

Regulation of Cryptoassets

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Handout

I. What are Cryptoassets

Purely a digital asset with NO tangible existence

Nothing more than a string of numbers, hosted on a blockchain, which is a digital (computerized) record of all prior transactions in that asset.

It has value because users agree it has value, and accept deals in which they accept crypto for tangible items or other forms of currency, such as government backed money (“fiat currency”)

*Cryptographically secure

*open source & distributed (all computers in the network can have access to the entire blockchain)

*decentralized to some extent (all computers have input into any changes to the programming—in conventional crypto at least. Those computers are called Nodes. It IS possible to have master nodes, where only SOME computers get the power to make changes. And it is possible that the underlying computer programming may have backdoors so that some people actually do have the ability to manipulate the code, even if a particular crypto claims to be decentralized)

*peer-to-peer to some extent (no middleman such as a bank or other trusted intermediary. All nodes are peers—unless the particular crypto is not really decentralized)

II. Why do People Use Crypto

*don’t trust government, banks, or national monetary stability

*Highly private

*Secure (cryptography)

*Borderless

*Egalitarian (in theory at least. For crypto that is decentralized and peer-to-peer (P2P))

III. Problems Associated with Crypto

*Money Laundering (Hiding illegal source of funds OR the reverse—Putting legitimately earned money into Illegal operations—as happened with Silk Road)

*Fraud (sales when there is no real token; Ponzi schemes; inflated claims; False claims of compliance)

*Market Manipulation (pump and dump, or wash trading)

*Hacking (of wallets and exchanges)

*Tax evasion

IV. Regulatory response to Money Laundering

BSA, Dept of Treasury and FinCEN

*prosecute money laundering, and impose AML and CTF requirements

*FinCEN treats crypto as virtual currency

V. Regulatory response to fraud on investors and the capital markets

SEC and CFTC

*SEC says most crypto is a security (investment contract under the Howey test), giving them authority to regulate and prosecute fraud

*CFTC says crypto is a commodity, giving them authority to regulate and prosecute fraud

VI. Regulatory response to tax evasion

IRS

IRS treats crypto as property, and requires reporting of income from transactions as if they involved barter. Not eligible for like-kind exchange status.

VII. State and International responses

States regulate money transmitters (safety and soundness) and also have state securities laws, and state taxing authorities

International groups adopt standards—FATF with its AML directives is the most influential, but there are international groups looking at monetary policy and financial stability, securities treatment, and other international concerns

Possible Additional Resources:

For terminology and general background, you might review Carol Goforth, *The Lawyer's Cryptionary: A Resource for Talking to Clients about Crypto-transactions*, 41 CAMPBELL L. REV. 47, 69 (2019). If you want more information on the types of crypto, you might look at Aashish Pahwa, *What is a Cryptoasset? Types of Cryptoassets [Ultimate Guide]*, Feedough (updated May 19, 2018) (archived at <https://perma.cc/2X2U-HBW9>) (although terminology is not used consistently by commentators).

For the official explanation of how FinCEN regulates crypto as a virtual currency, see FinCEN, Guidance, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using*

Virtual Currencies, FIN-2013-G001 (Mar. 18, 2013) (archived at <https://perma.cc/4FTP-336Q>) and FinCEN, Guidance, *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies*, FIN-2019-G001 (May 9, 2019) (archived at <https://perma.cc/4BSY-4YPS>).

For the SEC's position, see SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, '34 Act Release No. 81207 (July 25, 2017) (archived at <https://perma.cc/F862-YS5V>). This was the first time the SEC explained its approach to cryptoassets. A more complete explanation of the agency's current approach can be found at SEC, Public Statement, *Framework for "Investment Contract" Analysis of Digital Assets* (modified Apr. 3, 2019) (archived at <https://perma.cc/J4KQ-HW52>) (hereinafter *Framework*). It might also be helpful to review the joint staff statement (issued with the Office of General Counsel for FINRA), in 2019, which refers to crypto as "digital asset securities." SEC, Public Statement, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities* (July 8, 2019) (archived at <https://perma.cc/8A4T-J9H5>).

For the CFTC's position, you might start with CFTC, Release No. 7231-15, (Sept. 17, 2015) (archived at <https://perma.cc/J7Z7-6JFG>). For an explanation of the CFTC's approach when no future or swap was involved, see Keith Miller, Andrew P. Cross, and J. Dax Hansen, *CFTC Flexes Its Regulatory Muscle in a Case Involving a Virtual Currency*, Perkins Cole, Virtual Currency Report (Jan. 29, 2018) (archived at <https://perma.cc/T8GB-VNN2>).

For the IRS's official position see I.R.S. *Virtual Currency Guidance*, I.R.S. Notice 2014-21 (Mar. 25, 2014) (archived at <https://perma.cc/JM8H-XL6B>) and I.R.S. Rev. Rul. 2019-24, 26 C.F.R. 1.61-1 (archived at <https://perma.cc/M8YP-8463>).

More general resources:

Most books in the subject are about: (1) how to make money/invest/trade/mine cryptoassets; (2) the details of programming and how blockchain and cryptoassets work from a more technical standpoint; (3) the history of blockchain and/or bitcoin; or (4) what blockchain means for business in a broader sense, and what smart contracts can do now and might accomplish in the future. For current regulatory responses from a legal standpoint, there is not much out there.

For a compilation of how different countries regulate cryptoassets, the Law Library of Congress has a report on *Regulation of Cryptocurrency Around the World*. It is available online at <https://www.loc.gov/law/help/cryptocurrency/world-survey.php> and is a great starting point for international research. (It covers 130 countries).

I do have a book coming out, Carol Goforth, *REGULATION OF CRYPTOTRANSACTIONS* (West Academic, 2020), but it is mostly geared to law students. Because the law is moving so quickly, however, there is a lot of textual explanation and considerably more citations to authority than in conventional casebooks.