

European Regulatory Reactions to the Rise of Cryptocurrencies

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Today's webinar presenters



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Cryptocurrencies: introduction

- Cryptocurrencies aspire to be a new form of currency and promise to maintain trust in the stability of their value through the use of technology.
- Cryptocurrencies combine three key features. First, they are digital, aspiring to be a convenient means of payment and relying on cryptography to prevent counterfeiting and fraudulent transactions. Second, although created privately, they are no one's liability, ie they cannot be redeemed, and their value derives only from the expectation that they will continue to be accepted by others. This makes them akin to a commodity money (although without any intrinsic value in use). And, last, they allow for digital peer-to-peer exchange.
- Cryptocurrency transfers can in principle take place in a decentralized setting without the need for a central counterparty to execute the exchange.

Cryptocurrencies: introduction

- The technological challenge in digital peer-to-peer exchange is the so-called "double-spending problem". Any digital form of money is easily replicable and can thus be fraudulently spent more than once.
- Cryptocurrencies overcome the double-spending problem via decentralized record-keeping through what is known as a distributed ledger. The ledger can be regarded as a file that starts with an initial distribution of cryptocurrency and records the history of all subsequent transactions. An up-to-date copy of the entire ledger is stored by each user (this is what makes it "distributed").
- While all cryptocurrencies rely on a distributed ledger, they differ in terms of how the ledger is updated. One can distinguish two broad classes, with substantial differences in their operational setup.

Cryptocurrencies: introduction

- One class is based on "permissioned" DLT. Such cryptocurrencies are similar to conventional payment mechanisms in that, to prevent abuse, the ledger can only be updated by trusted participants in the cryptocurrency - often termed "trusted nodes". These nodes are chosen by, and subject to oversight by, a central authority, eg the firm that developed the cryptocurrency. Thus, while cryptocurrencies based on permissioned systems differ from conventional money in terms of how transaction records are stored (decentralised versus centralised), they share with it the reliance on specific institutions as the ultimate source of trust.
- A second class of cryptocurrencies promises to generate trust in a fully decentralised setting using "permissionless" DLT. The ledger recording transactions can only be changed by a consensus of the participants in the currency: while anybody can participate, nobody has a special key to change the ledger. (=> eg, Bitcoin, that relies on a specific DLT called blockchain).

Cryptocurrencies: introduction

- In summary, cryptocurrencies consist of three elements. First, a set of rules (the "protocol"), computer code specifying how participants can transact. Second, a ledger storing the history of transactions. And third, a decentralized network of participants that update, store and read the ledger of transactions following the rules of the protocol.
- Cryptocurrencies continue to garner significant attention from the media, governments, regulatory institutions, tech companies, and investors.
- Value
 - > \$200bn total market capitalisation
- Misuse



Misuse of cryptocurrencies

Money-laundering

- Easy access to “clean cash”, as authorities are unable to monitor transactions.

Terrorist financing

- Easy access to “clean cash” and transfer to unauthorised/sanctioned persons/entities.

Tax evasion

- Parties to transactions are unknown.

Risks to consumers generally

- Threat of price volatility, speculative trading, fraud, theft & hacking.

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Diverging National Approaches

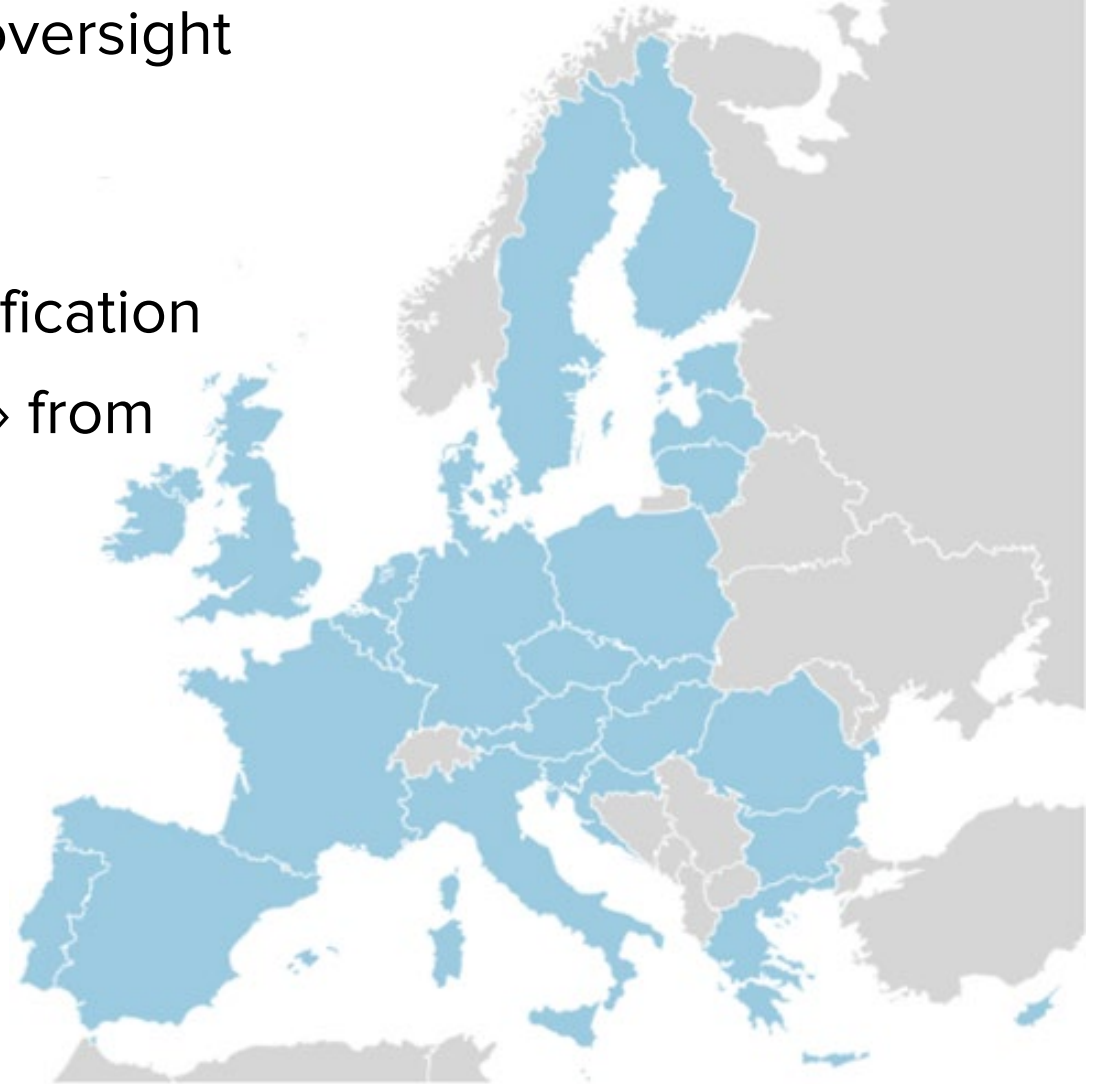
Time for change?



- Disparate national rules and lack of EU level regulation risked creating a landscape that may be exploited.
- Calls for legislative change at EU level.
- EBA advocates tailored regime in long-term and reform of AML Directive in the short-term.
- EBA to develop common monitoring template in 2019.

National regimes

- Potential for innovation vs. effective oversight and consumer protection
- Divergence
 - Lack of consensus as to legal classification
 - Lack of personification and « grip » from regulators
 - Areas of national reform



An example of national divergence: tax treatment of cryptocurrencies

- Lack of consensus as to the legal form of cryptocurrencies.
- Subject to different taxes e.g. income tax, capital gains tax.

Country	Tax treatment
UK	Chargeable asset, property – Capital Gains Tax, Inheritance Tax.
Netherlands	Taxable as income if gains from “source of income” or savings/investment.
Germany	Generally taxed as income. Capital gains taxable only if acquisition & sale within 1 year.
Spain	If held as an investment – capital gains tax Income from mining – income tax

Another example of national divergence: regulatory oversight of actors

- France : PACTE (Action Plan for Business Growth and Transformation) law was adopted on April 11, 2019. It establishes a legal framework for fundraising via the issuance of virtual tokens (ICOs) and digital asset service providers (“DASPs”).
 - The PACTE law introduces the possibility for ICO issuers to apply for an optional visa from the AMF for a public offering of tokens.
 - If they wish, “digital asset service providers” (“DASPs”) may be licensed and placed under the supervision of the AMF.
 - Whether or not they choose to obtain the optional license, service providers who wish to provide digital asset custody services to third parties or to purchase/sell digital assets in exchange for legal tender are subject to mandatory registration with the AMF.

Another example of national divergence: regulatory oversight of actors

- Malta: a comprehensive regulatory package:
 - The Malta Digital Innovation Authority (MDIA) Act
 - MDIA is to certify the developed DLT platform software and how the software will be managed.
 - The Innovative Technology Arrangements and Services Act (the ITAS Act)
 - Act establishes criteria for defining innovative technological arrangements and drafting registration requirements for Innovative technological Services (ITS) and Innovative Technology Arrangements (ITA). It also registers entities that provide the Innovative Technology Services (the ITS providers).
 - The Virtual Financial Assets Act
 - Creates a framework in which the regulatory bodies can work either directly or indirectly with various financial assets that include the ICOs, custodian wallet providers, token exchanges, brokerages, nominee service providers, portfolio managers and different investment advisers. Also contains guidelines and requirements for an STO (Security Token Offering) and an ICO (Initial Token Offering). Includes the whitepapers that are to be presented to the Malta Financial Services Authority.

Another example of national divergence: regulatory oversight of actors

- Switzerland: focus on ICOs
 - FINMA ICO Guidelines
 - In assessing ICOs, FINMA focuses on the economic function and purpose of the tokens. The key factors are the underlying purpose of the tokens and whether they are already tradeable or transferable.
 - Payment tokens are synonymous with cryptocurrencies and have no further functions or links to other development projects. Tokens may in some cases only develop the necessary functionality and become accepted as a means of payment over a period of time.
 - Utility tokens are tokens which are intended to provide digital access to an application or service.
 - Asset tokens represent assets such as participations in real physical underlyings, companies, or earnings streams, or an entitlement to dividends or interest payments. In terms of their economic function, the tokens are analogous to equities, bonds or derivatives.

EU-wide Regulation and the Problems of ‘Retro- Fitting’

Regulation at EU level

- No EU law specifically targeting cryptocurrencies
- European banking and securities regulation
 - Where cryptoassets qualify as “financial instruments”, they can be caught by MiFID (Markets in Financial Instruments Directive) and other financial rules which apply to issuers and/or firms providing investment services/activities linked to those instruments.
 - Cryptocurrencies generally do not fall within the scope of this
- Anti-money laundering

The Fourth Anti-Money Laundering Directive (aka AMLD4)

- Required to be transposed into national law by 26 June 2017
- Framework for **combating money-laundering and terrorist financing**
- The Directive **applies to “obliged entities”**
 - list including e.g. financial institutions and credit institutions
- Obligated entities must
 - carry out **customer due-diligence**; and
 - **inform national financial intelligence unit** of any suspected/known proceeds of crime/funds related to terrorist financing
- No definition of “funds”, only **“property”**
 - Could capture cryptocurrencies
 - List of **obliged entities does not capture key players** in cryptocurrencies

Expansion of the EU-wide Anti-Money Laundering Directive

Retrofitting the AMLD

- In May 2018, the European Parliament approved AMLD5:
 - Application extended to providers engaged in exchange services between virtual and fiat currencies and to custodian wallet providers;
 - Exchange service providers and custodian wallet providers must be registered;
- Must be transposed into national law by 10 January 2020
 - Some jurisdictions have already implemented national legislation
 - E.g. Finland
 - Helsinki-based LocalBitcoins have had to introduce a new ID verification system

Comparison – obliged entities

- Directive applies to obliged entities
 - Customer due diligence measures
 - Reporting of suspicious transactions

AMLD4

- Credit institutions
- Financial institutions
- Other defined natural and legal persons acting in exercise of their professional activities (e.g. auditors, accountants etc.)

AMLD5

- The list of other defined persons to which the Directive applies now explicitly includes:
 - Providers engaged in exchange services between virtual currencies and fiat currencies; and
 - Custodian wallet providers.

Comparison - supervision

AMLD4

- Art 47(1) - Member States shall provide that currency exchange and cheque cashing offices and trust or company service providers be licensed or registered and providers of gambling services be regulated.

AMLD5

- Art 47(1) - Member States shall ensure that providers of exchange services between virtual currencies and fiat currencies, and custodian wallet providers, are registered, that currency exchange and cheque cashing offices, and trust or company service providers are licensed or registered, and that providers of gambling services are regulated. (emphasis added)

Comparison – application to cryptocurrencies

AMLD4

- Money laundering - could fall within the definition of 'property' derived from criminal activity
- Terrorist financing – could fall within the definition of 'funds' for use in respect of terrorism offences

BUT

Irrelevant because the Directive does not apply to any player involved in cryptocurrency schemes (obliged entities).

AMLD5

- Virtual currencies - "a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency, and does not possess a legal status of currency or money, but is accepted by natural or legal persons, as a means of exchange, and which can be transferred, stored and traded electronically".

Problem solved?

Money-laundering

- Imposing customer due-diligence requirement removes anonymity and increases traceability

Terrorist financing

- Imposing customer due-diligence requirement removes anonymity and increases traceability

Tax evasion

- Not directly targeted, but:
 - Explicitly lists tax authorities in the list of competent authorities that must be granted access to the beneficial ownership register
 - Removal of anonymity aids discovery
 - Definition of criminal activity still includes tax crimes i.e. there is a reporting obligation

Risks to consumers generally

- Threat of price volatility, speculative trading, fraud, theft & hacking

Blind spots/areas for future reform?

- Preamble to AMLD5:
 - “The inclusion of providers engaged in exchange services between virtual currencies and fiat currencies and custodian wallet providers will not entirely address the issue of anonymity attached to virtual currency transactions, as a large part of the virtual currency environment will remain anonymous because users can also transact without such providers.”
- Common approach to crypto-assets
 - *“Europe needs a common approach on crypto-assets such as Libra. I intend to propose new legislation on this”* - Valdis Dombrovskis, European Union Commissioner for Financial Stability, Financial Services and Capital Markets Union (8 October 2019)