Bitcoin, Blockchain & the Regulatory Dynamic

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Bitcoin

— Decentralized, partially anonymous digital “currency”
   • Relies on peer-to-peer networking
   • Changes are only possible if broadly adopted
   • Not backed or issued by any government or other legal entity
— Allows for the proof and transfer of ownership without the need for a trusted third party
— Value of bitcoins is based purely on supply and demand
   • Unlike fiat currencies, whose value is derived (in part) through regulation or law and underwritten by a state
— Proposed by a person (or group of people) under the name of Satoshi Nakamoto in 2008
   • Implementing software was first released under the same name on January 3, 2009
   • As of early 2017, Bitcoin accounted for ~90% of decentralized virtual currencies market value
      • The current total market value of virtual currencies is about US$8 billion, which is relatively small (by comparison, U.S. currency currently in circulation is US$1.4 trillion)
Comparison Between Traditional Centralized Ledger and Distributed Ledger Technology

Current Market Structure

Central Authority

Possible Future Market Structure

Distributed Ledger

It Begins with Blockchain
What is Blockchain and How Does It Work?

Distributed Ledger + Cryptography + Consensus Network

Ledger distributed across members through non-permissioned or permissioned access
Based on secure authentication & verifiable transactions
Process for member agreement to finality of verified transactions
Blockchain Applications: Bigger Than Bitcoin

- Trade finance
- Securities trading and issuance
- Interbank settlement
- Precious metals
- Syndicated loans
- Automated “smart contracts”
- Decentralized Autonomous Organizations
- Real estate and land registries
- Shareholder voting
- Peer-to-peer payments
- Shipping logistics
- Secured messaging services
- Fine arts and music

Legal and Regulatory Issues
Legal & Regulatory Issues

- **Bitcoin** – created interest – and problems: Silk Road, Mt. Gox, etc.
- **Blockchain** – potential applications for trading commodities, securities and other rights, as well as a host of record-keeping/smart contract functions (DTC CDO & Delaware Blockchain initiative are examples)
- **Framework for Legal & Regulatory Issues:**
  - Whose law applies? Comity versus extraterritoriality
  - Regulatory Responsibility? State, National, Multinational; Consistency; Competition
  - Anti-Money Laundering/Bank Secrecy Act/Terrorist Financing Issues
  - Cyber security standards, requirements and compliance
  - Commercial Law: possession, transfer, delivery, ownership? What type of interest is conveyed? Intangible right? US UCC issues
  - Securities and Commodities Regulations: what interests can be conveyed?
  - Corporate Form & Investments – functional regulation meets tech and investment!
  - Application of technical legal standards: land registries, intangible property, and personal property registries; securities (Delaware Blockchain Initiative); others
  - Liability of blockchain participants for fraud or error?

Commercial Law, Securities Regulation & Risk

**Let’s take a practical, hypothetical example...**

- Permissioned Blockchain for DvP settlement of securities using tokenized Securities & Cash
  - Accelerated settlement, & improved record-keeping, transaction reconciliation, capital relief, risk management, etc.

**Sample Legal Issues (there are more!):**

- Commercial Law: Cash & Securities “tokens” – Allow participants to transfer securities.
  - Article 8 of US UCC allows “security entitlements” to be held by “securities intermediary” and credited to a “securities account” – allowing Blockchain transfer from one participant to another.

- Securities Law:
  - Tokens – “Securities”? - are they “investment contracts”? If merely evidence of a transfer and not motivated by “traditional investment considerations”, so probably not
  - SEC registration and regulation required for “clearing agency” – “intermediary in making payments or deliveries … or provides facilities for comparison of data”; given ambiguities, consider exemptions for “banks” or seek relief from SEC
  - Broker-dealers and security-based swap-dealers using blockchain to hold or pledge tokens as collateral must ensure held in a manner consistent with requirements related to the segregation of margin


- Insolvency Laws: Who holds the risk of loss? Are tokens property of operator? Who then? And when?
Anti-Money Laundering & Reporting

— By virtue of Silk Road and progeny, National Regulators focus closely on AML/Bank Secrecy/Terrorist Financing Issues
— US Financial Crimes Enforcement Network ("FinCEN") broadly defines regulation of "money transmitters"
  • Imposes certain transaction reporting, record-keeping, and monitoring obligations
  • FinCEN interpretations broadly cover clearing and settlement systems and transfers of funds on a blockchain
  • However, using Blockchain to record transactions is not money transmission.
— Recent Examples:
  • In FIN-2013-0001, FinCEN specified that blockchain transfer solely to settle “a bona fide purchase or sale of the real currency or other commodities for or with a customer” not acting as a money transmitter. However, freely transferable “tokens” with value is money transmission.
  • In FIN-2015-R001, FinCEN ruled that an e-precious metals company using a blockchain ledger that issued “freely transferable digital warehouse receipts” was a money transmitter. FinCEN stated “when the Company issues a freely transferable digital certificate of ownership to buyers, it is allowing the unrestricted transfer of value from a customer’s commodity position to the position of another customer or a third-party.”
  • Fairly ambiguous, but broad ruling – distinction appears to turn on the use of digital certificates of ownership themselves as a medium of exchange between parties who are not connected to a direct purchase and sale of the commodity.

Potential Applicability of U.S. State Regulatory Regimes

— Debate over National FinTech charter vs. State regulation (and regulators’ lawsuits)
— Traditional state regulations may cover blockchain applications
  • Consumer protection
  • Money transmitter services
  • Transfer services
  • Corporate structure
  • Securities and commodities transactions
  • Taxes
— On June 3, 2015, the New York State Department of Financial Services (DFS) finalized the first comprehensive regulatory framework for virtual currency in the United States – the so-called “BitLicense” framework
  • Also covers transactions undertaken for non-financial purposes – a critical point for the development of new products using blockchain technology
Potential Applicability of State Regulatory Regimes (continued)

— By contrast, North Carolina Office of the Commissioner of Banks has published FAQs exempting several blockchain technologies from its Money Transmitters Act (“NC MTA”)
  • Blockchain “technology includes such software innovations as ... smart contracts (i.e. agreements implemented on a virtual distributed ledger), and smart property (i.e. property that is titled using a virtual distributed ledger). These uses of the blockchain generally do not involve the use of virtual currency as a medium of exchange. As a result, these software innovations are not regulated by the NC MTA.”
— California, to date, has not adopted a state statute preferring to take a wait-and-see approach

Considerations for Regulators
Risks and Strategy for Regulation

— Highly competitive landscape
  • Large, established financial institutions are incumbents
— Increased regulatory scrutiny as industry grows is likely in multiple jurisdictions
  • Overlapping or potentially conflicting regulatory frameworks
— Start up nature of most fintech companies can mean less robust internal processes and compliance
  • Cybersecurity
  • Consumer Protection
  • Compliance with normally applicable regulatory framework
    • BSA and AML requirements; market regulation; payments requirements; etc.
    • Cross-border issues
— As with any new industry, the questions are when, who, and how to regulate?
  The answers depend on the goals of regulation.
  • What are the risks that you wish to control?
  • What risks are you comfortable with the companies running?
  • What trade-offs are you willing to make to promote innovation?

Questions for FinTech Companies

— Key issues to consider
  • What is the business?
    • Follow the money – what is the strategy for profit and what are the risks?
  • Regulatory compliance
    • What type of compliance framework and governance process is there for consumer protection, AML, banking secrecy and sanctions issues, market regulation and payment systems access
  • Cybersecurity and privacy
  • Capital and funding
  • Contracts and third party rights
  • Organizational documents
  • Contingent liabilities
— Structure and regulation of ownership
— Information sharing and confidentiality
— Who are the owners and what are their interests?