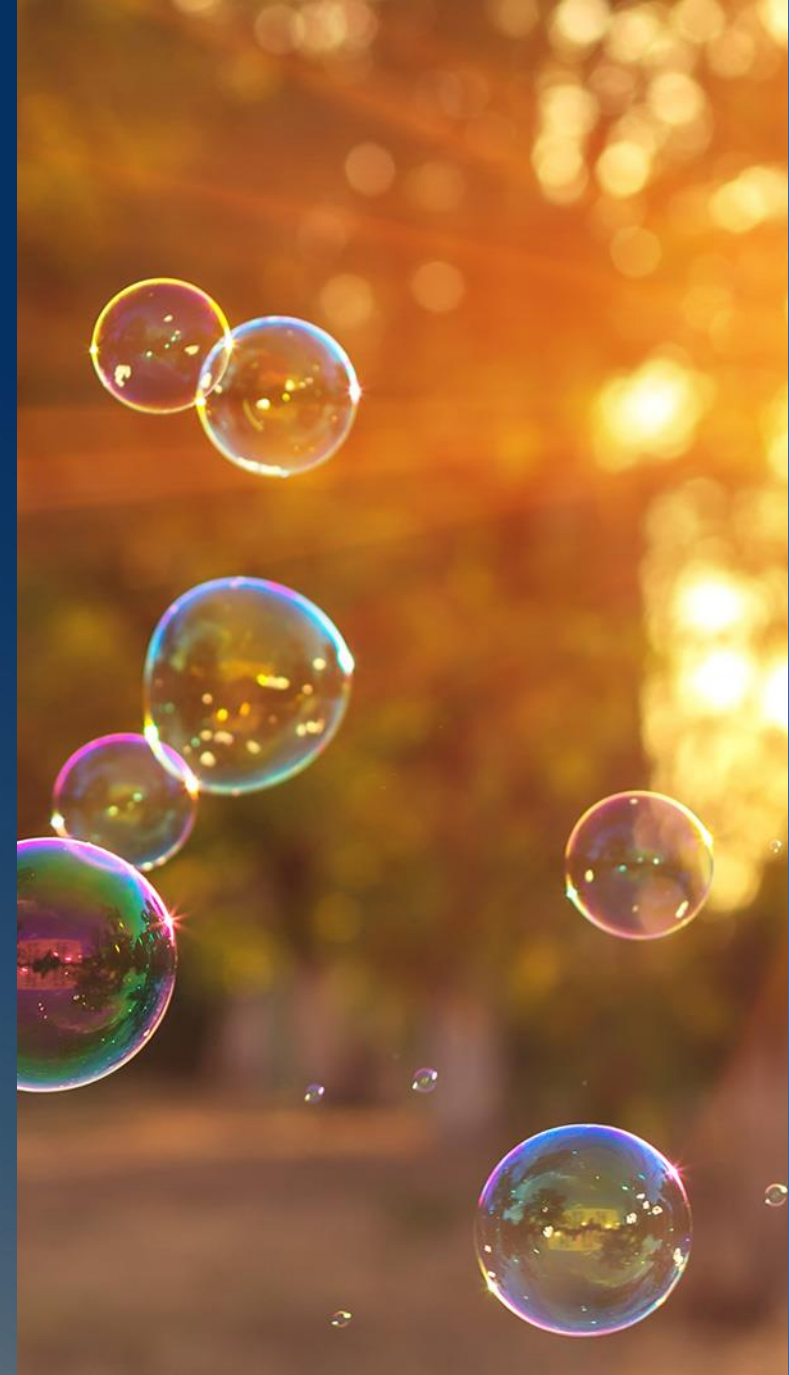


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Why regulate?

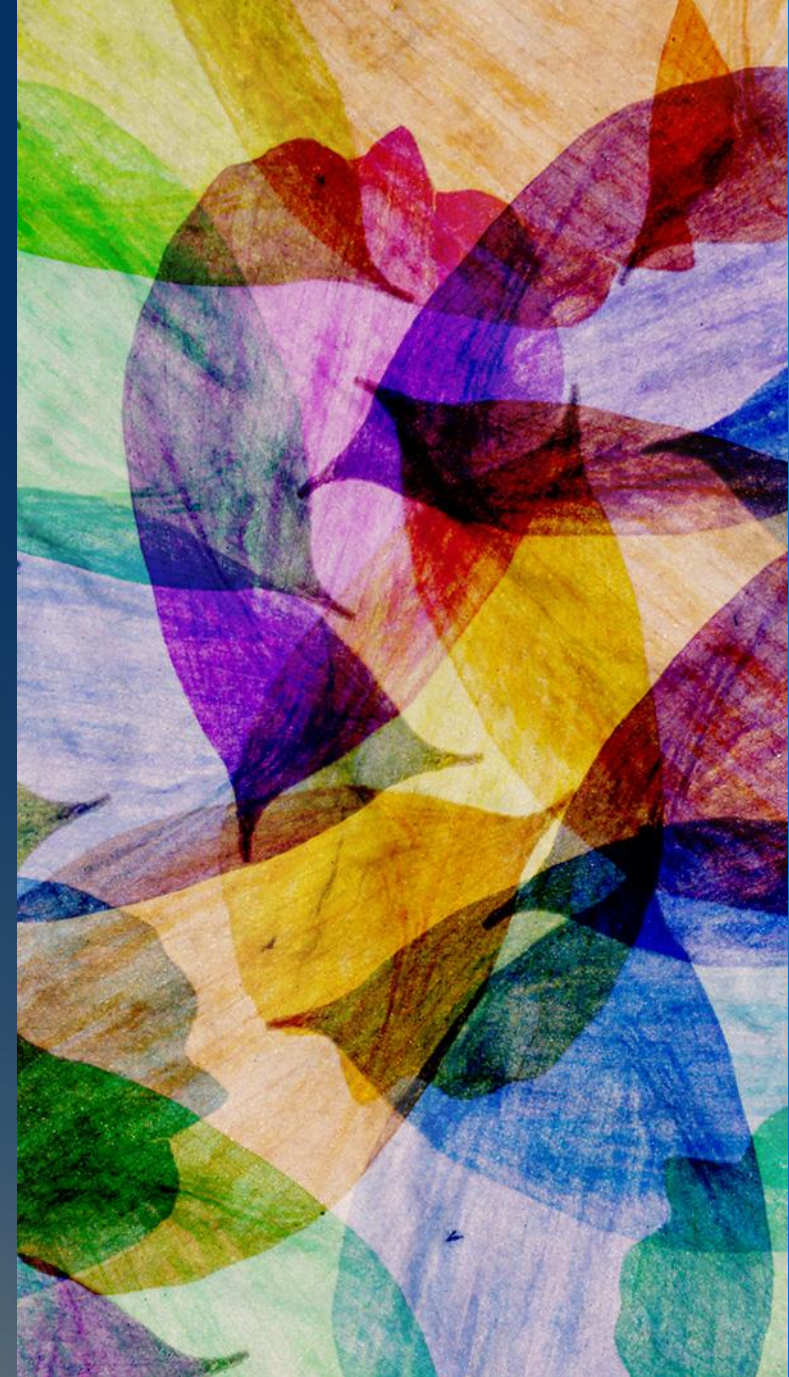
Regulatory rationales

- In some cases, buying cryptocurrencies is just like investment in traditional financial assets, vulnerable to the same types **abusive behaviour** like market manipulation, fraud, ponzi schemes, etc. It is not just the sinister conduct that causes concern, jokes can also lose investors money – Dogecoin, PonziCoin.
- Just like the conventional assets, cryptocurrencies are vulnerable to be exploited for **money laundering, terrorist financing and other criminal ends**. Some cryptocurrencies can provide anonymity and are difficult if not impossible to trace, making them particularly "suitable" for such criminal enterprises.
- Crypto assets have proven to be popular with **retail investors**, a group historically enjoying the high level of regulatory protection, especially in the context of complex, risky and volatile instruments.
- Authorisation, personal accountability, mandatory disclosure and other similar rules guarantee a certain level of propriety and dramatically reduce the extent of due diligence, **reducing transaction costs**.
- Crypto assets are increasingly being experimented with by mainstream financial institutions and being made available to their clients. Although currently cryptocurrencies relatively small, if linked to the key parts of financial system, they can introduce another poorly understood **risk to the global financial stability**.



Flavours of regulation

- There are various types of regulation that can be applied to a relatively new and unfamiliar industry or asset class. These are not necessarily mutually exclusive, and will often be used in concert, each performing its particular role. Broadly, the regulation can come in the form of:
 1. Top-down rules
 2. Bottom-up initiatives
 3. Lateral regulation



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Recent legal and regulatory developments

Supranational developments

- European Commission Action Plan on fintech: the Commission is not rushing to regulate cryptocurrencies but encourages coordinated supervision and explores the use cases for DLT in cross-border services and information storage.
- Warnings from most major national and international bodies highlighting the volatility, lack of disclosure, fraud and other risks associated with investing in cryptocurrencies.
- In a letter to G20, the FSB said that "crypto-assets do not pose risks to global financial stability at this time". The G20 itself did not announce any international regulatory initiatives, but asked the FSB, international standard-setting bodies and the FATF "to report in July 2018 on their work on crypto-assets".
- Christine Lagarde, the IMF Managing Director, said in February that regulatory action on cryptocurrencies is "inevitable". Later, in March, Mr Lagarde again highlighted the risk this sector poses in a blog post on the "Dark Side of the Crypto World".

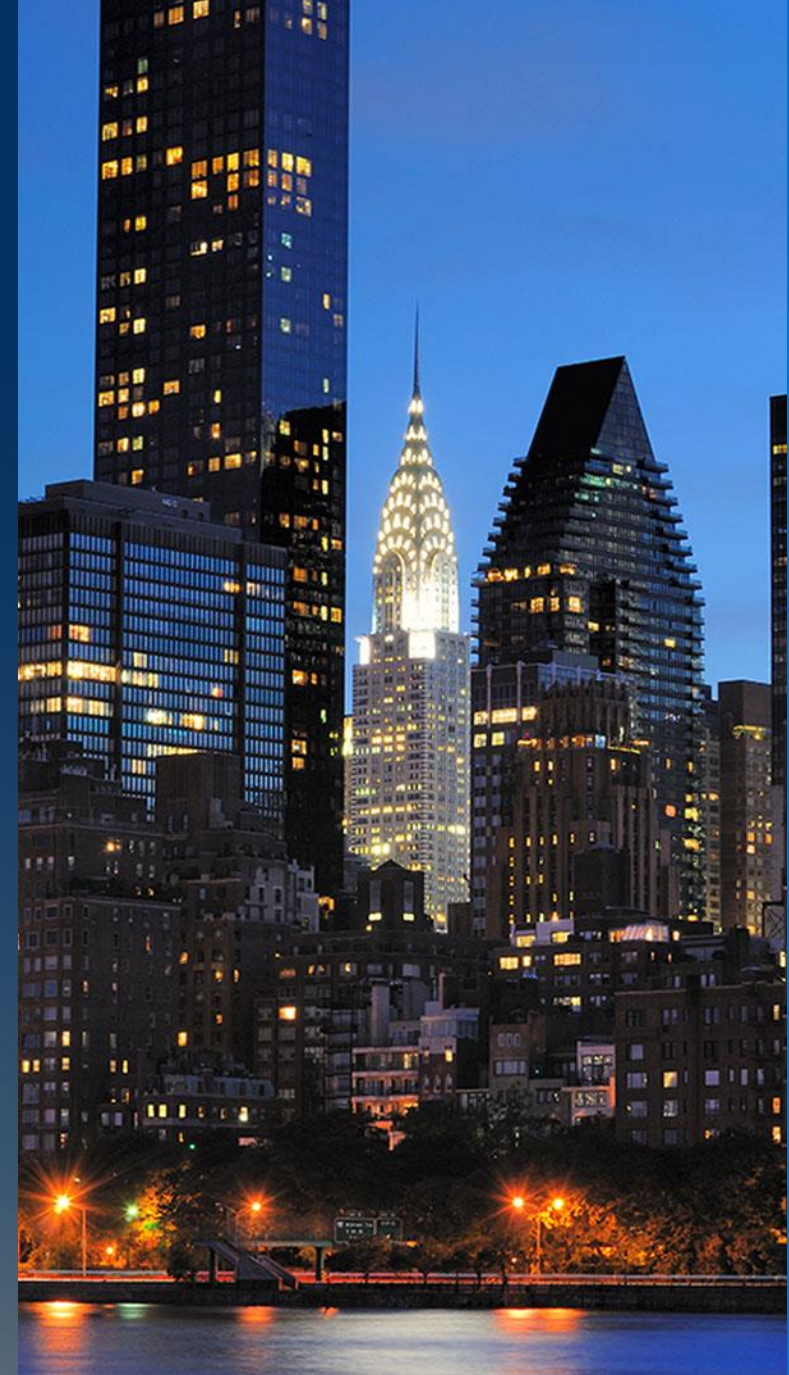


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Comparative assessment between
selected jurisdictions

1. The US

- The Commodity Futures Trading Commission (CFTC) declared that virtual currencies are **commodities** as early as 2015. This classification was confirmed by a New York court in a suit initiated by the CFTC against Patrick K. McDonnell and His Company CabbageTech, Corp. d/b/a Coin Drop Markets.
- In 2014, the Internal Revenue Service issued a notice clarifying that it will treat virtual currencies as **property** for the purposes of assessing the tax liability.
- The Financial Crimes Enforcement Network (part of the United States Department of the Treasury) published a letter in February 2018 classifying token issuers and exchanges as "**money transmitters**", thus requiring them to register as such and comply with the relevant anti-money laundering and know-your-customer rules. Failure to do so, can lead to criminal action.
- Cryptocurrencies can be **securities** if they satisfy the ordinary definition of a security (qualifying as an investment contract under the "Howey test"). However, the Chairman of the Securities Exchange Commission (SEC), Jay Clayton, recently said the following at the Senate hearing: "I believe every ICO I've seen is a security".
- Although securities law is a federal matter, the legislature of Wyoming recently passed 5 cryptocurrency related bills, setting out, among other things, an exemption from the state securities legislation for a category of tokens often referred to as "**utility tokens**".
- Gemini, a cryptocurrency exchange, proposed on 13 March to create a **self-regulatory** body to develop and maintain the standards in the industry.



2. The UK

- The UK regulators refrained from putting cryptocurrencies in any specific legal category, opting instead for a "technologically neutral" approach and **applying existing legislation** and guidance to cryptocurrencies and ICOs on a case by case basis. The FCA considered the issue in a recent discussion paper and concluded that new rules are not required at the moment.
 - Expressing a different viewpoint, the Governor of the Bank of England, Mark Carney, in a recent speech called for "[b]ringing crypto-assets onto a level regulatory playing field" with other **financial instruments**.
- Although cryptocurrencies are not regulated per se and are not considered by the FCA to be currencies or commodities under MiFID II, **derivatives** that use cryptocurrencies as the underlying investment are regulated by the FCA. Similarly, depending on the particular characteristics of a cryptocurrency, it may come within the scope of securities, funds, payments and other regimes currently in force in the UK.
- For **tax** purposes, the HMRC guidance provides that virtual currencies will generally not be subject to VAT, but will be subject to Income/Corporation tax and Capital Gains Tax.
- In February 2018, Coinbase, eToro, CryptoCompare, CEX.IO, BlockEx, CoinShares and CommerceBlock established a **self-regulatory** body called CryptoUK to improve industry standards and engage policy makers. CryptoUK has already issued a code of conduct.
- The UK Parliament has recently launched an **inquiry into digital currencies** and DLT. It will focus on the role and impact of digital currencies on the UK economy and the regulatory response of the UK authorities to digital currencies. The Government has also launched a **Cryptoassets Task Force** consisting of HM Treasury, the Bank of England, and the Financial Conduct Authority.



3. Germany

- Unlike in the US and the UK, for tax purposes bitcoin and other virtual currencies are treated as the "means of payment" by the German authorities, which means that capital gains on virtual currencies are not taxable. However, **VAT** legislation will apply to virtual currencies transactions.
- According to the legally binding decision of Federal Financial Supervisory Authority (BaFin), bitcoins (and any similarly structured cryptocurrency) are units of account and therefore **financial instruments**, but they do not come within the definition of e-money.
- According to the regulator, simply using virtual currencies as a substitute for cash or deposit money to participate in exchange transactions as part of the economic cycle does not require authorisation.
- However, in certain circumstances, trading virtual currencies will require authorisation, for example in the cases of **multilateral exchanges or brokers**.



4. The EU

- The amendment to the EU Fourth Money Laundering Directive will extend the application of **AML** and **KYC** rules to cryptocurrency exchanges.
- According to Mario Draghi, it is "not the ECB's responsibility" to regulate bitcoin and other cryptocurrencies.
- In an unrelated statement, Mr Draghi also said that Eurozone members are not allowed to issue **sovereign cryptocurrencies** as they would compete with Euro.
- ECB has been conducting exploratory research into the idea of **Central Bank Digital Currency**, but did not make any proposals.
- In response to a parliamentary question, the Commission explained that it has **no legal basis** to monitor or limit the amount of energy used to mine cryptocurrencies.
- Crypto assets, depending on how they are structured, may be covered by EU legislation on **alternative investment funds**, **payment services** and **e-money**.



Friend or Foe?

- **China** has banned ICOs and cracked down on exchanges, creating one of the most hostile regulatory jurisdictions in the world.
- **South Korea** also imposed a ban on ICOs but is considering their legalisation under appropriate regulation.
- **Russian** legislature is currently considering a draft bill "On Digital Assets". It states that digital financial assets (DFAs) (including cryptocurrencies) are not a legal means of payment and the only transactions in DFAs permitted are with a newly defined "digital financial assets exchange operator" that must be a legal person established in accordance with Russian securities legislation. Peer-to-peer transactions appear to be banned. Further, persons that are not "qualified investors" can only invest up to RUB50000 in any ICO.
- **Gibraltar** is holding itself out as a friendly place for launching ICOs. In March, it issued a white paper outlining its proposed regulatory regime for promotion, sale and distribution of tokens, as well as the operation of secondary markets and provision of token-related investment services.
- **Malta** is also consulting on a virtual currency and ICO legislative and regulatory framework, designed to contribute to a very friendly stance that has already attracted the largest and second largest cryptocurrency exchanges by volume.
- **Estonia** is a very enthusiastic about blockchain and cryptocurrencies, including a state cryptocurrency. It is transferring various government services on blockchain and has established an e-Estonia platform, including an e-Residency service that provides a digital business domicile for companies.
- Dubbed an aspiring "crypto-nation" by its economics minister, **Switzerland** hosts a large number of cryptocurrency projects in Zug, a bitcoin-friendly town. The Swiss financial regulator issued guidance explicitly stating that payment and utility tokens are not considered to be securities.



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Analysis of the primary challenges for the near future

Challenges

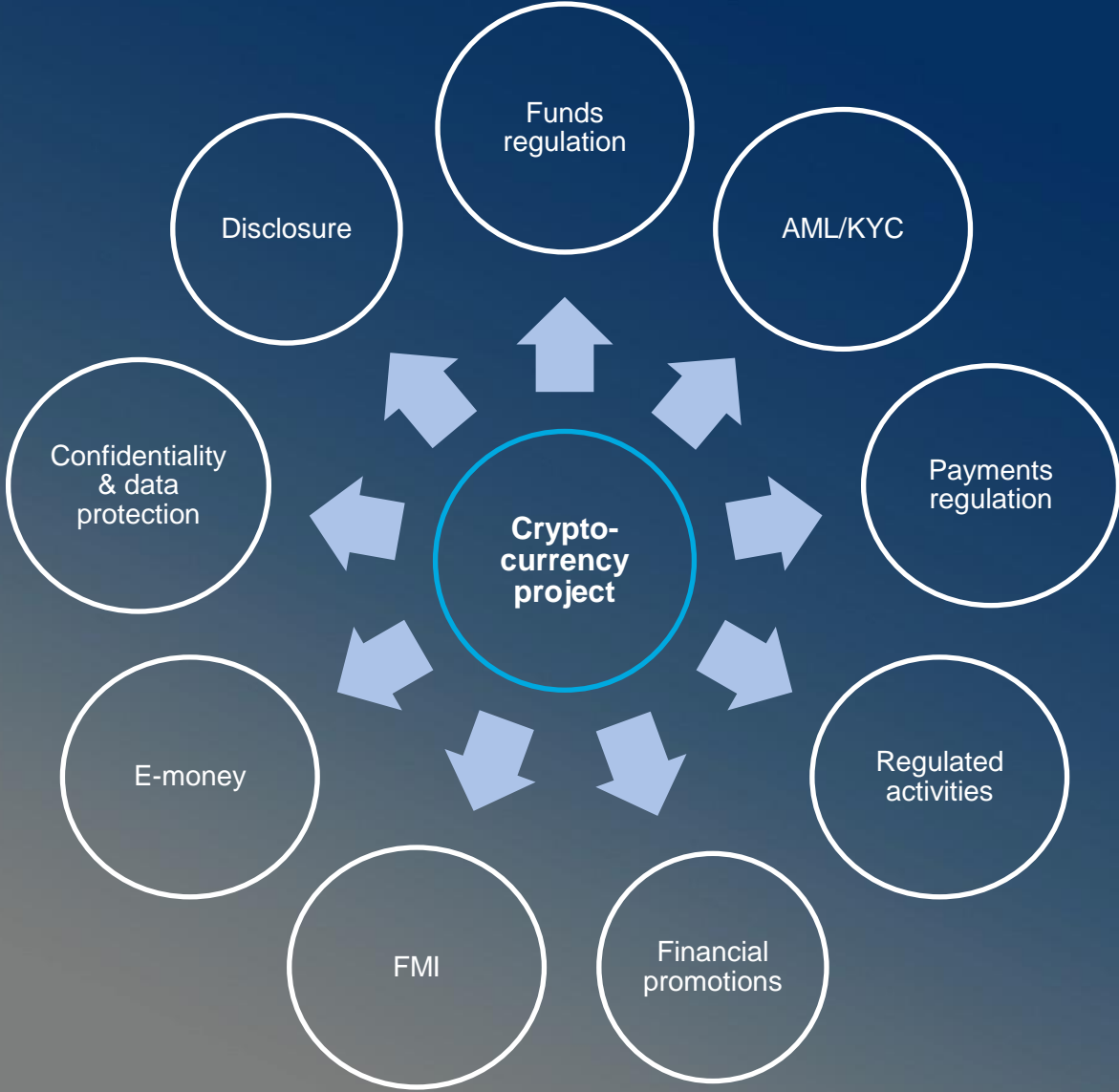
- One of the hallmarks of the rise of cryptocurrencies is the involvement of non-institutional players. **Safeguarding the retail investors** from the risks of fraud, extreme volatility and lack of disclosure has been identified by the regulators as the primary challenge in the short term.
- The development of **internationally harmonised rules** to classify virtual currencies for securities accounting and tax purposes is another challenge currently facing the regulatory and legislative bodies.
- A key challenge for the longer term as to decide whether the **integration** or **isolation** of cryptocurrencies from the traditional financial system is the best way to exploit the opportunities and combat the risks.
- For the regulatory authorities, the concern is to reconcile the limited jurisdictional reach of their powers with international (**anational**) and distributed nature of the cryptocurrency sector. The transnational nature of cryptocurrencies complicates the task by requiring almost universal consensus among the states holding radically different positions on cryptocurrencies.
- The **downsides of immutability**: German researchers have found files links to potentially illegal pornographic material on the bitcoin blockchain. This may prompt the national regulators to effectively outlaw bitcoin mining which requires possession of the entire blockchain (including illegal material). There is also a clash between immutability of the ledger and the need to unwind transactions linked to criminality or terrorism. Is the "right to be forgotten" compatible with an unalterable blockchain?
- Bitcoin mining is estimated to make up 0.13% of global **energy consumption**. Although the percentage is small, if bitcoin miners were a country, it would rank 61st in energy consumption (ahead of Ireland and 132 other states).



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Regulatory Aspects to be aware of

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”

CONNECTING THE DOTS

40+

Countries

90+

Offices

#1

Global M&A deal volume

\$2.47

Global revenue in \$USD billions for 2016

239K

pro bono and community engagement hours donated in 2016

LAW FIRM OF THE YEAR

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Real Estate
Intellectual Property
Franchise
Entertainment
Pro Bono

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GLOBAL PRACTICE AREAS

Corporate
Employment
Finance and Projects
Intellectual Property and Technology
Litigation and Regulatory
Real Estate
Restructuring
Tax

15

GLOBAL SECTORS

Consumer Goods	Insurance
Energy	Life Sciences
Financial Services	Manufacturing
Government Contracting	Media, Sports and Entertainment
Healthcare	Mining
Hospitality and Leisure	Real Estate
Infrastructure, Construction and Transport	Retail
	Technology

Any Questions?



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