KEY POINTS

- Despite the incompatibility of virtual currencies with existing regulatory regimes, the question is not whether virtual currencies will be regulated, but how.
- The extent to which virtual currencies can be incorporated into mainstream financial business will be limited by existing regulations.
- The European Securities and Markets Authority has noted the emergence of investment products based on virtual currencies.

Feature

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Legal and regulatory issues relating to virtual currencies

INTRODUCTION

This piece looks at how rule makers are responding to virtual currencies given that, as discussed here, the unique features of virtual currencies do not fit neatly into existing regimes. The backdrop is a clear global trend towards bringing virtual currencies within the scope of regulation.

VIRTUAL CURRENCIES: KEY CONCEPTS

Terminology

It is important to understand from the outset the key characteristics relating to virtual currencies, as these determine the extent to which virtual currencies may fall within existing regulation and how new regulation may need to be framed. This article uses the terminology set out by the Financial Action Task Force (FATF) in "Virtual Currencies Key Definitions and Potential AML/CFT Risks" (June 2014). Here "virtual currency" is defined as the digital representation of value that can be traded digitally and functions as a medium of exchange, unit of account, or store of value.

Virtual currencies are decentralised in the sense that they do not represent a claim on an issuer such as a government, although many may be centralised in the sense that they have a single administrator. As such, there is no issuer to be made subject to regulatory authorisation. Nor are traditional questions relating to issuer's liability or insolvency applicable.

Virtual, fiat and digital currencies

Virtual currencies are distinguishable from fiat currency and electronic money (e-money). Fiat currency is what is generally thought of as money, the legal tender of a particular country. E-money is the digital representation of fiat currency and is used for electronic transfers of value denominated in fiat currency. Digital currency refers to the digital representation of either fiat or non-fiat (virtual) currency.

A decentralised virtual currency is "an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party" (Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System 2008*). The "cryptographic proof" replaces trust in the issuer or central government. Virtual currency is not legal tender in any jurisdiction. It functions as a means of exchange by virtue of a consensus among a community of users, not on the basis of government-recognised status. The best-known example of virtual currency is Bitcoin.

While virtual currencies differ, the basics of the discovery and transfer of decentralised virtual currencies are as follows. The new coin discovery process is initiated when an owner of virtual currency makes a transfer of value by sending a payment message. The payment message is then distributed to a network of computers. The message contains a private key that is specific to that transaction.

"Miners" use computers to apply complex algorithms to match the private key to a public key to verify the transaction. Successful solution of multiple transactions leads to a "block", which is added to the "blockchain", or record of all transactions ever made. Then the updated public ledger is distributed to the entire network. The new coin is then available to the miners who first solved the algorithm.

Characteristics of virtual currencies

The distinguishing characteristics of virtual currencies relevant to determining legal and regulatory status are that they are:

- not issued by a central government;
- not a claim against a central
- government;
- not officially linked to any existing currency;
- not issued but discovered by "mining";
- valuable because of a consensus that they are a means of exchange for items of value;
- anonymous, as use does not depend on disclosure of true identity; and
- not restricted to any particular jurisdiction.

These unique characteristics mean virtual currencies cannot be directly compared to other forms of investment or payment mechanisms. These features set virtual currencies apart from fiat currency and make it difficult to apply or enforce traditional regulatory regimes.

Taxation of virtual currencies

Tax authorities have been among the first to respond to virtual currencies. The response has not, however, been uniform. How virtual currencies have been characterised for the purpose of VAT, for instance, varies within the EU. The different interpretations highlight the challenges posed by virtual currencies.

One question that has been raised centres on the interpretation of Art 135(1) of the Directive on the Common System of Value Added Tax (2006/112/EC)(VAT Directive), which provides that Member States must exempt from VAT:

- transactions, including negotiation,

concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection; [and]

- transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest.

The question is whether VAT is payable on payments made in virtual currency for goods and supplies, mining of virtual currencies and exchanges of virtual currency. Member States are divided, and their differing interpretations stem from fundamentally differing views on the nature of virtual currencies.

VIRTUAL CURRENCY PAYMENTS AND VAT

An increasing number of merchants and individuals accept virtual currencies in payment for goods and services. This gives rise to the question whether the person paying should charge VAT on the payment itself, in addition to paying the VAT applicable to the goods and services provided. VAT is a tax on the consumption of goods and services, not on the payment of money itself. If the tax authorities consider payment in virtual currencies to be payment in money, then no VAT is levied. Where they characterise these as services or goods, it will.

The UK tax authorities view virtual currencies as money or a means of payment for the purposes of VAT. Virtual currencies may therefore be used to pay for goods and services without incurring VAT. HMRC points out that its view of virtual currencies as regards VAT, "in no way reflects on how they are treated for regulatory or other purposes." (HM Revenue and Customs, *Tax treatment of activities involving Bitcoin and other similar cryptocurrencies*, 09/14, 3 March 2014).

The alternative interpretation, where payments in virtual currencies are considered payments in kind, leads to the result that consumers paying in virtual currency must charge VAT on their "supply" of virtual currency. This is the approach taken by, among others, Germany and Austria (Redmar Wolf, *Bitcoin and EU VAT*, International VAT Monitor, September/October 2014 p 255).

Virtual currency exchange fees and VAT

Characterisation is also relevant to the imposition of VAT on services related to currency exchanges. Virtual currencies can be traded on exchanges. Where virtual currencies are treated as any other currency, virtual currency exchanges are exempt from VAT under Art 135(1)(d) of the VAT Directive. The UK follows this view, as do some other Member States, such as Finland. Others, such as Austria, Poland, and Estonia, disagree.

A resolution to the issue is expected once the European Court of Justice (ECJ) rules on a case referred by the Swedish Supreme Court. A Swedish individual intended to engage in Bitcoin exchange services. The tax authorities appealed an initial ruling determining that these activities were exempt from VAT on grounds that Bitcoin is a currency. The tax authorities took the view that Bitcoin is not. The ECJ has been asked to determine whether transactions exchanging virtual for traditional currency, where the supplier receives consideration, fall under the VAT Directive exemption. An answer is expected within a year or two.

APPLICATION OF ANTI-MONEY LAUNDERING AND COUNTER-TERRORISM FINANCING MEASURES TO VIRTUAL CURRENCIES

Anti-money laundering is another area where the rise of virtual currencies has drawn the attention of regulators and law enforcement. The anonymity of virtual currencies renders them susceptible to use by criminals. A number of well-publicised cases involving criminal activity paid for in virtual currency, such as Ross Ulbricht's Silk Road, an online black market used as a platform for selling illegal drugs and other products, has reinforced the perception of a link between crime and virtual currency.

In June 2014, the FATF published a report on virtual currencies outlining the risks related to money laundering and terrorism financing. The FATF determined virtual currency systems are potentially vulnerable to risks associated with the anonymity of virtual currency transactions. The global reach of virtual currencies only increases these risks, as transactions may involve multiple jurisdictions, not all of which have adequate laws on financial crime.

In October 2014, however, the UK National Crime Agency (NCA) assessed the extent to which virtual currencies are used in criminal activity. Noting that the scale of threat was difficult to assess, the NCA concluded there was little evidence to establish that virtual currencies were widely used in money laundering operations or financing terrorism. Instead, the criminal use of virtual currencies was predominantly related to illicit goods and services.

In the EU

The nature of virtual currencies often keeps them outside the scope of anti-money laundering and counter-terrorism financing laws. The challenge now is how to bring virtual currencies into scope. Broadly speaking, anti-money laundering laws are aimed at combating the misuse of the financial system by persons seeking to launder the financial proceeds of criminal activity.

At EU level, the principal law is the Third Anti-Money Laundering Directive (AMLD3) (2005/60/EC), to be replaced by the Fourth Anti-Money Laundering Directive (AMLD4) in 2017.

AMLD3 applies to a variety of firms, including credit and financial institutions. This includes firms offering services involving the transfer of money, such as lending, money transmission and issuing and administering means of payment,

like credit cards. AMLD3 also applies to certain individuals when acting in a professional capacity, such as lawyers. It also applies to any legal or natural entity trading in goods for cash payments in excess of €15,000, whether in a single or series of linked transactions. AMLD4 is expected to adjust this threshold downward to €7,500.

When AMLD3 applies, firms have two principal obligations. The first is to confirm the identities of customers and assess the risk of doing business with them (customer due diligence or "CDD") and the second to report suspicions of money laundering. Anonymous clients or accounts are not permitted.

In the UK

In the UK, the AMLD3 obligations are implemented by the Money Laundering Regulations 2007, Proceeds of Crime Act 2002 (POCA), and Terrorism Act 2000. In line with AMLD3, POCA prohibits certain activities such as dealing with the proceeds of criminal conduct, tipping off and not disclosing such activity. POCA's rules are triggered where there are criminal proceeds and make it an offence to deal in the proceeds of crime, to aid and abet in this offence or to acquire, use or possess proceeds of crime.

As such, AMLD3 and the UK implementation thereof do not place obligations on out-of-scope entities that deal with sub-threshold values of virtual currencies. In practice, many virtual currency operations (particularly exchanges) do require CDD checks but this tends to be to satisfy AML requirements of other jurisdictions or for commercial reasons.

While at present transactions involving virtual currencies generally fall outside the scope of existing laws, governments are actively working to corral them. The UK Government announced on 18 March 2015 that it would apply AML regulations to virtual currency exchanges in the UK. Noting that "the distinctive features of digital currencies can be attractive to illegal users", HM Treasury announced that it "intends to apply anti-money laundering regulation to digital currency exchanges, to support innovation and prevent criminal use." (HM Treasury, "Digital currencies: response to call for information", p 19). How such regulation will be applied remains to be worked out over the coming months.

The UK is not alone in seeking to apply anti-money laundering regulations to virtual currencies. The European Banking Authority (EBA), in its "Opinion on 'virtual currencies'", proposed the introduction of active CDD requirements on all virtual currency market participants (other than users). These proposals were not set out in detail, but recommend widening the scope of entities that would trigger CDD (EBA/OP/2014/08).

In the US

In the US, the Financial Crimes Enforcement Network (FinCEN) published guidance in March 2013 (FIN-2013-G001) clarifying that exchangers and administrators of virtual currencies are money transmitters within the meaning of the Bank Secrecy Act (BSA). These money transmitters must register with FinCEN and implement an anti-money laundering program. The jurisdictional reach of the BSA requirements is broad. Entities doing business or providing services to customers in the US must comply with BSA requirements (FIN-2012-A001).

APPLICATION OF PAYMENTS TRANSACTIONS REGULATION TO VIRTUAL CURRENCIES

The essence of a payment transaction in a virtual currency is the absence of a trusted third party intermediary. A payment made in a virtual currency is transmitted from payer to payee using a network of computers to confirm the match between a private key held by the payer and a public key, through key pair cryptography. Compared to the traditional payment process, this takes very little time. Moreover, once completed, the transaction cannot be reversed. At present this payment process falls outside the EU regulatory regime applicable to payments and e-money.

Electronic money

The second EU Electronic Money Directive (2009/110/EC)(EMD) lays down a framework for the regulation of electronic money across the EU. It was implemented in the UK by the Electronic Money Regulations 2011 (SI 2011/99). Although virtual currencies share commonalities with e-money, they fall outside the scope of the EMD because:

- "electronic money" means electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions.

Virtual currencies fall at the first hurdle as they are not "represented by a claim on the electronic money issuer". Nor are new units of a virtual currency "issued" in exchange for funds; rather, new virtual currency results from mining.

Payment Services Directives

Virtual currencies also fall outside the scope of the EU Payment Services Directive (2007/64/EC) (PSD), which regulates certain types of payment services provided by a defined set of payment institutions (European Central Bank, "Virtual currency schemes 2012", p 43). It was implemented in the UK by the Payment Services Regulations 2009.

The in-scope payment service providers that are potentially relevant to virtual currencies are e-money institutions and payment institutions. E-money institutions are defined by reference to the EMD, which as noted above does not apply. Payment institutions are defined as entities with authorisation to provide and execute the payment services, where payment services are defined as any business activity listed in the Annex to the PSD.

Payment services are defined in the PSD Annex with both inclusive and exclusive elements. Included is "money

remittance" (PSD Annex (6)), which means a payment service where "funds" are received from a payer without any payment accounts being created for the purpose of transferring a corresponding amount to another party. The definition of "funds" is limited to banknotes, coins, scriptural money and electronic money, thus excluding virtual currencies.

Furthermore, excluded payment services covers:

- services provided by technical service providers, which support the provision of payment services, without the provider entering at any time into possession of the funds to be transferred, including:
  - the processing and storage of data; and
  - information technology.

The "technical service providers" of a virtual currency network are generally the miners who verify transactions, but also client side virtual currency wallet developers. Such services are therefore outside this definition of a "payment service" as defined in the PSD.

Moreover, the majority of the provisions of the PSD apply only to "payment services made in euro or the currency of a Member State outside the euro area." (PSD Art 2(2)) In other words, they will not apply to transactions in virtual currencies that do not involve euros or currencies of non-eurozone Member States.

The second Payment Services Directive

A second PSD (PSD II) will shortly be agreed upon and will most likely be implemented by mid- to late 2017. The agreed compromise draft from 1 December 2014 does not make any specific reference to virtual currencies.

Potential for incorporation

To the extent that transactions in virtual currencies operate on a peer-to-peer basis, where the involvement by third parties seeks only to add the transaction to the blockchain as part of the verification process, it is unclear what purpose would be served by bringing such transactions under the umbrella of the regulation of payments and e-money. In this sense, transactions in virtual currencies that do not involve any processing by third parties other than the verification process, seem most closely to resemble cash transactions, which are specifically excluded from the PSD.

MAINSTREAM EU INVESTMENT REGIME

While regulators are still only beginning to consider if and how to regulate virtual currencies, businesses have been nimbler at adapting to and capitalising on the opportunities they present. Consumers can now withdraw bitcoin from ATMs and use virtual currency to pay for mundane products at a growing number of retailers. Investors can put money into the increasing number of virtual currency-related products being offered by businesses that see virtual currencies as creating new investment opportunities. Most notably, sections of the traditional financial sector have been quick to engage with virtual currencies.

As regards the extent to which virtual currencies may fall within the definition of "financial instruments" and thereby within the scope of the Markets in Financial Instruments Directive (MiFID) (2004/39/EC), which forms the basis of investment regulation in the EU, virtual currencies do not fulfil the criteria for "transferable securities", meaning those classes of securities which are "negotiable on the capital market, with the exception of instruments of payment", (MiFID, Art 4(18)). The category of MiFID "financial instrument" most potentially applicable to virtual currencies is the derivative category (4) of Annex I, Section C, namely "Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash". Currently, therefore, broadly speaking virtual currencies are indirectly in scope as underlying investments, rather than being directly in scope themselves.

The European Securities and Markets Authority (ESMA) has noted the emergence of investment products based on virtual currencies, currently numbered at twelve collective investment schemes and seventeen exchange platforms offering virtual currency derivatives. ESMA also noted the increase in virtual currency-based financial assets that are distributed and traded using the virtual currency infrastructure rather than using third parties such as regulated exchanges or brokers (ESMA/2015/532).

The extent to which virtual currencies can be incorporated into mainstream financial business, however, will be limited by existing regulations. To give just one example, to the extent that virtual currencies may be considered to fall within the client money regime in Art 13 of MiFID, as implemented by the Financial Conduct Authority's client assets and money rules (CASS), it is difficult to see how compliance would be possible. Firms holding client money must deposit the "money" in bank accounts that fulfil certain requirements (CASS 7.13.13R). Where client money is in the form of virtual currencies, compliance with the CASS rules will not be possible unless banks accept deposits of virtual currencies.

CURRENT REGULATORY, LEGISLATIVE AND BUSINESS RESPONSES TO VIRTUAL CURRENCIES

In light of the increase in virtual currency-based investment, ESMA has put out a call for evidence on investments using virtual currency and distributed ledger technology (ESMA/2015/532).

The UK has also recognised the need to gather more information on the use of virtual currencies. In addition to applying anti-money laundering regulation to virtual currency exchanges, HM Treasury has announced that it will be investing

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£10m into a research initiative looking at the opportunities and challenges for virtual currency and blockchain technologies. The Government recognises that "the technology associated with digital currencies offers considerable promise" and that it can make it "possible for users to transfer value (or other information) quickly, efficiently and securely, providing a permanent record of what has taken place, and without the need for a trusted third party to oversee the process." (HM Treasury, "Digital currencies: response to the call for information", p 19).

At the other end of the spectrum are the views expressed by the EBA, in its Opinion on virtual currencies. While admitting that virtual currencies may have "some potential benefits", the EBA nonetheless concludes that the risks "are manifold". (EBA/Op/2014/08). It recommends a comprehensive regulatory approach to impose governance, capital requirements and client account segregation requirements on virtual currency enterprises. It would, for instance, require that regulated financial institutions providing virtual currency services establish separate entities for the virtual currency-related business, to ensure that these activities cannot impair the financial soundness of the principal entity (EBA/Op/2014/08, p 42).

It has been suggested that governments will ultimately not support virtual currencies as these would undermine their power through central banking mechanisms to control economies. However, in February 2015 the Bank of England announced it would be considering the potential benefits of central bank-issued digital currencies supported by a distributed ledger system (Bank of England, "*One Bank Research Agenda: Discussion Paper*", February 2015, p 31). The Bank noted that research would need to address multiple issues, including technological and regulatory hurdles.

The most prominent of legislative responses outside the EU has been the New York Department of Financial Services regulations on virtual currencies, which went into effect on 3 June 2015. The "BitLicense" is significant because of the size of the New York financial services industry and the New York regulator's role as a bellwether regulator in the US. The BitLicense requires virtual currency businesses with New York customers to obtain a licence. It also has requirements related to consumer protection, anti-money laundering and know your customer. The BitLicense attempts to strike a balance between consumer protection and not creating unreasonable barriers for entry for start-ups. A bill proposing a similar licence is currently making its way through the California legislature. At the opposite end of the spectrum are those countries that simply outlaw or discourage the use of virtual currencies, such as China, Iceland, Kyrgyzstan and Vietnam.

CONCLUSION

Despite the incompatibility of virtual currencies with existing regulatory regimes, the question is not whether virtual currencies will be regulated, but how. It is hoped that the rulemakers will balance the need to protect the interests of market integrity and consumer protection with the need to avoid stifling technological development. ■

Further Reading:

- Taking security over bitcoins and other virtual currency [2015] 7 JIBFL 401.
- The regulation of Bitcoin in Singapore [2014] 6 JIBFL 398.
- LexisPSL: Financial Services: Is a lack of regulation stunting the growth of Bitcoin?