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A Legal Analysis on The Worldwide Regulations of Cryptocurrencies

Introduction

The blockchain, being, in plain terms, a decentralized and cryptographic ledger of immutable data records replicated and distributed to each node of a peer-to-peer network, has begotten a considerable number of present and potential developments and applications over and above its initial focus on an avant-garde currency. Since the outset of the virtual currency (or cryptocurrency) named "Bitcoin", there have been a tremendous amount of discussions and speculations pertaining thereto. However, Bitcoin is not the only cryptocurrency as of today. Since the introduction of Bitcoin in 2008, many other virtual cryptocurrencies have been devised and numerous regulatory public positions have been adopted on these cryptocurrencies. Nonetheless, due to the fact that these cryptocurrencies are not created by a public entity or by banks, there is still ambiguity with respect to their legal and economic qualifications.

Beyond all this bewilderment and perplexity regarding the said cryptocurrencies, the progressive use of blockchain has induced a lot more of confusion on the recent developments. The blockchain has extended beyond its monetary usage and is now moving into record keeping and law. However, for maintaining a well-focused analysis on the most controversial medium of blockchain, namely the cryptocurrencies, the scope of this article is limited with the

legal aspects of cryptocurrencies and worldwide regulators' opinions and positions thereon.

Bitcoin and Other Cryptocurrencies

Bitcoin is the world's first digital, private cryptocurrency that is exchanged over the internet through the use of a peer-to-peer network. Bitcoin doesn't have any intrinsic value; and there is no government, institution or an independent organization upholding its value or monitoring its use. Instead, Bitcoin is facilitated on a peer-to-peer network to gain value through demand and maintains security through data-recording in this network.

Bitcoins are distributed into the market through the operation of software. This software tracks transaction blocks and adds them to a chain. However, this process is not a facile and an easy operation. The members of this chain using the software in question, have to take the time to compute the activities with respect to the operation of the network and produce a block which rewards them with Bitcoins. This process is called Bitcoin mining. Basically, the value to the person who acquires Bitcoins through the said mining process is determined with the value of his hardware required to execute the mining process and additionally the amount of time and energy spent. Public blockchain networks guarantee that all members thereof operate a completely identical database representing every single transaction bundled in blocks; and thus, everyone can see the transactions made with Bitcoins and other virtual currencies.

European Central Bank ("ECB") classifies virtual currencies under three types. First type is "closed virtual currency schemes." These schemes have almost no link to the real economy and are sometimes called "in-game only" schemes. In this system, users normally pay a subscription fee and then earn virtual money based on their online performance. This type of virtual currency can only be spent by purchasing virtual goods and services offered within the virtual community and, at least in theory, it cannot be traded outside the virtual community.

Second type of virtual currencies is named "virtual currency schemes with unidirectional flow." This type of virtual currency can

be purchased directly using real currency at a specific exchange rate, but it cannot be exchanged back to the original currency. In this system, the conversion conditions are established by the scheme owner.

Third and the last type of virtual currencies is "virtual currency schemes with bidirectional flow." Users can buy and sell this virtual money according to the exchange rates with their currency. This virtual currency is similar to any other convertible currency with regard to its interoperability with the real world. These schemes allow for the purchase of both virtual and real goods and services.

Regulatory Trends on Cryptocurrencies

I. US Regulations

Cryptocurrencies are regulated both at the federal and the state level in United States. In terms of its federal regulation, different regulators have tackled the matter.

The first US federal statement on cryptocurrencies was issued by the Financial Crimes Enforcement Network ("FinCEN") in March 2013.[1] On the contrary to FinCEN's currency definition, which is "the coin and paper money of the United States or of any other country that (i) is designated as legal tender and that (ii) circulates and (iii) is customarily used and accepted as a medium of exchange in the country of issuance", FinCEN has defined virtual currencies as "*a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender in any jurisdiction.*"

Later in March 2014, Internal Revenue Service ("IRS") has issued a notice on cryptocurrencies relating to taxational issues and stated, "For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to using virtual currency." therein.[2] Additionally, IRS declared that it does not regard cryptocurrency as a foreign currency, therefore, it

[1] Financial Crimes Enforcement Network, Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging or Using Virtual Currencies, FIN-2013-G001, 18 March 2013.

[2] Internal Revenue Service, Notice 2014-21, IR-2014-36, 25 March 2014.

cannot generate foreign currency gain or loss for U.S. federal tax purposes.

In September 2015, the Commodity Futures Trading Commission ("CFTC") has ruled by a settlement order that cryptocurrencies are encompassed in the broad definition and properly defined as commodities, thus being covered by the Commodity Exchange Act, and defined not as real currencies.[3]

The most awaited analysis on cryptocurrencies being that of the Securities and Exchange Commission ("SEC") was published in July 2017.[4] In its report, SEC has stated that certain types of virtual tokens can be considered as securities under the Securities Act and Securities Exchange Act. Furthermore, SEC has, therein, defined cryptocurrencies as "*a digital representation of value that can be digitally traded and functions as: (i) a medium of exchange; and/or (ii) a unit of account; and/or (iii) a store of value, but does not have legal tender status in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency, and is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.*"

II. EU Regulations

Abovementioned opinions of US regulators have greatly influenced the regulators in the EU region. However, even before the FinCEN's statement issued in March 2013, the European Central Bank ("ECB") enounced its position with respect to cryptocurrencies.[5] In its report ECB defines cryptocurrencies as "*a type of unregulated, digital money, which is issued and usually controlled by its developers, and used and accepted among the members of a specific virtual community.*"

[3] Commodity Futures Trading Commission, In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29., 17 September 2015.

[4] Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207, 25 July 2017.

[5] European Central Bank, Virtual Currency Schemes, October 2012 (updated in February 2015).

Following the ECB report, the European Banking Authority ("EBA") issued a statement in December 2013[6] and an opinion in July 2014[7], addressing the EU institutions and national regulators, which called for a comprehensive virtual currency regulatory approach for the long term. EBA had a critical approach to virtual currencies and warned consumers and institutions regarding its potential risks. Mainly, EBA discouraged financial institutions from buying, holding or selling virtual currencies until substantial regulations are adopted. Beyond this, EBA listed numerous risks in its reports such as: "(i) Criminals are able to launder proceeds of crime because they can deposit/transfer virtual currencies anonymously, (ii) Users holding virtual currencies may unexpectedly become liable to tax requirements, (iii) Users suffer loss due to changes made to the virtual currency protocol and other core components, (iv) Users lose virtual currency units through e-wallet theft or hacking" etc. EBA has also expressed that EU legislators should take immediate measures in short-term, and in particular should declare virtual currency market players, such as virtual currency exchange platforms and custodial wallet providers as obliged entities that must comply with the EU Anti-Money Laundering Directive.

The above-stated recommendation of EBA was approved by the European Commission ("EC") with a proposal in July 2016 to extend the scope of the EU Fourth Anti-Money Laundering ("AML") Directive No: 2015/849 for the purpose of covering the market players of virtual currencies.[8] The main aim in this proposal was to decrease the anonymity of virtual currencies and to monitor more efficiently the transactions carried out in using virtual currencies. Pursuant to these proposal, new obliged entities would have to process personal data information when exchanging virtual currency for fiat currencies.

[6] European Bank Authority, Warning to Consumers on Virtual Currencies, EBA/WRG/2013/01, 12 December 2013.

[7] European Bank Authority, EBA Opinion on Virtual Currencies, EBA/Op/2014/08, 4 July 2014.

[8] European Commission, Proposal for a Directive of the European Parliament and of the Council 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/EC, COM (2016) 450 final, 2016/0208 (COD), 5 July 2016.

In May 2016, the European Parliament ("EP") adopted a resolution and expressed that "*virtual currencies and distributed public ledgers have the potential to contribute positively to citizens' welfare and economic development, including in the financial sector.*"[9] After listing the risks that may arise from the use of virtual currencies, EP has stated that "*addressing these risks will require enhanced regulatory capacity, including technical expertise, and the development of a sound legal framework that keeps up with innovation...*" and "*if a regulation is adopted at a very early stage, it may not be adapted to a state of affairs which is still in flux and may convey a wrong message to the public about the advantages or security of virtual currencies.*" Additionally, in this resolution, EP has recommended EC to draw up a comprehensive analysis of virtual currencies, and, on the basis of this assessment, to consider revising the relevant EU legislation on payments in the light of the new possibilities afforded by new technological developments including virtual currencies and distributed public ledgers, with a view to further enhancing competition and lowering transaction costs, including by means of enhanced interoperability and possibly also via the promotion of a universal and non-proprietary electronic wallet.

The most notable action, so far, in the matter of virtual currencies' regulation in EU has been performed by the Court of Justice of the EU ("CJEU"). CJEU has stated, on 22 October 2015, by ruling, in the case "Skatteverket v David Hedqvist", that the exchanges of fiat currencies for units of the Bitcoin virtual currency (and vice versa) are exempt from VAT in application of Article 135 (1)(e) of the EU VAT Directive. It is deduced that the CJEU's said decision is also applied for other virtual currencies than just Bitcoin.

III. Notable Regulations in Other Regions

So far, no country has recognized a virtual currency as a legal tender except for Japan's notable regulation pertaining thereto. With a bill enacted on 25 May 2016, and brought into force on 1 April 2017, amending the Payment Services Act, which is a part of Banking Act, digital currencies including Bitcoin have been recognized as a legal

[9] European Parliament, European Parliament Resolution of May 2016 on Virtual Currencies (2016/2007(INI)).

method of payment. However, with this regulation, Bitcoin is to be treated as an asset rather than a legally-recognized currency. On the contrary to such a regulation in Japan, a few countries have prohibited any transaction in a virtual currency or its use as a means of payment. On 24 December 2017, the Central Bank of Bangladesh, has publicized a warning notice on its official website, stating that Bitcoin, Ethereum, Ripple, Litecoin and other cryptocurrencies are not authorized currencies and do not have any legal status due to being in inconformity with Foreign Exchange Regulation Act of 1947 and Money Laundering Prevention Act of 2012. With this notice, the Central Bank of Bangladesh has instructed citizens to stop making online transactions with Bitcoin and other cryptocurrencies. Likewise, in Vietnam, the State Bank of Vietnam publicized a notice with the title "Information related to the use of virtual currency" on its official website on the date of 30 October 2017, stating that "...according to the provisions of the law has led, Bitcoin virtual currency and other similar is not lawful means of payment in Vietnam; the issuance, supply, use of Bitcoin and other similar virtual currency as a means of payment is prohibited in Vietnam." In the said notice, it has also been declared that those breaching this rule will be subject to fine of between VND 150 million and 200 million.

On 17 August 2017, the Australian government introduced a bill into the parliament to regulate the activities of virtual currency exchange service providers. If the bill is brought into force in its current form, the provisions of the Anti-Money Laundering and Counter-Terrorism Financing Amendment Bill 2017 will mean that businesses providing convertible virtual currency exchange services will need to be registered with, and subject to mandatory reporting obligations to the Australian Transaction Reports and Analysis Centre, Australia's financial intelligence and regulatory agency. In addition to Australia, some other countries such as Canada and Singapore are regulating virtual convertible currency intermediaries under their anti-money laundering regulatory regimes in order to provide a greater legal certainty to transactions on such assets. The taxational treatments have also increasingly been brought forward, and it has been resolved to subject the virtual currencies transactions to capital gain taxes in Australia, Brazil, Canada and Israel.

Future Regulations

In November 2015, the Bank for International Settlements ("BIS") publicized a report on virtual currencies on its official website and expressed: "*Digital currencies and distributed ledgers are an innovation that could have a range of impacts on many areas, especially on payment systems and services. These impacts could include the disruption of existing business models and systems, as well as the emergence of new financial, economic and social interactions and linkages. Even if the current digital currency schemes do not persist, it is likely that other schemes based on the same underlying procedures and distributed ledger technology will continue to emerge and develop.*"[10] Later on, in a report publicized on BIS's official website on 17 September 2017, a medium called "central bank cryptocurrency" has been defined and central banks were called for the creation of cryptocurrencies.[11] This proposition for central bank cryptocurrencies is a focus of interest and naturally deserves major attention, as central banks and international institutes are vigorously scrutinizing this potential future development. Joachim Wuermeling, a member of the board of Germany's Central Bank, expressed on 15 January 2018 that "*Effective regulation of virtual currencies would therefore only be achievable through the greatest possible international cooperation, because the regulatory power of nation states is obviously limited.*" In this direction, the International Monetary Fund ("IMF") has been supportive of the development of virtual currencies since 2016 in some of its reports.[12] However, no concrete step has been taken so far by IMF regarding the use and implementation of cryptocurrencies.

As of today, primarily, official positions, public reports and nonbinding legal dispositions have been published worldwide, seeking a safe and balanced connection between investor protection and economic attractiveness of the countries. Very few hard law legislations and court rulings on cryptocurrencies are

[10] The Bank for International Settlements, Digital Currencies, November 2015.

[11] Morten Linnemann Bech and Rodney Garratt, Central Bank Cryptocurrencies, BIS Quarterly Review, 17 September 2017.

[12] IMF Staff Discussion Note, Virtual Currencies and Beyond: Initial Considerations, SDN/16/03, January 2016; Christine Lagarde, Central Banking and Fintech – A Brave New World?, Bank of England Conference, 29 September 2017.

existent today. Uncertainties remain with respect to the economic and legal qualification of cryptocurrencies and distributed ledger technology. 2018 is expected to be a notable period as to the regulation of this worldwide phenomenon.

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