Regulating cryptocurrencies

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Overview

- What are cryptocurrencies (CCs)?
- Why regulate cryptocurrencies?
- Regulatory initiatives in the US and the EU
- Challenges to regulators

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What are cryptocurrencies?

- <u>N.Y. BitLicence</u> : Virtual Currency means any type of digital unit that is used as a medium of exchange or a form of digitally stored value. Virtual Currency shall be broadly construed to include digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository or administrator; or (iii) may be created or obtained by computing or manufacturing effort.

- <u>Japan, Payment Services Act 2016</u> : (i) property of value, (ii) usable for payment to unspecified persons, (iii) purchasable from and sellable to unspecified persons and (iv) transferable by electronic processing devices.

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- ECB (2015) : "A digital representation of value, not issued by a central bank, credit institution or e-money institution, which in some circumstances can be used as an alternative to money."

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Currency, security, or commodity?

- From a legal standpoint: CCs are **neither money, nor currency**

    Currency (legal tender): medium of exchange, unit of account, store of value : No CC strictly satisfies all the above criteria.

    Mario Draghi & Janet Yellen: the ECB & the Fed have no authority to regulate CCs.

- CJEU : Case C-264/14, Skatteverket v David Hedqvist, (22 Oct 2015):

    ‣ Bitcoin is **a means of payment** & not a security

- different from e-money:
    - e-money: par value with fiat money;
    - cryptos: floating rate against fiat money

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Security?

ICO or network token presale: "an event in a project that uses cryptographic tokens where part of its token pool is exchanged for money, typically Bitcoin, to a community of developers and early adopters." e.g., Ethereum, DAO, Mastercoin (now Omni)

U.S. Securities and Exchange Commission (SEC) July 2017 :

DAO token platforms = exchange for securities

Howey test (SEC v. Howey) for identifying an investment contract (security):

1. Investment of money (& other assets),
2. Expectation of profits from the investment,
3. Common enterprise,
4. Profits coming from the efforts of a promoter or third party.

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Commodity?

U.S. Commodity Futures Trading Commission (**CFTC**) :
Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan (Sept. 17, 2015)

"Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities."

Section 1a(9) Title 7 U.S.Code "The term 'commodity' means wheat, cotton, rice, … , and **all other goods and articles**, … and **all services, rights, and interests** … **in which contracts for future delivery are presently or in the future dealt in."**

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The Bitcoin Ecosystem

1. inventors/developers
2. issuers
3. miners
4. processing service providers
5. users
6. wallet providers
7. exchanges/trading platforms
8. other service providers

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Why regulate cryptocurrencies?

Risks

EP report on virtual currencies

- Consumer or user protection problems

- High volatility & potential for speculative bubbles

- Black market transactions, money laundering & terrorist financing, tax fraud, and evasion, etc.

- Lack of transparency on the technical documentation regarding the functioning of the CCs

- Legal uncertainty

- Limited regulatory capacity in new technology

- Energy consumption (proof of work, proof of stake, proof of burn) —> more efficient forms of transaction verification

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Specific concerns for central bankers

- Monetary policy and price stability

- Financial stability

- Smooth operation of payment systems

Opportunities

- Faster & more cost effective payment solutions
- Promoting financial innovation

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Regulatory initiatives

- **Application of non-crypto laws:**

    - US: CFTC on Coinflip & SEC on DAO

    - Switzerland on E-Coin: the QUID PRO QUO Association engaged in activities "similar to the deposit-taking business of a bank" which is illegal unless the company holds a banking license.

    - Bitstamp Europe S.A. licensed by the CSSF (Register of payment institutions authorised in accordance with the law of 10 November 2009 relating to payment services)

    - Italy on OneCoin (Ponzi scheme); CSSF Warning on OneCoin

- **New crypto-legislation !!!**

    - US: NY BitLicense

    - Japan: Payment Services Act 2016

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EU regulatory initiatives

- Smart regulatory hands-off approach

  - EBA Warning (4 July 2014): Banks better stay away from CCs until regulation is in place

- AML/CFT

  - Amendement of 4th AML Directive : providers of exchange services between virtual currencies and fiat currencies and custodial wallet providers become "obliged entities"

    - EC (2 February 2016): "Action Plan to strengthen the fight against the financing of terrorism" (proposal to regulate the Custodian Wallet Providers (CWPs) and Virtual Currency Exchange Platforms (VCEPs))

    - EP (3 May 2016): Draft report on virtual currencies (2016/2007(INI)) Committee on Economic and Monetary Affairs (Rapporteur: Jakob von Weizsäcker)

    - EC, Proposal (COM(2016) 450 final) of July 5, 2016 for a Directive amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/E

- PSD 2 ?

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Challenges to regulators

- **anti-institutionalism of permissionless blockchains**

- **jurisdiction for global blockchains**

- **strategies to support disruptive technologies**

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Anti-institutionalism of permissionless DLTs

- who can/should be regulated ?
  - exchanges as interfaces between CC / fiat money
  - wallet providers
  - scheme governance authority (EBA, 2014)
- governance v. regulation
  - promoting self-governance
  - public standards/legal requirements for technical codes

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Jurisdiction for global DLTs

- limitations to national jurisdictions

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Regulatory strategies for disruptive tech

- **Smart regulation** :
  N. Gunningham and P. Grabosky, Smart Regulation: Designing
  Environmental Policy (Oxford: Clarendon Press, 1998)
  Zetzsche, Buckley, Arner & Barberis, Regulating a revolution 2017)

  - **Laissez-faire vs. regulatory clampdown** (preemptive & heavy-handed regulation)

  - **Command-and-control** (e.g., outright ban) **vs. economic instruments**

  - **Cost/benefit analysis**

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Supporting disruptive technologies

- **Design-based /Techno-regulation** (Lessig 1996, 1999, 2006)
    - requiring a certain % for transaction verification process (consensus mechanism/arbitration rules),
    - account segregation reqs/separation of clients accounts,
    - IT security requirements,
    - Separation of CC schemes from conventional payment systems.

- **Partial industry regulation** (Ayres & Braithwaite, 1992) e.g., regulating certain CCs to promote competition and race to the top by setting higher standards or probity, etc.

- **Pyramid approach**: escalating regulatory response using instrument sequencing, (e.g., Regulating CCs by the number of their user base/user adoption)

- **Regulatory sandbox approach**

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